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Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 228, 229 and 249

[Release Nos. 33–8098; 34–45907; International Series Release No. 1258; File No. S7–16–02]

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Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies

AGENCY: Securities and Exchange Commission (''Commission'').

ACTION: Notice of proposed rulemaking.

SUMMARY: As an initial step in improving the transparency of companies' financial disclosure, the Commission is proposing disclosure requirements that would enhance investors' understanding of the application of companies' critical accounting policies. The proposals would encompass disclosure in two areas: accounting estimates a company makes in applying its accounting policies and the initial adoption by a company of an accounting policy that has a material impact on its financial presentation. Under the first part of the proposals, a company would have to identify the accounting estimates reflected in its financial statements that required it to make assumptions about matters that were highly uncertain at the time of estimation. Disclosure about those estimates would then be required if 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. A company's disclosure about these critical accounting estimates would include a discussion of: the methodology and assumptions underlying them; the effect the accounting estimates have on the company's financial presentation; and the effect of changes in the estimates. Under the second part of the proposals, a company that has initially adopted an accounting policy with a material impact would have to disclose information that includes: what gave rise to the initial adoption; the impact of the adoption; the accounting principle adopted and method of applying it; and the choices it had among accounting principles. Companies would place all of the new disclosure in the ''Management's Discussion and Analysis of Financial Condition and Results of Operations' section (commonly referred to as ''MD&A'') of their annual reports, registration statements and proxy and information statements. In addition, in the MD&A section of their quarterly reports, U.S. companies would have to update the information regarding their critical accounting estimates to disclose material changes.

DATES: Comments should be received by July 19, 2002.

ADDRESSES: You should send three copies of your comments to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC, 20549–0609. You also may submit your comments electronically to the following address: *rule-comments@sec.gov*. All comment letters should refer to File No. S7–16–02; this file number should be included in the subject line if you use electronic mail. Comment letters will be available for public inspection and copying at the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549–0102. We will post electronically-submitted comment letters on the Commission's Internet Web site (*http://www.sec.gov*). We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Questions about this release should be referred to Anita Klein or Andrew Thorpe, Division of Corporation Finance (202–942–2980) or Jackson Day or Jenifer Minke-Girard, Office of the Chief Accountant (202–942–4400), Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

We are proposing amendments to Item 303 [1] of Regulation S–K, [2] Item 303 [3] of Regulation S–B [4] and Item 5 of Form 20–F [5] under the Securities Exchange Act of 1934 [6] (''Exchange Act'').

Table of Contents

I. Executive Summary
II. Background
A. Current MD&A Disclosure
B. Current Disclosure in Financial Statements about Accounting Estimates
C. Current Disclosure in Financial Statements about Initial Adoption of Accounting Policies
III. Proposed Rules
A. Objectives of the Current Proposals
B. Scope of the Proposals
C. Proposed Disclosure about Critical Accounting Estimates
1. Accounting estimates covered under the proposals
2. Identification and description of the accounting estimate, the methodology used, certain assumptions and reasonably likely changes
3. Impact of the estimate on financial condition, changes in financial condition and results of operations
4. Quantitative disclosures
a. Quantitative disclosures to demonstrate sensitivity
b. Quantitative and qualitative disclosures concerning past changes in the estimate
5. Senior management's discussions with the audit committee
6. Disclosure relating to segments
D. Examples of Proposed Disclosure about Critical Accounting Estimates
Example 1
Example 2
Example 3
E. Auditor Examination of MD&A Disclosure Relating to Critical Accounting Estimates
F. Quarterly Updates
G. Proposed Disclosure about Initial Adoption of Accounting Policies
H. Disclosure Presentation
I. Application to Foreign Private Issuers
J. Application to Small Business Issuers
K. Application of Safe Harbors for Forward-looking Information
IV. General Request for Comment
V. Paperwork Reduction Act
VI. Cost-Benefit Analysis
VII. Effects on Efficiency, Competition and Capital Formation
VIII.Initial Regulatory Flexibility Analysis
IX. Small Business Regulatory Enforcement Fairness Act
X. Codification Update
Statutory Bases and Text of Proposed Amendments

I. Executive Summary

One important challenge facing our capital markets today is the need to improve the quality and transparency of corporate disclosure. Our capital markets could reach a higher level of efficiency and investor confidence if companies were to provide higher-quality, more insightful financial information. To serve that purpose, we issued cautionary advice in December 2001 regarding MD&A disclosure. [7] In that release, we recognized the need for

[1] 17 CFR 229.303.

[2] 17 CFR 229.10 *et seq.*

[3] 17 CFR 228.303.

[4] 17 CFR 228.10 *et seq.*

[5] 17 CFR 249.308b.

[6] 15 U.S.C. § 78a *et seq.*

[7] *See* Securities Act Release No. 8040, FR–60 (Dec. 12, 2001) [66 FR 65013]. *See also* Securities Act Release No. 8056, FR–61 (Jan. 22, 2002)[67 FR 3746]. In addition, we recently announced our intention to propose other changes in disclosure rules to improve the financial reporting and disclosure system. *See* SEC Press Release No. 2002–22 (Feb. 13, 2002).

disclosure that allows investors to understand more completely the manner in which, and degree to which, a company's reported operating results, financial condition and changes in financial condition depend on estimates involved in applying accounting policies that entail uncertainties and subjectivity. We also asked companies to begin better addressing investors' need for this disclosure.

As contemplated in that release, we are now proposing to amend the MD&A requirements [8] to mandate improved disclosure in a new ''Application of Critical Accounting Policies'' section in companies' filed annual reports, annual reports to shareholders, registration statements and proxy and information statements. [9] The new section would encompass disclosure both about accounting estimates resulting from the application of critical accounting policies and the initial adoption of accounting policies that have a material impact on a company's financial presentation. The proposed disclosure requirements would apply to all companies except small business issuers that have not had revenues from operations during the last two fiscal years. The proposed MD&A disclosure requirements would cover the most recent fiscal year and any subsequent interim period for which financial statements are required to be presented.

To determine whether an accounting estimate [10] involved in applying the company's accounting policies would entail disclosure under the proposals, a company would have to answer two questions:

1. Did the accounting estimate require us to make assumptions about matters that were highly uncertain at the time the accounting estimate was made?

2. Would different estimates that we reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, have a material impact on the presentation of our financial condition, changes in financial condition or results of operations?

If the answers to both questions are ''yes,'' the accounting estimate would be a ''critical accounting estimate,'' and disclosure would be required in the new ''Application of Critical Accounting Policies'' section.

The proposed disclosure about these accounting estimates would involve three basic elements.[11] The first element would be the basic disclosures needed to understand the accounting estimates. A company would have to describe them, identify where and how they affect the company's reported financial results, financial condition and changes in financial condition, and, where material, identify the affected line items. It would have to describe the methodology underlying each critical accounting estimate, the assumptions that are about highly uncertain matters and other assumptions that are material. If applicable, a company would have to discuss why it could have chosen in the current period estimates that would have had a materially different impact on the company's financial presentation. Similarly, a company would have to discuss, if applicable, why the accounting estimate is reasonably likely to change in future periods with a material impact on the company's financial presentation.[12]

A company would have to identify the segments [13] of its business that a critical accounting estimate affects. A company also would have to provide appropriate parts of the proposed disclosure for affected segments where a failure to present that information would result in an omission that renders the disclosure materially misleading.

The second element of the proposed disclosure about critical accounting estimates would give investors a better understanding of the sensitivity of the reported operating results and financial condition to changes in those estimates or their underlying assumption(s). For each critical accounting estimate, a company would discuss changes that would result either from: (i) Making reasonably possible, near-term changes in the most material assumption(s) underlying the estimate; or (ii) using in place of the recorded estimate the ends of the range of reasonably possible amounts which the company likely determined when formulating its recorded estimate. The company would describe the impact of those changes on the company's overall financial performance and, to the extent material, on the line items in the company's financial statements. In addition, the proposals would require a quantitative and qualitative discussion of management's history of changing its critical accounting estimates in recent years.

The third element of the proposed disclosure about critical accounting estimates would require a company to state whether or not senior management discussed the development, selection and disclosure of those estimates with the company's audit committee. This part of the proposals is designed to inform investors about whether there is oversight of critical accounting estimates by audit committee members and may incidentally encourage such oversight and increase reliability of the proposed MD&A disclosure about critical accounting estimates.

Our proposals also address MD&A disclosure regarding initial adoption of an accounting policy. If an accounting policy initially adopted by a company had a material impact on the company's financial presentation, the company would provide certain disclosures about that initial adoption unless it resulted solely from new accounting literature issued by a recognized accounting standard setter. The initial adoption of

[8] We propose to amend Item 303 of Regulation S–K, and the parallel provisions in Regulation S–B (which applies to small business issuers) and Form 20–F (which applies to foreign private issuers).

[9] The proposals would not alter which documents require presentation of an MD&A. MD&A disclosure is only required in proxy and information statements themselves if action is to be taken with respect to: (1) the modification of any class of securities of the registrant; (2) the issuance or authorization for issuance of securities of the registrant; or (3) mergers, consolidations, acquisitions and similar matters. *See* Items 11, 12 and 14 of Schedule 14A, 17 CFR 240.14a–101. Investors otherwise receive the MD&A disclosure in the annual report to shareholders that must accompany or precede any proxy or information statement relating to an annual meeting at which directors are to be elected. *See* 17 CFR 240.14a–3.

[10] An accounting estimate is an approximation made by management of a financial statement element, item or account in the financial statements. Accounting estimates in historical financial statements measure the effects of past business transactions or events, or the present status of an asset or liability. *See Codification of Statements on Auditing Standards* (including related Auditing Interpretations) (''AU'') § 342, *Auditing Accounting Estimates* (''AU § 342''), paragraphs 1–3. For purposes of the proposals, an accounting estimate would include one for which a change in the estimate is inseparable from the effect of a change in accounting principle. *See* Accounting Principles Board (''APB'') Opinion No. 20, *Accounting Changes* (July 1971) (''APB No. 20''), paragraph 11. *See also* proposed Item 303(b)(3)(ii)(A) of Regulation S–B, 17 CFR 228.303(b) (3)(ii)(A); proposed Item 303(c)(2)(i) of Regulation S–K, 17 CFR 229.303(c)(2)(i); and proposed Item 5.E.2.(a) of Form 20–F, 17 CFR 249.220f.

[11] In the MD&A section of quarterly reports, U.S. companies would have to update their critical accounting estimates disclosure to reflect material changes.

[12] The statutory and Commission rule safe harbors for forward-looking statements would be available to companies satisfying their terms and conditions in making forward-looking statements in connection with the proposed critical accounting estimates discussion. *See* Securities Act Section 27A, 15 U.S.C. 77z–2, Securities Act Rule 175, 17 CFR 230.175, Exchange Act Section 21E, 15 U.S.C. 78u–5, and Exchange Act Rule 3b–6, 17 CFR 240.3b–6.

[13] A segment for financial reporting purposes is defined by Financial Accounting Standards Board (''FASB'') Statement of Financial Accounting Standards (''SFAS'') No. 131, *Disclosures about Segments of an Enterprise and Related Information* (June 1997) (''SFAS No. 131'').

an accounting policy may occur in situations such as 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 proposed MD&A disclosure about the initial adoption of accounting policies seeks more qualitative information from companies about those types of situations. The disclosures we are proposing would include a description of:

- The events or transactions that gave rise to the initial adoption;
- The accounting principle adopted and the method of applying that principle; and
- The impact, discussed qualitatively, on the company's financial presentation.

In addition, if upon initial adoption the company had a choice between acceptable accounting principles under generally accepted accounting principles (GAAP), the company would disclose that it made a choice, explain the alternatives and state why it made the choice that it did. Further, if no accounting literature governed the accounting upon initial adoption, the company would have to explain which accounting principle and method of application it decided to use and how it made its decision.

All of the proposed MD&A disclosure regarding the application of critical accounting policies would have to be presented in language and a format that is clear, concise and understandable to the average investor. Boilerplate disclosures, or disclosures written in overly technical accounting terminology, would not satisfy the proposed requirements.

Our proposals do not attempt to address all circumstances where a company may exercise discretion in its accounting under GAAP. We focus our proposals on two areas involving the application of critical accounting policies in which there is a clear need for improved disclosure—critical accounting estimates and the initial adoption of accounting policies that have a material impact. As discussed below, disclosure in many other areas of accounting judgment is provided by existing MD&A requirements, materiality standards and financial statement disclosure requirements.

II. Background

A. Current MD&A Disclosure

For decades, the regulations governing disclosure in registration statements under the Securities Act of 1933 (''Securities Act'') and the Exchange Act, as well as annual and quarterly reports and proxy and information statements by public companies under the Exchange Act, have mandated MD&A disclosure.[14] MD&A disclosure should satisfy three related objectives:

1. To provide a narrative explanation of companies' financial statements that enables investors to see the company through the eyes of management;
2. To improve overall financial disclosure and provide the context within which financial statements should be analyzed; and
3. To provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.[15]

In MD&A, a company must discuss its results of operations, liquidity and capital resources and other information necessary to an understanding of the company's financial condition or changes in financial condition. A well-prepared MD&A discussion focuses on explaining a company's financial results and condition by identifying key elements of the business model and the drivers and dynamics of the business, and also addressing key variables. A company currently must disclose known trends, demands, commitments, events and uncertainties that are reasonably likely to occur and have material effects.[16]

In addition to these general subjects, a company must include in MD&A historical and prospective analysis of its financial statements, and identify the cause of material changes from prior periods in the line items of the financial statements where those changes are reflected. A company must analyze significant components of revenues or expenses needed to understand the results of operations. It also must discuss significant or unusual economic events or transactions that materially affected results of operations. Finally, a company also must discuss its ability to generate adequate amounts of cash to meet its short-term and long-term needs for capital and identify the anticipated sources of funds necessary to fulfill its commitments.

These requirements do not call for, and indeed we have discouraged and continue to discourage companies from providing, 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. Rather, companies should emphasize material factors and their underlying reasons and preferably omit, or at least differentiate, immaterial information.

Recognizing the paramount importance of MD&A information to investors, in addition to today's proposal, we intend to continue to focus on improving disclosure in this area. In particular, we are considering MD&A proposals that will focus discussion on the three key objectives of MD&A noted above. We are considering a more explicit requirement for a summary of the MD&A section that would, in relatively short form, identify what management considers the most important factors in determining its financial results and condition, including the principal factors driving them, the principal trends on which management focuses and the principal risks to the business. We also are considering how to adjust the relative attention devoted in MD&A towards a more general discussion of material matters and away from a detailed description of business results that too often recites information that is otherwise available or is not material to investors.

In addition, we are continuing our consideration of subjects as to which we believe MD&A disclosure is particularly important, including the topics discussed in our January 22, 2002 release regarding MD&A.[17] For example, investors have become increasingly concerned about the sufficiency of disclosure regarding structured finance transactions, including those consummated using special purpose entities. A company's relationships with those types of entities may facilitate its transfer of, or access to, assets. Investors

[14] *See* Item 303 of Regulation S–K, 17 CFR 229.303, Item 303 of Regulation S–B, 17 CFR 228.303 and Item 5 of Form 20–F, referenced in 17 CFR 249.220f. Although the current MD&A disclosure requirements were adopted starting in 1980, earlier versions date back to 1968. *See* Securities Act Release Nos. 6231 (Sept. 2, 1980) [45 FR 63630] and 4936 (Dec. 9, 1968) [33 FR 18617]. *See also* Securities Act Release No. 5520 (Aug. 14, 1974) [39 FR 31894].

[15] *See* Securities Act Release No. 6711 (Apr. 23, 1987) [52 FR 13715], Section II.

[16] In assessing whether disclosure of a trend, event, etc. is required, management must consider both whether it is reasonably likely to occur and whether a material effect is reasonably likely to occur. As the Commission noted when it adopted the requirement, the ''reasonably likely to occur'' test is to be used rather than the *Basic* v. *Levinson* probability and magnitude test for materiality of contingent events. *See* Securities Act Release No. 6835 (May 18, 1989) [54 FR 22427] at fns. 27–28 and accompanying text.

[17] Securities Act Release No. 8056; FR–61 (Jan. 22, 2002) [67 FR 3746].

need to know more about the liquidity risk, market price risks and effects of ''off-balance sheet'' transaction structures and obligations. Another item of concern is a lack of transparent disclosure about transactions where that information appeared necessary to understand how significant aspects of the business were conducted. Investors would better understand financial statements in many circumstances if MD&A included descriptions of all material transactions involving related persons or entities, with a clear discussion of terms that differ from those which would likely be negotiated with clearly independent parties. Investors should understand these transactions' business purpose and economic substance, their effects on the financial statements, and any special risks or contingencies arising from them.

Finally, we are considering improvements to MD&A disclosures relating to trend information. We believe that investors may be better able to see the company through management's eyes if MD&A includes information about the trends that a company's management follows and evaluates in making decisions about how to guide the company's business. As with today's proposal, that disclosure would naturally entail a certain degree of forward-looking information.

B. Current Disclosure in Financial Statements about Accounting Estimates

Currently, GAAP and generally accepted auditing standards acknowledge that there are numerous circumstances in which companies, in applying accounting policies, exercise judgment and make estimates for purposes of the financial statements. For example, they call for companies to communicate in a number of circumstances about the use of estimates in the preparation of financial information. The use of estimates results in the presentation of many amounts that are in fact approximate rather than exact.[18] For example, APB No. 20 notes that ''changes in estimates used in accounting are necessary consequences of periodic presentation of financial statements'' because preparing financial statements requires estimating the effects of future events, and future events and their effects cannot be perceived with certainty.[19] Estimating the impact of those events therefore requires the exercise of judgment. Because the preparation of financial statements requires estimates that are likely to change over time, APB No. 20 requires disclosure about changes in estimates that are expected to affect several future reporting periods and that are not made each period in the ordinary course of accounting. It recommends disclosure if the effects of other changes in the estimate are material.[20]

In addition, AICPA Statement of Position No. 94–6 [21] requires general disclosure in notes to financial statements that the preparation of financial statements requires the use of estimates in the determination of the carrying amounts of assets or liabilities, including gain or loss contingencies.[22] That Statement also requires note disclosure regarding those specific estimates when known information indicates that it is at least reasonably possible [23] that the estimate will change in the near term and the effect would be material to the financial statements.[24] A company must disclose the nature of the uncertainty, in addition to stating that a change in the estimate in the near term is at least reasonably possible. SOP 94–6, encourages, but does not require, disclosure of the factors that cause an estimate to be susceptible to change from period to period.[25]

SOP 94–6 references SFAS No. 5, which itself requires certain disclosures about accounting estimates—specifically, estimated losses that arise from loss contingencies. A company is required to accrue (by a charge to income) an estimated loss from a loss contingency if certain criteria are met.[26] If an estimated loss does not meet the criteria for accrual, but there is at least a reasonable possibility that a loss may have been incurred, the company is required to disclose the nature of the contingency and an estimate of the possible loss or range of loss, or state that an estimate of the loss cannot be made. Although SFAS No. 5 elicits useful disclosure about certain accounting estimates, not all uncertainties inherent in the accounting process give rise to loss contingencies as that term is used in SFAS No. 5, and therefore that Statement does not apply to all estimates in the financial statements.[27]

Further, while not specifically requiring disclosure about estimates, APB Opinion No. 22 requires disclosure about the application of accounting policies which may entail generalized disclosure about estimation techniques.[28] APB No. 22 notes that a company's accounting principles, and their method of application, can affect significantly the presentation of its financial position, results of operations and cash flows,[29] and accordingly, requires disclosure that describes those accounting principles and the company's methods of applying them.[30] In particular, APB No. 22 indicates that a company should provide disclosure when:

- Unusual or innovative applications of accounting principles materially affect the determination of financial position, results of operations or cash flows (such as the recognition of revenue);

[18] *See* American Institute of Certified Public Accountants (''AICPA'') Statement of Position (''SOP'') No. 94–6, *Disclosure of Certain Significant Risks and Uncertainties* (Dec. 1994), (''SOP 94–6''), paragraph B–20; *See also* AU § 380, *Communication with Audit Committees* (''AU § 380'') and AU § 508, *Reports on Audited Financial Statements* (Apr. 1998).

[19] *See* APB No. 20, paragraph 10.

[20] *See* APB No. 20, paragraph 33.

[21] *See* SOP 94–6, particularly paragraphs 11–19.

[22] *See* FASB SFAS No. 5, *Accounting for Contingencies* (Mar. 1975) (''SFAS No. 5''), paragraph 1, which defines a contingency as ''an existing condition, situation, or set of circumstances involving uncertainty as to possible gain * * * or loss * * * to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.''

[23] The term ''reasonably possible'' as used in SOP 94–6 is consistent with its use in SFAS No. 5. *See* SOP 94–6, fn. 7. SFAS No. 5 states that ''reasonably possible'' means the chance of a future transaction or event occurring is more than remote but less than likely. Reasonably possible events are less likely to occur than probable events.

[24] SOP 94–6, paragraph 17, notes: ''Whether the estimate meets the criteria for disclosure under this SOP does not depend on the amount that has been reported in the financial statements, but rather on the materiality of the effect that using a different estimate would have had on the financial statements. Simply because an estimate resulted in the recognition of a small financial statement amount, or no amount, does not mean that disclosure is not required under this SOP.''

[25] *See* SOP 94–6, paragraph 14.

[26] *See* SFAS No. 5, paragraph 8. An estimated loss should be accrued when *both* it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. Also, when it is probable that an asset has been impaired or a liability has been incurred and the reasonable estimate of the loss is a range, the company is required to accrue an amount for the loss. *See* FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (Sept. 1976), paragraph 3.

[27] *See* SFAS No.5, paragraph 2.

[28] *See* APB Opinion No. 22, *Disclosure of Accounting Policies* (Apr. 1972) (''APB No. 22'').

[29] *See* APB No. 22, paragraphs 6–7. APB No. 22 defines accounting policies of a reporting entity as ''the specific accounting principles and the methods of applying those principles that are judged by the management of the entity to be the most appropriate in the circumstances to present fairly financial position, results of operations, and cash flows in accordance with generally accepted accounting principles * * *.'' APB No. 22, paragraph 6, as amended.

[30] *See* APB No. 22, paragraph 12.

• A selection is made among alternative permissible policies; or

• Policies are unique to the industry of the reporting company.[31]

Under APB No. 22, a company's disclosure also should encompass important judgments as to appropriateness of principles relating to revenue recognition and allocation of asset costs to current and future periods. Although the particular format or location of these APB No. 22 disclosures in financial statements is not prescribed by GAAP, a summary of these significant accounting policies is customarily the first note to the financial statements.

Finally, some accounting standards currently prescribe specific disclosures about accounting estimates or the underlying methodologies and assumptions.[32] For example, Statement of Financial Accounting Standards No. 132 requires specific disclosures of the assumptions used in accounting for pensions and other post-retirement benefits.[33] Statement of Financial Accounting Standards No. 140 requires disclosure regarding the measurement of retained interests in securitized financial assets, including the methodology, assumptions and sensitivity of the assumptions used in determining their fair value.[34]

C. Current Disclosure in Financial Statements About Initial Adoption of Accounting Policies

Certain general requirements under GAAP may elicit information about the initial adoption of an accounting policy by a company. When companies present comparative financial statements, any exceptions to comparability between the most recent period and prior periods must be clearly presented.[35] In addition, if a company initially adopts an accounting policy and considers that policy to be a significant accounting policy, the company would provide certain disclosures about that policy as required by APB No. 22.[36]

APB No. 20 provides financial statement disclosure requirements for accounting changes, which include changes in an accounting principle, an accounting estimate and the reporting entity.[37] Neither ''(a) the initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect nor (b) adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring'' are considered, however, to be ''accounting changes'' under GAAP.[38] As discussed below, our proposals about initial adoption of accounting policies address these circumstances that are not accounting changes under GAAP if they have a material impact on a company's financial presentation.

III. Proposed Rules

A. Objectives of the Current Proposals

Our proposals would promote greater investor understanding of a company's important accounting estimates that reflect significant management judgment and uncertainty, and of a company's initial adoption of accounting policies that may reflect such judgment and uncertainty. Our primary objectives are:

• To enhance 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;

• To give investors an appreciation for how sensitive those estimates are; and

• To give investors an understanding of new material accounting policies as they arise and affect a company's financial results.

Our aim is to increase the transparency of the application of those accounting policies where management is the most prone to use judgment, generally because objective data and methodologies do not exist for the estimates or management is given initial policy choices under GAAP. We believe that it is these accounting policies that are least understood by investors and that mandated disclosure regarding areas of the application of them would provide meaningful insight into the importance of estimates and adoption of policies to a company's financial presentation. With a greater understanding of the application of critical accounting policies, we believe that investors would be in a better position to assess the quality of, and potential variability of, a company's earnings.

We propose to mandate enhanced disclosure of critical accounting estimates and initial adoption of material policies by specifically linking them to the objectives of MD&A, and the type of disclosure presented in MD&A. A focused discussion of these areas is well-suited to MD&A because it would further explain to investors the company's financial condition ''through management's eyes.'' Moreover, MD&A's emphasis on disclosure of significant uncertainties and favorable or unfavorable trends naturally dovetails with disclosure of the more subjective aspects used in arriving at critical accounting estimates or selecting which accounting policies to adopt initially. Finally, as we have noted previously, the less technical language customarily used outside the financial statements may be conducive to a clearer explanation to investors of the effects of estimates, assumptions, methodologies and initial accounting policy adoption on a company's financial reporting.[39]

B. Scope of the Proposals

Our proposals address estimates that a company makes in preparing financial statements using accounting policies under GAAP and the initial adoption by a company of an accounting policy under GAAP that has a material impact on its financial presentation.[40] We believe the proposals address directly and clearly two areas where there is a need for improved disclosure. While certain elements of our proposed critical accounting estimates disclosure are subsumed in existing general MD&A requirements, we believe more direct

[31] *Id.*

[32] In addition to the examples cited in the paragraph, see the disclosure requirements in FASB SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* (Dec. 1991); FASB SFAS No. 123, *Accounting for Stock-Based Compensation* (Oct. 1995) (''SFAS No. 123''); and FASB SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (Aug. 2001) (''SFAS No. 144'').

[33] *See* FASB SFAS No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits* (Feb. 1998).

[34] *See* FASB SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (a replacement of FASB Statement No. 125) (Sept. 2000).

[35] *See* Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins* (June 1953), Chapter 2, ''Form of Statements,'' Section A, ''Comparative Financial Statements,'' paragraph 3, and paragraph 2 (''the well recognized principle that any change in practice which affects comparability should be disclosed'').

[36] *See* APB No. 22, paragraph 12.

[37] *See* APB No. 20, paragraph 6.

[38] *See* APB No. 20, paragraph 8.

[39] *See* Securities Act Release No. 7793 (Jan. 21, 2000) [65 FR 4585] (suggesting that additions to financial disclosure outside the financial statements could help address concerns relating to lack of transparency in some aspects of financial reporting within the financial statements).

[40] These could include estimates made on a one-time basis, on a few occasions, or on a recurring basis.

and complete requirements in our rules would lead to improved disclosure. In addition, while there are financial statement disclosure requirements that would elicit certain information about initially adopted accounting policies in some cases, our proposals are designed to provide additional MD&A disclosure that would assist investors to understand better a company's new accounting policies.

We are leaving disclosure about other circumstances where a company may exercise discretion over its accounting under GAAP to existing MD&A disclosure requirements, materiality standards and existing financial statement disclosure requirements. Our proposals do not, for example, alter disclosure requirements regarding a company's change from an accounting policy it has been using to another policy acceptable under GAAP.[41] The proposals also do not require disclosure of a company's adoption of a new accounting pronouncement where the company must make its best judgment as to how to apply the new accounting pronouncement in the absence of interpretive guidance.

Discipline surrounding a company's changes in accounting policies is provided under GAAP and the federal securities laws. When a company changes an accounting policy, the company must determine that the alternative principle is preferable under the circumstances.[42] We require that the company file a letter from its independent public accountant confirming its opinion to that effect.[43] In addition, a company is required to make certain disclosures in the financial statements about the accounting change, including the nature and justification for the change and its effect on income when the change is made.[44] In its justification for the change, the company is required to explain clearly why the newly adopted accounting principle is preferable.[45]

In addition to the existing disclosure requirements in the financial statements, scrutiny over management's discretion and judgment in applying accounting policies occurs on a number of different levels. Auditors are required to inform audit committees about management's ''initial selection of and changes in significant accounting policies or their application'' and about management's judgments and estimates.[46] We have encouraged companies, management, audit committees and auditors to consult with our accounting staff if they are uncertain about the application of GAAP.[47] We also have committed to provide assistance to companies in a timely fashion to address problems before they happen.

We recognize that the circumstances where a company may exercise discretion over its accounting policies under GAAP could yield significantly different financial results. Given the existing disclosure regime, we are not currently proposing additional MD&A disclosure to address all of these cases. Companies should provide complete, transparent disclosure under the applicable requirements. While we believe the proposed disclosure may be sufficient to achieve our currently stated objective, we may revisit the other circumstances where a company may exercise discretion over its accounting policies under GAAP at a later date.

We solicit comment with regard to broadening the scope of our proposals to achieve a more expansive objective.

- Should we require additional MD&A disclosure specifically regarding the effects of a change by a company from one accounting policy to another acceptable (and preferable) accounting policy under GAAP?
- Should we require in MD&A a discussion of the impact that alternative accounting policies acceptable under GAAP would have had on a company's financial statements even when a company did not choose to apply the alternatives?
- What costs would companies incur if they had to prepare disclosure about the effects of alternative accounting policies that could have been chosen but were not?
- Beyond a company's initial adoption of those policies, should we require disclosure in MD&A regarding a company's reasons for choosing, and the effects of applying, accounting policies used for unusual or innovative transactions or in emerging areas? Similarly, should we require companies to disclose in MD&A the effects of accounting policies that a company could have adopted, but did not adopt, for unusual or innovative transactions or in emerging areas?
- Should we require more disclosure by companies about their process of making estimates, or in other areas of discretion relating to recognition and measurement in financial statements? If so, please describe in detail.
- Should we require in MD&A a discussion of the impact of a company's choice among accounting methods under GAAP that are used in the company's industry (for example, the completed contract and the percentage of completion methods of accounting for construction-type contracts[48]) Should we require that type of disclosure only where a company uses a method under GAAP that is not generally used by other companies in the industry?

C. Proposed Disclosure About Critical Accounting Estimates

To inform investors of each critical accounting estimate and to place it in the context of the company's financial presentation, we would require the following information in the MD&A section:[49]

- A discussion that identifies and describes:
- The critical accounting estimate;
- The methodology used in determining the critical accounting estimate;
- Any underlying assumption that is about highly uncertain matters and any other underlying assumption that is material;
- Any known trends, demands, commitments, events or uncertainties that are reasonably likely to occur and materially affect the methodology or the assumptions described;

[41] When a company has selected an accounting policy from acceptable alternatives, it is required under GAAP to make certain disclosures about that accounting policy. *See* APB No. 22, paragraph 12. *See supra* fns. 28–31 and accompanying text.

U.S. GAAP provides only a limited number of situations in which more than one method of accounting would be considered acceptable. Over the years, the combined efforts of accounting standard setters, the accounting profession, public and non-public companies, and regulatory agencies have significantly reduced the number of acceptable alternatives in U.S. GAAP. *See* APB No. 22, paragraph 5. Areas remaining in U.S. GAAP in which there are acceptable alternatives include inventory pricing and depreciation methods. *See* APB No. 20, paragraph 9. *See also* SFAS No. 123 (providing a choice of accounting methods for an employee stock option or similar equity instrument).

[42] *See* APB No. 20, paragraph 16.

[43] *See* Accounting Series Release No. 177 (Sept. 10, 1975) [40 FR 46107], as codified in the Codification of Financial Reporting Policies § 304.02, *Preferability Letters,* Fed. Sec. L. Rep. (CCH) ¶ 73,096. *See also* Item 601(b)(18) of Regulations S–K and S–B, 17 CFR 229.601(b)(18) and 17 CFR 228.601(b)(18). A preferability letter generally is not required when a company adopts a new accounting policy as a result of implementing a new accounting pronouncement or rule issued by the FASB, AICPA or SEC.

[44] *See* APB No. 20, paragraphs 17–30.

[45] *Id.*

[46] *See* AU § 380, paragraphs 7 and 8.

[47] *See, e.g.,* Securities Act Release No. 8040, FR–60 (Dec. 12, 2001) [66 FR 65013].

[48] *See* SOP No. 81–1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (July 1981).

[49] In addition to the information specifically required, a company would be required to provide any other information necessary to keep its disclosure from being materially misleading. *See* Securities Act Rule 408, 17 CFR 230.408, and Exchange Act Rule 12b–20, 17 CFR 240.12b–20.

• If applicable, why different estimates that would have had a material impact on the company's financial presentation could have been used in the current period; and

• 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 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 overall financial performance and, to the extent material, line items in the financial statements if the company were to assume that the accounting estimate were changed, either by using reasonably possible near-term changes in the most material assumption(s) underlying the accounting estimate or by using the reasonably possible range of the accounting estimate; [50]

• 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;[51]

• 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 accounting estimate on a segment basis, to the extent that a failure to present that information would result in an omission that renders the disclosure materially misleading.

Unless otherwise stated, the discussion would cover the financial statements for the most recent fiscal year and any subsequent period for which interim period financial statements are required to be included.[52]

1. Accounting estimates covered under the proposals

A number of circumstances can require a company to make accounting estimates. For example, a company typically will estimate the net realizable value of its accounts receivable and of its inventory.[53] Not all accounting estimates in a company's financial statements, however, will necessarily be critical accounting estimates to which the proposed disclosure relates. An accounting estimate would be a critical accounting estimate for purposes of the proposed disclosure only if it meets two criteria. First, the accounting estimate must require a company to make assumptions about matters that are highly uncertain at the time the accounting estimate is made. Second, it must be the case that different estimates that the company reasonably could have used for the accounting estimate 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.[54]

For purposes of the first criterion, 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 some degree of precision from available data. Accordingly, a matter that is highly uncertain requires management to use significant judgment in making assumptions about that matter. The application of management's judgment in those circumstances typically results in management developing a range within which it believes the accounting estimate should fall.

The second criterion focuses the proposals further on two types of accounting estimates involved in the application of accounting policies. First, it includes accounting estimates for which a company in the current period could reasonably have recorded in the financial statements an amount sufficiently different such that it would have had a material impact on the company's financial presentation. Second, it includes any accounting estimate that is reasonably likely to change from period to period to the extent that the change would have a material impact on the company's financial presentation. Thus, whether management's judgment has an impact primarily in the current period or on an ongoing basis (or both), the estimate would qualify.

Under the proposals, a company would discuss any accounting estimate that it determines to be critical. We believe that few of a company's accounting estimates generally would meet those thresholds. We do not currently propose an outside limit to the number of accounting estimates that a company must discuss under the proposals. As the term ''critical accounting estimate'' implies, however, the disclosure should not encompass a long list of accounting estimates resulting from the application of accounting policies which cover a substantial number of line items in the company's financial statements.[55] While the number of critical accounting estimates will vary by company, we would expect a very few companies to have none at all and the vast majority of companies to have somewhere in the range of three to five critical accounting estimates. The number could be at the high end of the range, or be slightly higher, for companies that conclude that one or more critical accounting estimates must be identified and discussed primarily because of particular segments. Investors, however, will not benefit from a lengthy discussion of a multitude of accounting estimates in which the truly critical ones are obscured. If we adopt the proposals without a maximum number, we may monitor disclosure to determine whether disclosure would be improved if a maximum number were set.

We seek comment on the proposed definition of critical accounting estimates.

• Is the definition appropriately tailored?

[50] If those changes could have a material effect on the company's liquidity or capital resources, then the company also would have to explain that effect.

[51] As described below, we would phase in the three-year period and use two years for small business issuers.

[52] The proposed rules would apply equally to business development companies. Business development companies are defined in Section 2(a)(48) of the Investment Company Act of 1940. *See* 15 USC § 80a–2(a)(48). Business development companies are a category of closed-end investment companies that are not required to register under the Investment Company Act, but file Forms 10–K and 10–Q, and also include MD&A in their annual reports to shareholders.

[53] Other examples of accounting estimates include: property and casualty insurance loss reserves, current obligations that will be fulfilled over several years, future returns of products sold, the amount of cash flows expected to be generated by a specific group of assets, revenues from contracts accounted for by the percentage of completion method and pension and warranty expenses. *See* AU § 342, paragraph 2. For a more detailed list, *see* the Appendix to AU § 342.

[54] ''Critical accounting estimate'' is defined in proposed Item 303(b)(3)(ii)(B) of Regulation S–B, 17 CFR 228.303(b)(3)(ii)(B); proposed Item 303(c)(2)(ii) of Regulation S–K, 17 CFR 229.303(c)(2)(ii); and proposed Item 5.E.2.(b) of Form 20–F, 17 CFR 249.220f.

[55] *See* proposed Instruction 3 to paragraph (b)(3) of Item 303 of Regulation S–B, 17 CFR 228.303(b)(3); proposed Instruction 4 to paragraph (c) of Item 303 of Regulation S–K, 17 CFR 229.303(c); and proposed Instruction 3 to Item 5.E of Form 20–F, 17 CFR 249.220f.

• Does the definition capture the appropriate type and scope of accounting estimates?

• Is the definition appropriately designed to identify the accounting estimates that require management to use significant judgment or that are the most uncertain? If not, what other aspects descriptive of that type of estimate should be included?

• Is the definition appropriately designed to identify the accounting estimates involving a high potential to result in a material impact on the company's financial presentation?

• Would it be difficult for a company to discern which of its accounting estimates require assumptions about highly uncertain matters? If so, how could the proposal better target them?

• Should we consider setting a minimum percentage impact on results of operations in the second criterion of the definition, or would that be unnecessary because the proposed definition would not capture changes that have an insignificant impact?

• How many accounting estimates would a company typically identify as critical accounting estimates under the proposed definition?

• Would a company with multiple segments have a greater number of critical accounting estimates than a company without multiple segments? If so, please provide an explanation.

• Should we establish a maximum number of accounting estimates that may be discussed as critical accounting estimates (*e.g.,* seven)? If so, what should the maximum number be and what criteria should be applied to set the number so as to strike the appropriate balance between information truly useful to investors and overly extensive disclosure of marginal use? If a maximum were set, should the number of segments a company has be considered?

• Should we expand the definition to include MD&A disclosure of volatile accounting estimates that use complex methodologies but do not involve significant management judgment? Should we do so only when the underlying assumptions or methodologies of those estimates are not commonly used and therefore not understood by investors?

2. Identification and Description of the Accounting Estimate, the Methodology Used, Certain Assumptions and Reasonably Likely Changes

A company first would have to identify and describe each critical accounting estimate in such a way that it gives the appropriate context for investors reading that section and reflects management's view of the importance of the critical accounting estimate.[56] A company would have to disclose the methodology it used in determining the estimate. It also would have to disclose the assumptions underlying the accounting estimate that reflect matters highly uncertain at the time the estimate was made as well as other assumptions underlying the estimate that are material. We recognize that a critical accounting estimate may involve multiple assumptions. The proposed disclosure would focus in the first instance on those that are about highly uncertain matters because they have the greatest potential to make the accounting estimate highly susceptible to change.

If applicable, the company would have to describe why different estimates could have been used in the current period and why the accounting estimate is reasonably likely to change from period to period in the financial statements. For example, a critical accounting estimate related to a significant portfolio of over-the-counter derivative contracts may require that a company estimate the fair value of such contracts using a model or other valuation method. In that case, the company would disclose the methods it employs to estimate fair value, *e.g.,* the types of valuation models used such as the present value of estimated future cash flows, and assumptions such as an estimated price in the absence of a quoted market price.[57]

A company also would have to explain known trends, demands, commitments, events or uncertainties that are reasonably likely to occur and materially affect the assumptions made or the methodology used. Like the requirements elsewhere in MD&A, disclosure would be required if the trend, demand, commitment, event or uncertainty is currently known, it is reasonably likely to occur and it is reasonably likely to have a material impact. Disclosure would not be required if management could affirmatively conclude that the trend, demand, commitment, event or uncertainty is not reasonably likely to come to fruition or that a material effect is not reasonably likely to occur.[58]

3. Impact of the Estimate on Financial Condition, Changes in Financial Condition and Results of Operations

For each critical accounting estimate, a company would have to explain its significance to the company's financial condition, changes in financial condition and results of operations and, where material, identify its effect on the line items in the company's financial statements.[59] Because not all estimates themselves are line items in the financial statements,[60] their existence and their effect may not be readily apparent. Thus, this disclosure would provide additional information and clarity for investors.

4. Quantitative Disclosures

There are two areas of the proposed MD&A disclosure relating to critical accounting estimates in which we explicitly would require a presentation of quantitative information.[61] First, the proposals would require disclosure that demonstrates the sensitivity of financial results to changes made in connection with each critical accounting estimate. Second, the proposals would require quantitative disclosure relating to historical changes in a company's critical accounting estimates in the past three years.

a. Quantitative Disclosures To Demonstrate Sensitivity

We propose to require that a company present quantitative information about changes in its overall financial performance and, to the extent material, line items in the financial statements that would result if certain changes relating to a critical accounting estimate were assumed to occur. The company would identify the change being assumed and discuss quantitatively its impact on the company. Because the point of the disclosure is to demonstrate the degree of sensitivity, the impact on overall financial performance would be discussed regardless of how large that is.

As proposed, a company would have two possible choices of changes it would assume for purposes of the sensitivity analysis. First, the company

[56] *See* proposed Item 303(b)(3)(iii)(A) of Regulation S–B, 17 CFR 228.303(b)(3)(iii)(A); proposed Item 303(c)(3)(i) of Regulation S–K, 17 CFR 229.303(c)(3)(i); and proposed Item 5.E.3.(a) of Form 20–F, 17 CFR 249.220f.

[57] *See also* Securities Act Release No. 8056, FR–61 (Jan. 22, 2002) [67 FR 3746], Section II.B. (providing an example of a critical accounting estimate related to non-exchange traded contracts accounted for at fair value).

[58] *See supra* fn. 16.

[59] *See* proposed Item 303(b)(3)(iii)(B) of Regulation S–B, 17 CFR 228.303(b)(3)(iii)(B); proposed Item 303(c)(3)(ii) of Regulation S–K, 17 CFR 229.303(c)(3)(ii); and proposed Item 5.E.3.(b) of Form 20–F, 17 CFR 249.220f.

[60] For example, an estimate of fair value used to measure an impairment loss on a long-lived asset may not itself appear as a line item in the financial statements.

[61] *See* proposed Item 303(b)(3)(iii)(C) of Regulation S–B, 17 CFR 228.303(b)(3)(iii)(C); proposed Item 303(c)(3)(iii) of Regulation S–K, 17 CFR 229.303(c)(3)(iii); and proposed Item 5.E.3.(c) of Form 20–F, 17 CFR 249.220f.

could choose to assume that it changed the most material assumption or assumptions underlying the critical accounting estimate and discuss the results of those changes. Second, the company could choose to assume that the critical accounting estimate itself changes. In addition to providing two choices of methods to demonstrate sensitivity, we allow a company to determine the amount of the change that it assumes for this analysis rather than attempting to standardize those amounts. Under the first choice, a company could select the alternative material assumption or assumptions to use as long as the alternative represents a change that is reasonably possible in the near term. ''Reasonably possible'' means the chance of a future transaction or event occurring is more than remote but less than likely.[62] ''Near-term'' means a period of time going forward up to one year from the date of the financial statements.[63] Under the second choice, the company would use the upper and the lower ends of the range of reasonably possible estimates which it likely determined in formulating its recorded critical accounting estimate. It would substitute the upper end of the range for the recorded estimate and discuss the results. It would do the same for the lower end of the range.

We believe the most informative disclosure about sensitivity would result if we allow companies significant flexibility to customize these analyses. Our approach would accommodate different types of companies, different critical accounting estimates and different types of underlying assumptions. The parameters selected for the sensitivity analysis must, however, be realistic and meaningful measures of change.[64] For purposes of the sensitivity analysis, a company should disclose, if known or available, the likelihood of occurrence of the changes it selects, such as estimated probabilities of occurrence or standard deviations where applicable.

Under the first choice for demonstrating sensitivity, we would provide that a company choose its most material assumption underlying the critical accounting estimate and alter it at least twice[65] to reflect reasonably possible, near-term changes.[66] A company would have to complete the analysis assuming a positive change in the assumption. It would also have to complete the analysis assuming a negative change. In some cases, a company may not be able to select a single most material assumption to use for purposes of these analyses, or it may believe that using a single assumption would not provide meaningful sensitivity information for investors. If that were to occur, a company either could select the second choice for analyzing sensitivity (*i.e.,* using the ends of the range) or it could demonstrate the effects of near-term reasonably possible changes in more than one material assumption underlying the critical accounting estimate. If the company chooses the latter course of action, it also would have to disclose clearly the separate effect of each changed assumption.

In general, we believe the impact of a positive change and the impact of a negative change would both have to be disclosed where a company is assuming changes in its most material assumption (or assumptions). There may be cases, however, where both types of changes would not be applicable. In some instances, an increase in an assumption, but not a decrease in an assumption, or vice versa, would have no effect on the line items or the overall financial performance and therefore would not have to be discussed other than noting that fact.[67] It is conceivable that in other cases either a decrease or an increase would not be reasonably possible and therefore would not have to be discussed other than noting that fact.

With the proposed analysis, a company would demonstrate sensitivity of reported results to changes that affect its critical accounting estimates. Investors would have a better understanding of the extent to which there is a correlation between management's key assumptions and the company's overall financial performance. Investors also would understand better which particular line items in reported results would be materially affected and how much. In addition, a company would be required to state whether those assumed changes could have a material effect on the company's liquidity or capital resources. If they could have such an effect, the company would have to explain how, as a company currently is required to explain in MD&A when factors affecting liquidity or capital resources are present.[68]

From the proposed disclosure, the average investor should be able to ascertain the general degree to which the company's results of operations, liquidity and capital resources are susceptible to changes in management's views relating to critical accounting estimates. Along with the other provisions in the proposal, this quantitative and qualitative disclosure conveys information about the impact of management's subjective assumptions on current and future financial results.

We request comment on the proposed identification and analysis of changes.

- Are there some types of critical accounting estimates or some circumstances where the proposed disclosure relating to sensitivity would not be meaningful or otherwise helpful to investors? If so, which estimates or what circumstances?
- In addition to the two choices we propose for assuming changes relating to the critical accounting estimates to analyze sensitivity, are there others that we should permit? Should we require instead that all companies use the same method? If so, which one?
- Should we require a company to use whichever of the two proposed choices demonstrates the greatest impact on the company's financial presentation?
- Are there circumstances under which a company should be required to demonstrate sensitivity using both of the proposed choices?
- Are there any critical accounting estimates for which neither of the two

[62] ''Reasonably possible'' would have the same meaning as defined in SFAS No. 5. *See supra* fn. 23. *See also* proposed Item 303(b)(3)(ii)(D) of Regulation S–B, 17 CFR 228.303(b)(3)(ii)(D); proposed Item 303(c)(2)(iv) of Regulation S–K, 17 CFR 229.303(c)(2)(iv); and proposed Item 5.E.2.(d) of Form 20–F, 17 CFR 249.220f.

[63] ''Near-term'' would have the same meaning as defined in SOP 94–6 at paragraph 7. *See* proposed Item 303(b)(3)(ii)(C) of Regulation S–B, 17 CFR 228.303(b)(3)(ii)(C); proposed Item 303(c)(2)(iii) of Regulation S–K, 17 CFR 229.303(c)(2)(iii); and proposed Item 5.E.2.(c) of Form 20–F, 17 CFR 249.220f.

[64] For example, companies would be required to select meaningful changes in material assumptions and not ones so minute as to avoid, or materially understate, any demonstration for investors of sensitivity. *See* proposed Instruction 1 to paragraph (b)(3) of Item 303 of Regulation S–B, 17 CFR 228.303(b)(3); proposed Instruction 1 to paragraph (c) of Item 303 of Regulation S–K, 17 CFR 229.303(c); and proposed Instruction 1 to Item 5.E of Form 20–F, 17 CFR 249.220f.

[65] Where use of only one positive change, or use of only one negative change, would render the analysis materially misleading, companies would have to include more than one assumed positive change, or more than one assumed negative change, to avoid that result.

[66] In completing the analysis, companies would have to consider whether assumed events that alter the most material assumption also could have some impact on other assumptions made in formulating the critical accounting estimate. For example, if a company were to assume a reasonably possible near-term change in fuel prices occurred, that change may impact multiple assumptions underlying a critical accounting estimate that each take fuel prices into account. Companies would have to determine whether and how their other assumptions would change and disclose the aggregate effect of all of those changes.

[67] For an example of when this could take place, *see infra* Example 3 in Section III.D.

[68] *See, e.g.,* Item 303(a)(1)–(2) of Regulation S–K, 17 CFR 229.303(a)(1)–(2).

choices for selecting the assumed changes would be appropriate?

• Will companies be able to select appropriate changes in their most material assumption or assumptions, or should we provide further guidance?

• To enhance an investors' ability to compare the sensitivity of various companies' financial statements to changes relating to a particular type of accounting estimate, should we standardize the changes that companies must assume for various types of estimates? If so, what should they be and why? For example, should we set a specified percentage increase and decrease to assume (*e.g.,* a 10% increase and decrease), or a presumptive increase and decrease, provided that degree of change is reasonably possible in the near term?

• Conversely, would any changes we standardize not be equally meaningful to measure sensitivity, or equally probable, for various accounting estimates, industries and companies, and thus reduce the value of any disclosure about sensitivity?

b. Quantitative and Qualitative Disclosures Concerning Past Changes in the Estimate

We recognize that a company will change its accounting estimates over time as new events occur or as management acquires more experience or additional information. Existing MD&A disclosure rules would call for discussion of the effects of changes in accounting estimates where those changes are material to an investor's understanding of financial position or results of operations. For example, MD&A currently requires companies to disclose:

• Information necessary for an understanding of financial condition, changes in financial condition and results of operations;[69]

• Significant components of revenues or expenses that should, in the company's judgment, be described in order to understand results of operations;[70]

• A material change in the relationship between costs and revenues resulting from a known event;[71]

• Matters that will have an impact on future operations and have not had an impact in the past;[72] and

• Matters that have had an impact on reported operations and are not expected to have an impact upon future operations.[73]

Notwithstanding the existing MD&A disclosure requirements, we believe it would be appropriate to require specific disclosure regarding past changes in critical accounting estimates. This type of information required under the proposal would give investors a clear understanding of a company's recent history of those changes. A company other than a small business issuer would have to include the proposed quantitative and qualitative discussion of any material changes in those accounting estimates under the proposals during the past three fiscal years.[74] A small business issuer would discuss material changes in its critical accounting estimates during the past two years.[75] Companies would have to identify how the material changes affected measurements in the financial statements and their overall financial performance.[76] This would enable investors to evaluate management's formulation of critical accounting estimates over time.

Companies also would be required to describe the reasons for those changes. If no material changes in the critical accounting estimates were made in the prescribed time period, or if a company did not make that estimate during any part of that period, a company would only be required to disclose that fact.

Although the period covered for the proposed disclosure of past changes in critical accounting estimates would be two years for small business issuers and three years for other companies, our proposed requirement relating to past changes would be put into effect in stages. Thus, when a small business issuer or other company files its first covered report, registration statement or proxy or information statement following adoption of the proposed rules, the rules would require it to provide the proposed specific past changes disclosure only for the past one or two years respectively. For example, if the first report were an annual report on Form 10–K for the fiscal year ended December 31, 2002, the company would include that information in the ''Application of Critical Accounting Policies'' section of MD&A about changes in 2001 and 2002 (and a small business issuer would include it only for 2002). In the first annual report, registration statement or proxy or information statement filed by a company more than one year following the effective date of the rules, it would have to provide that information for the past three years (two years for a small business issuer).[77]

We solicit comment on the proposed disclosure of past material changes in critical accounting estimates.

• Is sufficient disclosure of these changes already required under current MD&A requirements?

• Is a three-year period the most appropriate period of time over which investors should consider changes? If not, why would a shorter or longer period be more appropriate?

• Would requiring disclosure over a longer period, such as five years, make it easier for investors to identify trends? If so, over how many years should we phase in a longer period requirement?

• Should we mandate a standardized format for quantitative disclosure about past changes in critical accounting estimates (*e.g.,* a chart illustrating the dollar value of the change from the prior year for each year showing the impacted line items and other effects in each year)?

5. Senior Management's Discussions with the Audit Committee

Independent auditors discuss accounting estimates with management in order to conduct an audit, and the auditors may discuss them with the audit committee. In 1999, following the recommendations in the Report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, we adopted a rule that would require an audit committee report in proxy or information statements connected to board of

[69] *See, e.g.,* Item 303(a) of Regulation S–K, 17 CFR 229.303(a).

[70] *See, e.g.,* Item 303(a)(3)(i) of Regulation S–K, 17 CFR 229.303(a)(3)(i).

[71] *See, e.g.,* Item 303(a)(3)(ii) of Regulation S–K, 17 CFR 229.303(a)(3)(ii).

[72] *See, e.g.,* Instruction 3(A) to Item 303(a) of Regulation S–K, 17 CFR 229.303(a).

[73] *See, e.g.,* Instruction 3(B) to Item 303(a) of Regulation S–K, 17 CFR 229.303(a).

[74] *See* proposed Item 303(c)(3)(iv) of Regulation S–K, 17 CFR 229.303(c)(3)(iv), and proposed Item 5.E.3.(d) of Form 20–F, 17 CFR 249.220f. As part of its disclosure, a company would have to include discussion of assumptions that changed materially from a prior period but did not cause the estimate itself to change by a material amount. For example, a company could change two or more material assumptions underlying an accounting estimate, but the changes in the assumptions could have an offsetting impact, resulting in no material change to the amount of the accounting estimate recorded in the financial statements.

[75] *See* proposed Item 303(b)(3)(iii)(D) of Regulation S–B, 17 CFR 228.303(b)(3)(iii)(D). These periods correspond to the time frame currently encompassed by the MD&A requirements applicable to each of those types of companies.

[76] *Compare* APB No. 20, paragraph 33, which requires financial statement disclosure of the effect on income before extraordinary items, net income, and related per share amounts of the current period for a change in an estimate not made in the ordinary course of accounting that materially affects several future periods.

[77] Of course, the phase-in of the specific MD&A disclosure about changes in estimates would not delay the effect of the rest of the proposed changes or affect the requirements for disclosure under current MD&A rules.

director elections.[78] Among other items, the audit committee report must state whether the audit committee has discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards (''SAS'') No. 61 (codified in AU § 380), as may be modified or supplemented.[79] SAS 61 requires independent auditors to communicate certain matters related to the conduct of an audit to those who have responsibility for oversight of the financial reporting process, specifically the audit committee. With respect to accounting estimates, SAS 61 states, ''[t]he auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.''[80] In addition, in connection with each SEC engagement, the auditor should discuss with the audit committee the auditor's judgments about the quality of the entity's accounting principles as applied in its financial reporting. The discussion should include items that have a significant impact on the financial statements (for example, estimates, judgments and uncertainties, among other items).[81]

In addition to the disclosure relating to SAS 61 (as amended), the audit committee report must state whether the audit committee has reviewed and discussed the audited financial statements with management.[82] Because that item relates to the financial statements generally, a focused discussion on critical accounting estimates may or may not result from it. Moreover, the newly required disclosure in MD&A would not be a part of the financial statements, and therefore would not necessarily be covered by that proxy statement disclosure requirement.

The existing audit committee report also requires audit committees to state whether, based on discussions with management and the auditors, the committee recommended to the board of directors that the audited financial statements be included in the company's Form 10–K or 10–KSB for the last fiscal year.[83] This disclosure requirement conveys whether the audit committee review of the financial statements and discussions with management and the auditors have provided a basis for recommending to the board that the audited financial statements be filed with the Commission. This item too does not require any specific discourse between management and the audit committee about critical accounting estimates.

We believe that senior management should discuss the company's critical accounting estimates with the audit committee of its board of directors.[84] If specific discussions between senior management and audit committees regarding the development, selection and disclosure of the critical accounting estimates were to take place, the audit committee may seek to understand the company's critical accounting estimates, the underlying assumptions and methodologies, the appropriateness of management's procedures and conclusions, and the disclosure about those accounting estimates. This type of oversight would have the potential to improve the quality and the transparency of disclosure.

Requiring a company to disclose in MD&A whether or not senior management has engaged in discussions with the audit committee about the critical accounting estimates would give investors a better understanding of whether such oversight by those responsible for the general oversight of the financial reporting process was applied to those accounting estimates and the disclosure about those accounting estimates. We therefore are proposing to require such disclosure.[85] When senior management and the audit committee have not had those discussions, we would require disclosure that they have not, and an explanation of the reasons why they have not.[86] If the company does not have an audit committee, then the proposed disclosure would address discussions with the board committee that performs equivalent functions to those of an audit committee or, if no such committee exists, the entire board of directors.[87] Unlike the audit committee report, our proposed disclosure of discussions between the audit committee and senior management would not be limited to proxy and information statements that involve the election of directors.[88]

We do not propose to require disclosure of the substance of the discussions between senior management and the audit committee. We believe that such a requirement could deter the type of open discourse that we expect to take place in those discussions.

We request comment on the proposed disclosure about discussions between senior management and the audit committee regarding the development, selection and disclosure of critical accounting estimates.

- To what extent does senior management currently discuss critical accounting estimates with the audit committee of the board of directors and the company's auditors?
- Would the proposed requirement provide useful information to investors?
- Would the proposed disclosure be a catalyst for discussion between audit committees and senior management? Could it chill discussions?
- Is there other related disclosure that should be required for the benefit of investors?
- Should we require that companies disclose any unresolved concerns of the audit committee about the critical accounting estimates or the related MD&A disclosure?
- Should we require disclosure of any specific procedures employed by the audit committee to ensure that the company's response to the proposed

[78] *See* Exchange Act Release No. 42266 (Dec. 22, 1999) [64 FR 73389] and Item 306 of Regulation S–K, 17 CFR 229.306.

[79] *See* Item 306(a)(2) of Regulation S–K, 17 CFR 229.306(a)(2), SAS No. 61, *Communication with Audit Committees* (Apr. 1988) (''SAS 61'') and SAS No. 90, *Audit Committee Communications* (Dec. 1999) (''SAS 90'') (amending SAS 61 and AU § 380).

[80] SAS 61, paragraph 8.

[81] *See* AU § 380, paragraph 11 (added by SAS 90).

[82] *See* Item 306(a)(1) of Regulation S–K, 17 CFR 229.306(a)(1).

[83] *See* Item 306(a)(4) of Regulation S–K, 17 CFR 229.306(a)(4).

[84] *See* Securities Act Release No. 8040, FR–60 (Dec. 12, 2001) [66 FR 65013].

[85] *See* proposed Item 303(b)(3)(iii)(E) of Regulation S–B, 17 CFR 228.303(b)(3)(iii)(E); proposed Item 303(c)(3)(v) of Regulation S–K, 17 CFR 229.303(c)(3)(v); and proposed Item 5.E.3.(e) of Form 20–F, 17 CFR 249.220f.

[86] The proposed MD&A disclosure is distinguishable from the audit committee report in annual proxy or information statements. Under the proxy requirements, the audit committee must prepare a report and state whether it recommended, based on its review and discussions with management and the auditors, that the financial statements be included in the Form 10–K. In our proposals, we would not require an audit committee report or recommendation, but only that the company state whether or not discussions between the audit committee and senior management occurred and, if they did not, why not. We therefore are not convinced that a liability exemption like that applicable to the audit committee report is necessary for disclosure in MD&A of whether or not a company's senior management has discussed the development and selection of critical accounting estimates, and the disclosure in MD&A regarding them.

[87] If the registrant is not a corporation, the disclosure would address senior management's discussions with the equivalent group responsible for the oversight of the financial reporting process.

[88] This disclosure would be required in annual reports filed with the Commission, annual reports to shareholders, registration statements and proxy and information statements. When a new critical accounting estimate is identified in a quarterly report, there also would be disclosure in the Form 10–Q or Form 10–QSB regarding whether the development, selection and disclosure regarding the estimate was discussed by management with the audit committee of the board of directors.

disclosure requirements is complete and fair?

• Should we consider requiring disclosure of whether the audit committee recommends the disclosure be included in the MD&A, which is akin to the disclosure required in the Item 306 audit committee report?

• Instead of the proposed disclosure, should we amend Item 306 of Regulation S–K and Regulation S–B to require that the audit committee report disclose whether the audit committee has reviewed and discussed with senior management the development, selection and disclosure regarding critical accounting estimates?

• If we were to amend Items 306 in this manner, should we also expand them to include the discussions about critical accounting estimates between senior management and the audit committee as one of the bases for the audit committee's recommendation to include the financial statements in the annual report?

• Should we expand Items 306 to require disclosure of whether, based on an audit committee's review of and discussions about the MD&A, the audit committee recommended to the board of directors that the MD&A be included in the company's annual report?

• Should we expand Items 306 to require disclosure of whether the audit committee has reviewed and discussed the entire MD&A disclosure (current and proposed) with management and/or the auditors?

• If any of a company's accounting policies diverge, to its knowledge, from the policies predominately applied by other companies in the same industry, should we require that the company disclose, possibly in connection with the audit committee report, whether the audit committee has had discussions with senior management about the appropriateness of the accounting policies being used? When such discussions have taken place, should we require that the company disclose the audit committee's unresolved concerns about the divergent accounting policies being applied? Prior to the adoption of our proposals, to what extent would a company know that its accounting policies diverge from those of other companies in its industry?

6. Disclosure Relating to Segments

Current MD&A disclosure requirements provide companies with the discretion to include a discussion of segment information where, in the company's judgment, such a discussion would be appropriate to an understanding of the company.[89] In 1989, we stated in an interpretive release, ''[t]o the extent any segment contributes in a materially disproportionate way to [revenues, profitability, and cash needs], or where discussion on a consolidated basis would present an incomplete and misleading picture of the enterprise, segment disclosure should be included.'' [90] In accordance with this interpretation, we are proposing disclosure regarding the impact of critical accounting estimates on segments of a company's business.[91] Where applicable, we believe that this disclosure would be important for investors because it would enable them to determine which reported segments' results are dependent on management's subjective estimates, and material information would be provided on a segment basis.

Under the proposals, if a company operates in more than one segment [92] and a critical accounting estimate affects fewer than all of the segments, the company would have to identify the segments it affects. A company also would have to determine whether it must include, in addition to the disclosure on a company-wide basis, a separate discussion of the critical accounting estimates for each identified segment about which disclosure is otherwise required.[93] That determination would follow an analysis similar to that in the 1989 guidance. A company would have to provide a discussion on a segment basis to the extent that discussion only on a company-wide basis would result in an omission that renders the disclosure materially misleading.[94] We would not mandate repetition on a segment basis of all matters discussed on a company-wide basis. Rather, a company would have to disclose only that information necessary to avoid an incomplete or misleading picture.

We request comment regarding identification of the segments affected and the proposed additional disclosure of the critical accounting estimates on a segment basis.

• Should we provide more guidance for determining the circumstances that warrant segment disclosure?

• Should we require the additional segment discussion only when more than one segment is affected?

D. Examples of Proposed Disclosure About Critical Accounting Estimates

To assist in understanding the scope of the MD&A disclosure that is proposed, we have developed three examples. Each example examines how a fictional public company that has identified a critical accounting estimate could draft MD&A disclosure to satisfy the proposal. The examples are illustrative only. In addition, our January 22, 2002 release provides an example of disclosure that companies should consider when discussing in MD&A trading activities involving contracts that are accounted for at fair value where a lack of market price quotations necessitates the use of fair value estimation techniques.[95]

Example 1

Background

Alphabetical Company manufactures and distributes electrical equipment used in large-scale commercial pumping and water treatment facilities. The company operates in four business segments. The company's equipment carries standard product warranties extending over a period of 6 to 10 years. If equipment covered under the standard warranty requires repair, the company provides labor and replacement parts to the customer at no cost. Historically, the costs of fulfilling warranty obligations have principally related to providing replacement parts, with labor costs representing the remainder. Over the past 3 years, the cost of copper included in replacement parts constituted approximately 35% to 40% of the total cost of warranty obligations.

A liability for the expected cost of warranty-related claims is established when equipment is sold. The amount of the warranty liability accrued reflects the company's estimate of the expected future costs of honoring its obligations under the warranty plan. Because of the long-term nature of the company's equipment warranties, estimating the

[89] *See* Item 303(a) of Regulation S–K, 17 CFR 229.303(a).

[90] *See* Securities Act Release No. 6835 (May 18, 1989) [54 FR 22427].

[91] *See* proposed Item 303(b)(3)(iii)(F) of Regulation S–B, 17 CFR 228.303(b)(3)(iii)(F); proposed Item 303(c)(3)(vi) of Regulation S–K, 17 CFR 229.303(c)(3)(vi); and proposed Item 5.E.3.(f) of Form 20–F, 17 CFR 249.220f.

[92] *See* SFAS No. 131 for requirements as to presentation of segment disclosure in the financial statements.

[93] Certain foreign private issuers providing disclosure under Item 17 of Form 20–F are not required to provide segment disclosure in their filed financial statements and therefore would not be required to provide a quantitative discussion of the identified segments.

[94] Any discussion on a segment basis would appear in the section of MD&A devoted to critical accounting estimates, and not in the separate discussion of segment results in MD&A.

[95] *See* Securities Act Release No. 8056, FR–61 (Jan. 22, 2002)[67 FR 3746], Section II.B.

expected cost of such warranties requires significant judgment. Based on management's evaluation of analysts' forecasts for copper prices, management believes a 30% decrease in copper prices or a 50% increase in copper prices is reasonably possible in the near term. In each of the last three years, warranty expense represented approximately 19% to 22% of cost of sales.

Possible MD&A Disclosure Under the Proposal

Application of Critical Accounting Policies

Alphabetical's products are covered by standard product warranty plans that extend 6 to 10 years. A liability for the expected cost of warranty-related claims is established when equipment is sold. The amount of the warranty liability accrued reflects our estimate of the expected future costs of honoring our obligations under the warranty plan. We believe the accounting estimate related to warranty costs is a ''critical accounting estimate'' because: changes in it can materially affect net income, it requires us to forecast copper prices in the distant future which are highly uncertain and require a large degree of judgment, and copper is a significant raw material in the replacement parts used in warranty repairs. The estimate for warranty obligations is a critical accounting estimate for all of our four segments.

Historically, the costs of fulfilling our warranty obligations have principally related to replacement parts, with labor costs representing the remainder. Over the past 3 years, the cost of copper included in our parts constituted approximately 35% to 40% of the total cost of warranty repairs. Over that same period, warranty expense represented approximately 19% to 22% of cost of sales.

Over the past 10 years, the price of copper has exhibited significant volatility. For example, during 1994, the price of copper rose by approximately 72%, while in 2001 the price decreased by approximately 19%. Our hedging programs provide adequate protection against short-term volatility in copper prices, as described in ''Risk Management,'' but our hedging does not extend beyond 5 years. Accordingly, our management must make assumptions about the cost of that raw material in periods 6 to 10 years in the future. Management forecasts the price of copper for the portion of our estimated copper requirements not covered by hedging. Our forecasts are based principally on long-range price forecasts for copper which are published by private research companies specializing in the copper markets.

Each quarter, we reevaluate our estimate of warranty obligations, including our assumptions about the cost of copper. During 2001, we decreased our estimated cost of unhedged copper purchases over the next 10 years by 15%, reflecting a growing excess of supply over forecasted demand, which reduced our accrued warranty costs and our cost of sales (and, accordingly, increased operating income) by $15 million. In contrast, during 2000, long-term price forecasts were essentially unchanged, so we made no adjustments to our estimated cost of unhedged copper purchases over the next 10 years. During 1999, copper prices increased by approximately 28% over the prior year. Long-term prices also reflected increases in prices over those projected in 1998. Thus, in 1999, we increased our estimated cost of unhedged copper purchases over the next 10 years (through 2009) by 15%. That increase in our estimate resulted in an $18 million addition to our accrued warranty cost and our cost of sales, and an equal reduction in our operating income.

If, for the unhedged portion of our estimated copper requirements, we were to decrease our estimate of copper prices as of December 31, 2001 by 30%, our accrued warranty costs and cost of sales would have been reduced by approximately $27 million or 6% and 4%, respectively, while operating income would have increased by 9%. If we were to increase our estimate as of December 31, 2001 by 50%, our accrued warranty costs and cost of sales would have been increased by approximately $45 million or 10% and 7%, respectively, while our operating income would have been reduced by 23%.

A very significant increase in our estimated warranty obligation, such as one reflecting the increase in copper prices that occurred in 1994, could lower our earnings and increase our leverage ratio (leverage refers to the degree to which a company utilizes borrowed funds). That, in turn, could limit our ability to borrow money through our revolving credit facilities described in ''Liquidity and Capital Resources.''

Our management has discussed the development and selection of this critical accounting estimate with the audit committee of our board of directors and the audit committee has reviewed the company's disclosure relating to it in this MD&A.

Example 2

Background

MQB Corp. is a developer and publisher of desktop publishing software that operates in two segments. MQB distributes its products primarily through third-party distributors, resellers, and retailers (customers). Like many companies in the software industry, MQB has a product return policy and has historically accepted significant product returns. MQB permits its customers to return software titles published and distributed by the company within 120 days of purchase.

MQB recognizes revenues under SOP 97–2, ''Software Revenue Recognition.'' The company ships its products FOB (Free on Board) shipping point. Therefore, legal title to the products passes to the customers upon shipment, and the company has no legal obligation for product damage in transit. Accordingly, MQB recognizes revenue upon shipment of its software products, provided that collection of payment is determined to be probable and no significant obligations on MQB's part remain. Payment is due from customers 30 days after shipment. At the time revenue is recorded, MQB accounts for estimated future returns by reducing sales by its estimate of future returns and by reducing accounts receivable by the same amount. For example, MQB reduced its gross sales and accounts receivable by 12% for its fiscal year ended December 31, 2001 to reflect estimated product returns. In the last three years, the range in which the company has reduced its gross sales and accounts receivable to reflect product returns has been between 11% and 13%.

MQB receives weekly reports from distributors and retailers regarding the amount of MQB products in their inventory. A historical correlation exists between levels of inventory held by distributors and retailers (together, the distribution channel) and the amount of returns that actually occur. The weekly reports from distributors and retailers provide the company with visibility into the distribution channel such that MQB has the ability to estimate future returns. In each of the past few years, actual returns have varied from period to period, although they have not exceeded the estimated amounts by more than 5%. The company's products are, however, subject to intense marketplace competition, including several recently introduced competing products. If actual returns significantly exceed the previously estimated amounts, it would result in materially lower sales and net income before taxes in one or more future periods.

Possible MD&A Disclosure Under the Proposal

Application of Critical Accounting Policies

Our recognition of revenue from sales to distributors and retailers (the ''distribution channel'') is impacted by agreements we have giving them rights to return our software titles within 120 days after purchase. At the time we recognize revenue, upon shipment of our software products, we reduce our measurements of those sales by our estimate of future returns and we also reduce our measurements of accounts receivable by the same amount.

For our products, a historical correlation exists between the amount of distribution channel inventory and the amount of returns that actually occur. The greater the distribution channel inventory, the more product returns we expect. For each of our products, we monitor levels of product sales and inventory at our distributors' warehouses and at retailers as part of our effort to reach an appropriate accounting estimate for returns. In estimating returns, we analyze historical returns, current inventory in the distribution channel, current economic trends, changes in consumer demand,

introduction of new competing software and acceptance of our products.

In recent years, as a result of a combination of the factors described above, we have materially reduced our gross sales to reflect our estimated amount of returns. It is also possible that returns could increase rapidly and significantly in the future. Accordingly, estimating product returns requires significant management judgment. In addition, different return estimates that we reasonably could have used would have had a material impact on our reported sales and thus have had a material impact on the presentation of the results of operations. For those reasons, we believe that the accounting estimate related to product returns is a ''critical accounting estimate.'' Our estimate of product returns is a critical accounting estimate for both of our segments. Management of the company has discussed the development and selection of this critical accounting estimate with the audit committee of our board of directors and the audit committee has reviewed the company's disclosure relating to it in this MD&A.

We are aware of several recently introduced products that compete with several of our significant products. These new competitive factors have not, to date, materially impacted returns; therefore, we have made no adjustment as a result of these factors in our estimated returns for 2001. In our highly competitive marketplace, these factors have some potential to increase our estimates of returns in the future. The introduction of new competing products has impacted our estimate of returns in the past. In 1999, we increased our estimate of returns over the previous year by 1%, as a percentage of gross sales, because of increased inventory in the distribution channel due to new products introduced by two of our competitors.

In preparing our financial statements for the year ended December 31, 2001, we estimated future product returns for all of our products to be $145 million, and we reduced our gross sales by that amount. Our 2001 estimate for returns was $20 million greater than our estimate in 2000 and $15 million greater than our estimate in 1999. From 1999 to 2000, products introduced by two of our competitors in 1998 lost market share to our products and our sales increased. Due to our increased sales in 2000, the distribution channel inventory declined over levels in 1999, which also resulted in a 2% decline in the estimated amount of returns, as a percentage of gross sales. In 2001, with the slow down in consumer spending over the prior period, distribution channel inventory grew faster than sales, necessitating an increase in the estimated returns equal to 1% of gross sales. The estimates for returns represented approximately 12%, 11% and 13% of our gross sales for 2001, 2000 and 1999, respectively.

If we were to assume that our estimate of future product returns for all of our products was changed to the upper end or lower end of the range we developed in the course of formulating our estimate, the estimate for future returns as of December 31, 2001 would range from $130 million to $160 million. Accordingly, the amounts by which we would reduce gross sales and operating income also would range from $130 million to $160 million as compared to the recorded amount of $145 million. In each of the years in the three-year period ended 2001, our actual returns have not deviated from our estimates by more than 5%. Our actual returns for 2000 and 1999 were $129 million and $134 million, respectively. If we were to change our estimate of future product returns to the high end of the range, there would be no material impact on our liquidity or capital resources.

Example 3

Background

Betascott Company manufactures and sells data storage devices including computer hard drives. The hard drive industry is subject to intense competition and significant shifts in market share amongst the competitors. In the last three years, Betascott has reported falling sales and market share, which has contributed to a fiscal year 2001 loss from operations in the hard drive segment. (This trend is separately discussed in MD&A.)

As of December 31, 2001, the company had $200 million in property, plant and equipment (''PP&E'') used in producing hard drives. The company's accounting policies require that it test long-lived assets for impairment whenever indicators of impairment exist. The 2001 fiscal year loss from operations in that segment, coupled with the company's falling sales and market share, are indicators of a potential impairment of the hard drive-related PP&E.

The company follows the provisions of FASB SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets To Be Disposed Of.*[96] That accounting standard requires that if the sum of the future cash flows expected to result from the assets, undiscounted and without interest charges, is less than a company's reported value of the assets, then the asset is not recoverable and the company must recognize an impairment. The amount of impairment to be recognized is the excess of the reported value of the assets over the fair value of those assets.

The hard drive-related PP&E accounts for approximately 67% of Betascott's PP&E. The sum of Betascott's current estimate of expected future cash flows from its hard drive-related PP&E, undiscounted and without interest charges, is near the reported value of that PP&E. In the year ended December 31, 2001, Betascott would have been required to recognize an impairment loss of approximately $30 million if its estimate of those future cash flows had been 10% lower.

[96] SFAS No. 144 superseded SFAS No. 121 and is effective for financial statements issued for fiscal years beginning after December 15, 2001.

Possible MD&A Disclosure Under the Proposal

Application of Critical Accounting Policies

We evaluate our property, plant and equipment (''PP&E'') for impairment whenever indicators of impairment exist. Accounting standards require that if the sum of the future cash flows expected to result from a company's asset, undiscounted and without interest charges, is less than the reported value of the asset, an asset impairment must be recognized in the financial statements. The amount of impairment to recognize is calculated by subtracting the fair value of the asset from the reported value of the asset.

As we discuss in the notes to the financial statements, we operate in four segments, one of which is the hard drive segment. In our hard drive segment, we reviewed our hard drive-related PP&E for impairment as of December 31, 2001, due to a trend of declining sales and market share. We determined that the undiscounted sum of the expected future cash flows from the assets related to the hard drive segment exceeded the recorded value of those assets, so we did not recognize an impairment in accordance with GAAP. The PP&E in our hard-drive segment represents approximately two-thirds of our total PP&E.

We believe that the accounting estimate related to asset impairment is a ''critical accounting estimate'' because: (1) It is highly susceptible to change from period to period because it requires company management to make assumptions about future sales and cost of sales over the life of the hard drive-related PP&E (generally seven years); and (2) the impact that recognizing an impairment would have on the assets reported on our balance sheet as well as our net loss would be material. Management's assumptions about future sales prices and future sales volumes require significant judgment because actual sales prices and volumes have fluctuated in the past and are expected to continue to do so. Management has discussed the development and selection of this critical accounting estimate with the audit committee of our board of directors and the audit committee has reviewed the company's disclosure relating to it in this MD&A.

In estimating future sales, we use our internal budgets. We develop our budgets based on recent sales data for existing products, planned timing of new product launches, customer commitments related to existing and newly developed products, and current unsold inventory held by distributors.

Our estimates of future cash flows assume that our sales of hard drive inventory will remain consistent with current year sales. While actual sales have declined by an average of approximately 2% per year during the last three years, our introduction of the Stored line of hard drives in August 2001 has resulted in a 0.5% increase in market share over the last five months of 2001, and a

corresponding increase in sales of 5% over the comparable 5-month period last year. We therefore have assumed that sales will not continue to decline in the future. We have also assumed that our costs will have annual growth of approximately 2%. This level of costs is comparable to actual costs incurred over the last two years, following the 1999 restructuring of the hard drive division (which is described in the note 2 to the financial statements).

In each of the last two years, we have tested the hard drive-related PP&E for impairment and in each year we determined that, based on our assumptions, the sum of the expected future cash flows, undiscounted and without interest charges, exceeded the reported value and therefore we did not recognize an impairment. Because 2001 sales were lower than those in 2000 and 1999, despite the improvement in the latter part of the year, and because our estimates of future cash flows are assumed to be consistent with current year sales, the current year impairment analysis includes estimated sales that are 2% and 5% less than those assumed in the 2000 and 1999 impairment tests, respectively.

As of December 31, 2001, we estimate that our future cash flows, on an undiscounted basis, are greater than our $200 million investment in hard drive-related PP&E. Any increases in estimated future cash flows would have no impact on the reported value of the hard drive-related PP&E. In contrast, if our current estimate of future cash flows from hard drive sales had been 10% lower, those cash flows would have been less than the reported amount of the hard drive-related PP&E. In that case, we would have been required to recognize an impairment loss of approximately $30 million, equal to the difference between the fair value of the equipment (which we would have determined by calculating the discounted value of the estimated future cash flows) and the reported amount of the hard drive-related PP&E. A $30 million impairment loss would have reduced PP&E and Total Assets as of December 31, 2001 by 10% and 3%, respectively. That impairment loss also would have increased Net Loss Before Taxes, for the year ended December 31, 2001, by 100%.

If we had been required to recognize an impairment loss on our hard-drive related PP&E, it would likely not have affected our liquidity and capital resources because, even with the impairment loss, we would have been within the terms of the tangible net-worth covenant in our long-term debt agreement discussed in note 5 to the financial statements.

E. Auditor Examination of MD&A Disclosure Relating to Critical Accounting Estimates

A company's management bears primary responsibility for its accounting estimates. Auditors also have important responsibilities regarding a company's accounting estimates. A company's auditor currently is responsible for evaluating the reasonableness of the accounting estimates made by management in the context of the financial statements taken as a whole.[97] When a company's audited financial statements are included in an annual report filed with the Commission, the independent auditor is required to read the information in the entire filed document, including the MD&A, and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[98]

Despite the current auditing standards, and the auditor's consideration of the proposed MD&A disclosure that may take place by virtue of them, we are considering whether to take additional steps with a view to ensuring the accuracy and reliability of the proposed disclosure. Subjecting the MD&A disclosure to the auditing process itself would require the imposition of auditing standards, including examination of the disclosure itself, application of auditing processes regarding internal controls, coverage in management representations of material relevant to the disclosure and other procedures. One possible approach would be to adopt a requirement that an independent auditor must examine, in accordance with Attestation Standards,[99] the new MD&A disclosure relating to critical accounting estimates.

The American Institute of Certified Public Accountants has established standards and procedures when an auditor is engaged by a company to examine and render an opinion that the disclosure in a company's MD&A satisfies applicable Commission requirements.[100] An auditor's objective in an examination is to express an opinion on:

- Whether the MD&A presentation includes in all material respects the required elements of the disclosure mandated by the Commission;
- Whether the historical financial amounts have been accurately derived, in all material respects, from the company's financial statements; and
- Whether the underlying information, determinations, estimates and assumptions of the company provide a reasonable basis for the disclosures contained in the MD&A.[101]

To complete an examination, an auditor must examine documents and records and accumulate sufficient evidence in support of the disclosures and assumptions and take other steps to get reasonable assurance of detecting both intentional and unintentional misstatements that are material to the MD&A presentation.[102] To accept an examination engagement, an auditor must have sufficient knowledge about the company and its operations. AT § 701 therefore requires that an auditor must have at least audited the company's financial statements for the most recent period covered by the MD&A, and the other periods covered by the MD&A must have been audited by it or another auditor.[103]

Auditor examinations of MD&A disclosure are, we believe, undertaken on few occasions. Some companies have engaged independent auditors to conduct an examination of their MD&A disclosures either in connection with their initial public offering or after a major restructuring or acquisition when the company disclosure is being presented on a pro forma basis.[104] In

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[97] *See* AU § 342, paragraph 4. In evaluating the reasonableness, the auditor's objective is ''to obtain sufficient competent evidential matter to provide a reasonable assurance that—

a. All accounting estimates that could be material to the financial statements have been developed.

b. Those accounting estimates are reasonable in the circumstances.

c. The accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed.''

AU § 342, paragraph 7. The auditor normally focuses on key factors and assumptions that are significant to the accounting estimate, that are sensitive to variations, that are deviations from historical patterns or that are subjective and susceptible to misstatement and bias. *See* AU § 342, paragraph 9.

[98] *See* AU § 550, *Other Information in Documents Containing Audited Financial Statements* (''AU § 550'').

[99] *See* Codification of Statements on Standards for Attestation Engagements (''AT'') § 101, *Attest Engagements* and AT § 701, *Management's Discussion and Analysis.*

[100] AT § 701 contemplates two levels of service by an auditor with respect to MD&A: an ''examination'' of an MD&A presentation and a more limited ''review'' of an MD&A presentation. Unlike an examination, a review culminates with the auditor giving negative assurance. The auditor's review report states whether any information came to the auditor's attention to cause him or her to believe that: the MD&A presentation taken as a whole does not include in all material respects the required elements of the disclosure; the historical financial amounts have not been accurately derived, in all material respects, from the company's financial statements; or the underlying information, determinations, estimates and assumptions of the company do not provide a reasonable basis for the disclosures contained in the MD&A. In undertaking a review, an auditor is expected to apply analytical procedures and make inquiries of people at the company who are responsible for financial, accounting and operational matters, but is not expected to test accounting records through inspection or observation, obtain corroborating evidence in response to inquiries, or take other steps required during an MD&A examination. An auditor's review report is not intended to be filed with the Commission. *See* AT § 701, paragraph 2.

[101] *See* AT § 701, paragraph 5.

[102] *See* AT § 701, paragraphs 28–29.

[103] *See* AT § 701, paragraph 6.

[104] Goldman Sachs engaged an auditor to review its MD&A disclosure in connection with its initial

one case, an auditor examination of MD&A was undertaken pursuant to a settlement with the Commission of an enforcement action alleging material deficiencies in the company's past MD&A disclosure.[105]

We solicit comment with respect to independent auditor examinations of the proposed MD&A disclosure regarding critical accounting estimates.

• Should we require that the critical accounting estimates disclosure in the MD&A undergo an auditor examination comparable to that enumerated in AT § 701?

• Would these engagements significantly improve the disclosure provided in MD&A?

• In practice, when companies engage auditors to examine the MD&A pursuant to AT § 701, does it elicit a higher quality of disclosure than when auditors consider only, as currently required, whether an MD&A is materially inconsistent with the financial statements?

• If we were to require examinations by auditors of part or all of MD&A disclosures, should we also require that a company file, or disclose the results of, the auditor's reports?

• If we do not require auditors' examinations of MD&A disclosure but an auditor nonetheless examines MD&A disclosure on critical accounting estimates, should we require that the auditor's report be filed or the results be disclosed?

• What would be the relative benefits and costs of a requirement for an auditor examination with respect to the critical accounting estimates portion of the MD&A?

• Should we require an auditor ''review'' under standards comparable to AT § 701,[106] as opposed to an auditor ''examination'' of the critical accounting estimates MD&A disclosure?

• Do current requirements relating to what an auditor must consider make an examination or review of the proposed MD&A disclosure under standards comparable to AT § 701 unnecessary?

• If we do not require auditor examination or review, are there other steps we should take to help ensure the quality of disclosure in this proposed section of MD&A?

F. Quarterly Updates

Material changes relating to critical accounting estimates may occur from fiscal period to fiscal period. For example, management could materially change an accounting estimate previously disclosed as a critical accounting estimate because it changes the methodology for computing it. A company could determine that an additional accounting estimate met the standards and is a critical accounting estimate for the period subsequent to its most recent annual or quarterly report. A company also could materially change one of the important assumptions underlying an existing critical accounting estimate (which may or may not result in a change to the critical accounting estimate depending on what changes in other assumptions underlying the estimate are made). Any of those changes could have a material effect on the company's financial condition, changes in financial condition or results of operations. We expect that U.S. companies would be evaluating accounting estimates and the underlying assumptions and methodologies on at least a quarterly basis [107] and therefore we believe that quarterly updates to reflect material developments would be appropriate. Disclosure of material developments made only at the end of each fiscal year also may not identify changes quickly enough to inform investors adequately.

In quarterly reports on Form 10–Q or Form 10–QSB, companies would be required to provide an update to the MD&A information related to critical accounting estimates discussed in the company's last filed annual or quarterly report under the Exchange Act.[108] Newly identified critical accounting estimates would be disclosed in the same manner as in an annual report. If other material changes have occurred that would render the critical accounting estimates disclosure in the company's latest report materially out of date or otherwise materially misleading, we propose that those changes and their effect be described in the quarterly report. The proposed rules would not, however, require quarterly updates with regard to the proposed quantitative and qualitative discussion concerning past material changes in critical accounting estimates in annual reports, registration statements and proxy and information statements.

We solicit comment on the quarterly updating requirement for U.S. companies.

• Are there some accounting estimates or material assumptions or methodologies that would normally be considered by companies only on a less frequent basis than quarterly? If so, which ones? Should they be omitted from the quarterly updating requirement on that basis?

• Is the scope of the disclosure required in a quarterly update appropriate? If not, what should be added or omitted?

G. Proposed Disclosure About Initial Adoption of Accounting Policies

A company initially adopts an accounting policy when events or transactions that affect the company occur for the first time, when events or transactions that were previously immaterial in their effect become material, or when events or transactions occur that are clearly different in substance from previous events or transactions. For example, a company may for the first time enter into transactions involving derivative instruments, such as interest rate swaps, or may begin selling a new type of product that has delivery terms and conditions that are different from those associated with the products the company has previously been selling.

If an initially adopted accounting policy has a material impact on the company's financial condition, changes in financial condition or results of operations, that impact will likely be of interest to investors, to financial analysts and others. If a company considers an accounting policy that it has initially adopted to be a significant accounting policy, the company would provide certain disclosures about that accounting policy as required by APB No. 22. Those disclosures are typically in the first note to the financial statements.[109] The disclosure provided in the notes to the financial statements, however, may not adequately describe,

public offering. *See* Form S–1, Commission File No. 333–74449. In addition, in the course of reading agreements between issuers and their underwriters created in connection with registered offerings, the staff has noted that approximately 50 companies have agreed to engage an auditor to conduct an examination of the company's MD&A disclosure as a condition to closing.

[105] In 1998, we issued a cease-and-desist order in a settlement with Sony Corporation that required Sony to engage an independent auditor to examine its MD&A disclosure for the fiscal year ending March 31, 1999. *See SEC* v. *Sony Corporation,* Litigation Release No. 15832 (Aug. 5, 1998).

[106] *See* supra fn. 100.

[107] The procedures performed by an independent accountant to issue a review report on the financial statements filed in a Form 10–Q generally would include reading information such as that found in the MD&A section of the Form 10–Q. Further, the independent accountant's association with those financial statements would require the independent accountant to read the MD&A. *See* AU § 722, *Interim Financial Information,* paragraph 35 and AU § 550, paragraph 4.

[108] *See* proposed Item 303(b)(3)(v) of Regulation S–B, 17 CFR 228.303(b)(3)(v), and proposed Item 303(c)(5) of Regulation S–K, 17 CFR 229.303(c)(5). To assist companies in preparing quarterly updates, we would allow them to presume that investors have read, or have access to, the discussion of critical accounting estimates in their previously filed Exchange Act annual reports and any quarterly reports filed subsequent to the most recent annual report.

[109] *See* APB No. 22, paragraphs 12 and 15.

in a qualitative manner, the impact of the initially adopted accounting policy or policies on the company's financial presentation. We are therefore proposing additional MD&A disclosure to further describe, where a material impact exists, the initial adoption of accounting policies.[110] The proposed MD&A disclosure would be provided in companies' filed annual reports, annual reports to shareholders, registration statements and proxy and information statements and would include description of:

- The events or transactions that gave rise to the initial adoption of an accounting policy;
- The accounting principle that has been adopted and the method of applying that principle; and
- The impact (discussed qualitatively) resulting from the initial adoption of the accounting policy on the company's financial condition, changes in financial condition and results of operations.

If, upon initial adoption of one of those accounting policies, a company is permitted a choice among acceptable accounting principles,[111] the company also would be required to explain in MD&A that it had made a choice among acceptable alternatives, identify the alternatives, and describe why it made the choice that it did. In addition, where material, the company would have to provide a qualitative discussion of the impact on the company's financial condition, changes in financial condition and results of operations that the alternatives would have had. Finally, if no accounting literature exists that governs the accounting for the events or transactions giving rise to the initial adoption of a material accounting policy (*e.g.,* the events or transactions are unusual or novel or otherwise have not been contemplated in past standard-setting projects), the company would be required to explain its decision regarding which accounting principle to use and which method of applying that principle to use.

We seek comment on the proposed disclosures related to initial adoption of accounting policies.

- Would the proposed disclosures about initial adoption of accounting policies provide useful information to investors and other readers of financial reports?
- Are there particular situations involving the initial adoption of a material accounting policy for which we should require additional disclosure? If so, what are those situations and what additional disclosure should we require?
- Should we require companies to disclose, in MD&A or in the financial statements, the estimated effect of adopting accounting policies that they could have adopted, but did not adopt, upon initial accounting for unusual or novel transactions?
- What would be the costs for companies to prepare disclosure about the effects of alternative accounting policies that could have been chosen but were not?
- Would investors be confused if companies presented disclosure of the effects of acceptable alternative policies that were not chosen?
- Should we require in MD&A a discussion of whether the accounting policies followed by a company upon initial adoption differ from the accounting policies applied, in similar circumstances, by other companies in its industry, and the reasons for those differences? Please explain. If such a discussion should be required, please identify the specific disclosures companies should make.
- Would a company know the policies applied in similar circumstances by other companies in its industry? If not, would auditing firms or other financial advisors be able to assist companies in determining whether their accounting policies generally diverge from industry practices?

H. Disclosure Presentation

The proposals would require that a company present the required information in a separate section of MD&A. While the proposed disclosure may relate to other aspects of the discussion in MD&A, such as the results of operations or liquidity and capital resources, we have chosen to separate it both to highlight the discussion and because we believe the proposed discussion would present information that is better communicated separately to promote understanding.

The proposed MD&A discussion must be presented in language, and a format, that is clear, concise and understandable to the average investor.[112] The disclosure should not be presented in such a way that only an investor who is also an accountant or an expert on a particular industry would be able to understand it fully. To reinforce the importance of the disclosure being presented in a manner that investors will understand, we also would specify that the proposed disclosure must not be presented, for example, solely as a single discussion of the aggregate consequences of multiple critical accounting estimates or the aggregate consequences of the initial application of multiple new accounting policies.[113] Because a company may identify and discuss more than one critical accounting estimate or more than one newly adopted accounting policy, and those estimates or those policies could materially affect a company's financial presentation in differing ways, a separate discussion of the application of each estimate and each new accounting policy will facilitate investors' understanding of the implications of each one.

Boilerplate disclosures that do not specifically address the company's particular circumstances and operations also would not satisfy the proposed requirements.[114] Disclosure that could easily be transferred from year to year, or from company to company, with no change would neither inform investors adequately nor reflect the independent thinking that must accompany the periodic assessment by management that is intended under the proposal. Finally, the purpose of the proposed disclosure would be hindered if a company were to include disclosures that consisted principally of blanket disclaimers of legal responsibility for its application of a new accounting policy or its development of its critical accounting estimates in light of the uncertainties associated with them. While the Commission fully expects companies to craft the proposed disclosure responsibly to take advantage of any available safe harbors, simple disclaimers of legal liability would be contrary to the disclosure goals underlying the proposal and would not be permitted.[115]

We solicit comment on the disclosure presentation aspects of the proposals.

- Should the proposed disclosure be presented in a separate section of MD&A

[110] *See* proposed Item 303(b)(3)(iv) of Regulation S–B, 17 CFR 228.303(b)(3)(iv); proposed Item 303(c)(4) of Regulation S–K, 17 CFR 229.303(c)(4); and proposed Item 5.E.4. of Form 20–F, 17 CFR 249.220f. These proposed disclosures would not be required if the initial adoption of an accounting policy solely results from adoption of new accounting literature issued by a recognized accounting standard setter (including, in the U.S., new accounting pronouncements or rules issued by the FASB, AICPA or SEC or a new consensus of the Emerging Issues Task Force (EITF)).

[111] *See supra* fn. 31 and accompanying text.

[112] *See* proposed Instruction 3 to paragraph (b)(3) of Item 303 of Regulation S–B, 17 CFR 228.303(b)(3); proposed Instruction 4 to paragraph (c) of Item 303 of Regulation S–K, 17 CFR 229.303(c); and proposed Instruction 3 to Item 5.E. of Form 20–F, 17 CFR 249.220f.

[113] *Id.*

[114] *Id.*

[115] *Id.*

or should we require that it be integrated into the other discussions of financial condition, changes in financial condition, results of operations and liquidity and capital resources when the proposed disclosure is closely related to an aspect discussed in those separate sections of MD&A?

• Should other requirements relating to the language and format be added to the requirement for clear, concise and understandable disclosure? If so, what requirements?

I. Application to Foreign Private Issuers

In annual reports and registration statements filed with the Commission by foreign private issuers,[116] we propose to apply the same MD&A disclosure requirements regarding the application of accounting policies that would apply to U.S. companies.[117] Foreign private issuers, however, may present their financial statements either in accordance with U.S. GAAP, in accordance with GAAP of a foreign country, or in accordance with International Accounting Standards and International Financial Reporting Standards issued by the International Accounting Standards Committee and the International Accounting Standards Board. If financial statements are presented in accordance with non-U.S. GAAP, a reconciliation to U.S. GAAP accompanies them. The MD&A disclosure that foreign private issuers currently make in documents filed with the Commission [118] must focus on the primary financial statements, whether those are prepared in accordance with non-U.S. GAAP or U.S. GAAP, although the reconciliation also must be taken into account.[119]

The proposed MD&A disclosure regarding critical accounting estimates would do the same. If the primary financial statements were in non-U.S. GAAP, the company would have to consider critical accounting estimates in connection with both its primary financial statements and its reconciliation to U.S. GAAP. The reasons are essentially two. First, a company could make an accounting estimate under non-U.S. GAAP that would not constitute a critical accounting estimate or could use a method under non-U.S. GAAP that would not involve an estimate, but in applying U.S. GAAP in the reconciliation could be required to make different assumptions that involve highly uncertain matters therefore causing it to be highly susceptible to change where change would have a material impact. For example, non-U.S. GAAP may permit or require derivative instruments held as investments to be reported at cost (or not recognized), while U.S. GAAP would require the same instruments to be reported at fair value. If the instruments are not traded and therefore no quoted market prices are available, assumptions about highly uncertain matters would be required to estimate fair value for purposes of the reconciliation.

Second, a foreign private issuer could apply different accounting methods under U.S. GAAP than under non-U.S. GAAP, and while both may involve critical accounting estimates, they may do so for different reasons that investors would need to understand. For example, both non-U.S. GAAP and U.S. GAAP may require recognition of liabilities for environmental or mass tort claims. However, the methodologies, assumptions and judgments necessary to estimate the amount to recognize may be significantly different under the two different GAAPs. Thus, a foreign private issuer would be required also to include the proposed disclosure for any critical accounting estimate that is related to the application of U.S. GAAP.[120]

Similarly, the proposed MD&A disclosures about the initial adoption of accounting policies would focus on the primary financial statements but also take into account the reconciliation to U.S. GAAP. When a foreign private issuer initially adopts an accounting policy under non-U.S. GAAP, it may have different acceptable alternative principles available to it than it would if it were initially adopting an accounting policy under U.S. GAAP. Those alternatives may be unfamiliar to investors. Accordingly, we would require that the foreign private issuer provide the proposed disclosure about initial adoption in relation to its primary financial statements. Foreign private issuers also would be required to consider the reconciliation to U.S. GAAP. The reconciliation would not necessarily present an initial adoption of an accounting policy simply because the company is initially adopting a policy under non-U.S. GAAP. In the event that it does, however, and it has the requisite material impact on the foreign private issuer's financial presentation, we believe disclosure would be appropriate.

The Commission has fundamentally conformed the non-financial statement disclosure requirements for foreign private issuers to the non-financial statement disclosure requirements adopted by the International Organization of Securities Commissions (IOSCO).[121] The MD&A-equivalent provision is intended to mirror in substance the MD&A requirements for U.S. companies in Regulation S–K.[122] Our application of the proposed critical accounting estimates disclosure and the disclosure regarding initial adoption of an accounting policy to foreign private issuers is consistent with the current approach to MD&A. MD&A disclosure is narrative financial disclosure and the proposed MD&A disclosure can be viewed particularly as an important new aspect of financial disclosure.

Foreign private issuers are not required to submit quarterly reports on Form 10–Q or Form 10–QSB to the Commission. Instead, foreign private issuers submit information on Form 6–K, which encompasses only information that the issuer makes public under its home country requirements.[123] In addition, foreign private issuers are exempt from U.S. proxy and information statement disclosure

[116] Foreign private issuers are non-governmental foreign issuers that primarily are owned by non-U.S. investors or are primarily located, doing business and managed outside the U.S. *See* 17 CFR 240.3b–4. Foreign governments, and Canadian issuers filing reports and registration statements with the Commission pursuant to Canadian disclosure requirements under the Multijurisdictional Disclosure System with Canada, would be unaffected by the proposals.

[117] Under the proposals, the MD&A disclosure would apply to foreign private issuers regardless of whether they reconcile in accordance with Item 17 or Item 18 of Form 20–F.

[118] Item 5 in Form 20–F, the provision parallel to disclosure entitled ''MD&A'' for domestic issuers, is entitled ''Operating and Financial Review and Prospects.''

[119] Instruction 2 to Item 5 states that the ''discussion should focus on the primary financial statements presented in the document. You should refer to the reconciliation to U.S. GAAP, if any, and discuss any aspects of the differences between foreign and U.S. GAAP, not otherwise discussed in the reconciliation, that you believe are necessary for an understanding of the financial statements as a whole.''

[120] *See* proposed Instruction 2 to Item 5 of Form 20–F, 17 CFR 249.220f.

[121] See Securities Act Release No. 7745 (Sept. 28, 1999) [64 FR 53900].

[122] Although the wording of the MD&A requirement in Form 20–F was revised in 1999, the Commission's adopting release noted that we interpret that Item as calling for the same disclosure as Item 303 of Regulation S–K. *See* Securities Act Release No. 7745 (Sept. 28, 1999) [64 FR 53900 at 59304]. In addition, Instruction 1 to Item 5 in Form 20–F provides that issuers should refer to the Commission's 1989 interpretive release on MD&A disclosure under Item 303 of Regulation S–K (Securities Act Release No. 6835 (May 18, 1989) [54 FR 22427]) for guidance in preparing the discussion and analysis by management of the company's financial condition and results of operations required in Form 20–F.

[123] Many foreign country disclosure systems do not require quarterly reporting. Nonetheless, some registered foreign private issuers do report financial information on a quarterly basis. If a foreign regulatory authority were to adopt the proposed MD&A requirements, foreign private issuers subject to it would provide the information on Form 6–K.

requirements.[124] Thus, unless a foreign private issuer files a registration statement that must include interim period financial statements and related MD&A disclosure, it would not be required to update the proposed MD&A disclosure more frequently than annually. Foreign private issuers could, however, voluntarily disclose newly identified critical accounting estimates and any other material changes to the most recent MD&A disclosure on Form 6–K, and we encourage them to do so.

We request comment regarding the proposed MD&A disclosure of the application of critical accounting policies as it relates to foreign private issuers.

- Should we apply different standards for foreign private issuers with respect to the proposed MD&A disclosure?
- Are there specific items of the proposed disclosure that would be less appropriate for foreign private issuers? If so, what should substitute for that disclosure?
- Should we consider applying an updating requirement to the proposed critical accounting estimates disclosure for foreign private issuers that do not file quarterly reports? If so, what should trigger that updating requirement?
- Are there reasons to distinguish this aspect of MD&A disclosure when foreign private issuers otherwise may not prepare MD&A-equivalent disclosure on a quarterly basis?

J. Application to Small Business Issuers

Small business issuers[125] are permitted to register and report under somewhat different disclosure requirements than those applicable to larger companies. With respect to MD&A disclosure, the requirements for small business issuers and larger companies are substantially similar.[126] One exception, however, is that small business issuers that have not had revenues from operations in each of the last two fiscal years (or the last fiscal year and any interim period presented in the furnished financial statements) must provide business plan disclosure rather than MD&A disclosure.[127] Those small business issuers must discuss in the business plan disclosure matters such as: how they will satisfy their requirements for cash and raise additional funds in the next 12 months; planned product research and development in that period; expected acquisitions or dispositions of plant and significant equipment; and anticipated significant changes in the number of employees.

Under our proposals, we would not apply the new requirements for MD&A disclosure to the small business issuers disclosing their business plans instead of providing MD&A disclosure. We believe a modified approach is consistent with the objectives underlying the small business issuer disclosure system's alteration of the MD&A disclosure requirements for these companies. Thus, we would not add to the compliance burdens for these small companies. Small business issuers with a recent history of revenues would be required to provide the proposed MD&A disclosure.

We request comment regarding the application to small business issuers of the proposed MD&A disclosure.

- Should we require the proposed MD&A disclosure for small business issuers with no recent revenues even though MD&A disclosure by them is otherwise not required? If so, why?
- Are there modifications or simplifications to the proposed disclosure requirements that we could make, consistent with our ongoing simplification and reduction of burden for small business issuers, that still would achieve the goal of providing investors with an adequate understanding of the implications of management's critical accounting estimates and its initial adoption of accounting policies with a material impact?
- Should we create an exemption from the quarterly updating, or simplify it, for small business issuers?

K. Application of Safe Harbors for Forward-Looking Information

As we note in the proposed MD&A requirements, companies preparing disclosure under the proposal that would constitute a forward-looking statement should consider the conditions under which several existing safe harbors apply.[128] As defined in the relevant statutory provisions, a ''forward-looking statement'' generally is

- A statement containing a projection of revenues, income (or loss), earnings (or loss) per share, capital expenditures, dividends, capital structure, or other financial items;
- A statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;
- A statement of future economic performance, including any such statement contained in MD&A;
- Any statement of assumptions underlying or relating to any statement described in the three bullet points above; or
- Any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer.[129]

The Exchange Act and the Securities Act contain parallel safe harbor protection for forward-looking statements against private legal actions that are based on allegations of a material misstatement or omission.[130] In addition, two Commission rules under those Acts that pre-date the adoption of the statutory safe harbors also provide protection for forward-looking statements.

The statutory safe harbors provide three separate bases for a company to claim the protection against liability for forward-looking statements made in the company's MD&A. First, a forward-looking statement would fall within that safe harbor if it is identified as forward-looking and it is accompanied by meaningful cautionary statements that identify important factors that could cause actual results to differ materially from those in the forward-looking statement. Second, the safe harbor protects from private liability any forward-looking statement that is not material. Finally, the safe harbor precludes private liability if a plaintiff fails to prove that the forward-looking statement was made by or with the approval of an executive officer of the

[124] *See* 17 CFR 240.3a12–3(b).

[125] ''Small business issuer'' is defined to mean any entity that (1) has revenues of less than $25,000,000, (2) is a United States or Canadian issuer, (3) is not an investment company, and (4) if a majority-owned subsidiary, has a parent corporation that also is a small business issuer. An entity is not a small business issuer, however, if it has a public float (the aggregate market value of the outstanding equity securities held by non-affiliates) of $25,000,000 or more. *See* 17 CFR 228.10.

[126] *Compare* Item 303 of Regulation S–B, 17 CFR 228.303, to Item 303 of Regulation S–K, 17 CFR 229.303.

[127] *See* Item 303(a) of Regulation S–B, 17 CFR 228.303(a).

[128] *See* proposed Instruction 2 to Item 303 of Regulation S–B, 17 CFR 228.303; proposed Instruction 2 to Item 303(c) of Regulation S–K, 17 CFR 229.303(c); and proposed Instruction 2 to Item 5.E of Form 20–F, 17 CFR 249.220f.

[129] *See* 15 U.S.C. 77z–2 and 78u–5.

[130] While the statutory safe harbors by their terms do not apply to forward-looking statements included in financial statements prepared in accordance with U.S. GAAP, they do cover MD&A disclosures. The statutory safe harbors would not apply, however, if the MD&A forward-looking statement were made in connection with: an initial public offering, a tender offer, an offering by a partnership or a limited liability company, a roll-up transaction, a going private transaction, an offering by a blank check company or a penny stock issuer, or an offering by an issuer convicted of specified securities violations or subject to certain injunctive or cease and desist actions. *See* 15 U.S.C. 77z–2(b) and 78u–5(b).

company who had actual knowledge that it was false or misleading. The statutory safe harbors cover statements by reporting companies, persons acting on their behalf, outside reviewers retained by them, and their underwriters (when using information from, or derived from, the companies).

The Commission safe harbor rules that apply to forward-looking statements are Rule 175 under the Securities Act and Rule 3b–6 under the Exchange Act.[131] Under those rules, a forward-looking statement made by or on behalf of a company is deemed not to be a fraudulent statement if it is made in good faith and made or reaffirmed with a reasonable basis. The rule-based safe harbors apply to a company if it is a reporting company at the time it makes the forward-looking statement or if it is not a reporting company but it is making the statement in a Securities Act registration statement[132] or an Exchange Act registration statement. The safe harbors cover forward-looking statements in filed documents, in annual reports to shareholders and in Part 1 of Forms 10–Q and 10–QSB.[133]

Some of the proposed MD&A disclosure, but not all of it, would require a company to make forward-looking statements. For example, a company's disclosure of the reasonably possible, near-term changes in its most material assumption(s) underlying accounting estimates would qualify as forward-looking statements, but its quantitative disclosure of the changes it made to its accounting estimates during the past three years would not. Other examples of forward-looking statements that could be made in response to the proposed mandates are: A discussion of the assumptions underlying an estimate that involve, for example, projections of future sales; and a discussion of the expected effect if a known uncertainty were to come to fruition and result in a change in management's assumptions.

In light of the forward-looking statements that would be required, we propose to delete the statements in the existing MD&A rules that indicate that companies are not required to make forward-looking statements under those rules.[134] New Instructions would note that forward-looking statements are required, provide some examples of required forward-looking statements and alert companies preparing the proposed MD&A disclosure to consider the terms, conditions and scope of the safe harbors in drafting their disclosure.

We request comment regarding the application of safe harbors for forward-looking information to the proposed MD&A disclosure.

- Is there any need for further guidance from the Commission with respect to the application of either the statutory or rule safe harbors?

IV. General Request for Comment

The Commission is proposing these amendments to the MD&A requirements to improve the quality and relevance of explanatory disclosure about a company's financial condition, changes in financial condition, results of operations and reasonably likely trends, demands, commitments, events and uncertainties affecting a company. We welcome your comments. We solicit comment, both specific and general, upon each component of the proposals. If you would like to submit written comments on the proposals, to suggest additional changes or to submit comments on other matters that might affect the proposals, we encourage you to do so.

We also solicit comment on the following general aspects of the proposals:

- Is the additional information elicited by the proposals useful to investors, other users of company disclosure and readers of a company's financial statements? If not, how can it be improved to achieve that goal?
- In addition to the requirements we propose, are there particular aspects of critical accounting estimates or their development or impact that the proposals should specifically require companies to address? If so, what are they?
- In addition to the requirements we propose, are there particular aspects concerning a company's initial adoption of an accounting policy that the proposals should specifically require companies to address? If so, what are they?
- Is disclosure necessary concerning the procedures that management follows in selecting its critical accounting estimates? If so, what additional disclosure should be provided?
- Is additional disclosure or regulation necessary or appropriate concerning the role of the audit committee in discussing the critical accounting estimates and the disclosure about them that management drafts?
- In addition to the proposed disclosure, should we adopt a specific requirement that a company must provide any other information that is needed to make the proposed disclosure reflective of management's view of the critical accounting estimates and the initially adopted policies being discussed?
- For critical accounting estimates of fair value, should we mandate the example in FR–61 [135] as part of these rules? If yes, do other areas exist for which that type of detailed disclosure would be appropriate?
- If the proposed disclosure would involve competitive or other sensitive information, are there any mechanisms that would ensure full and accurate disclosure while reducing a company's risk of competitive harm?
- Are there some aspects of the proposed disclosure that should be retained while eliminating other parts of the proposed disclosure? We solicit comment on the desirability of adopting some sections of the proposed rules, but not all sections.

Any interested person wishing to submit written comments on any aspect of the proposals, as well as on other matters that might have an impact on the proposals, is requested to do so. In addition, we request comment on whether any further changes to our rules

[131] *See* 17 CFR 230.175 and 17 CFR 240.3b–6. Forward-looking statements covered by the safe harbors under Rules 175 and 3b–6 are:

- Projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure, other financial items;
- Management's plans and objectives for future operations;
- Statements of future economic performance in MD&A and
- Statements of assumptions underlying or relating to any of the above.

[132] Thus, unlike the statutory safe harbors, the Rule 175 safe harbor would protect MD&A forward-looking statements made in a registration statement or prospectus for an initial public offering.

[133] The rule safe harbors also cover statements that reaffirm forward-looking statements made in those documents and forward-looking statements made prior to filing or submission of those documents that are reaffirmed in those documents.

In addition to the statutory and rule safe harbors directed at forward-looking statements, companies preparing the proposed MD&A disclosure also could be protected by the ''bespeaks caution'' legal doctrine that has developed through case law and is recognized by most circuit courts of appeal. *See, e.g., Lilley* v. *Charren,* 2001 U.S. App. LEXIS 19430 (9th Cir. 2001); *EP Medsystems, Inc.* v. *Echocath Inc.,* 235 F.3d 865; (3d Cir. 2000); *Parnes* v. *Gateway 2000,* 122 F.3d 539 (8th Cir. 1997). The bespeaks caution doctrine recognizes that forecasts, projections and expectations must be read in context and that accompanying cautionary language can render a misstatement or omission immaterial or render a plaintiff's reliance on it unreasonable. For a forward-looking statement to be covered by the bespeaks caution doctrine, there must be adequate cautionary language that warns investors of the potential risks related to the forward-looking statement.

[134] *See* Instruction 2 to Item 303 of Regulation S–B, 17 CFR 228.303; Instruction 7 to Item 303(a) of Regulation S–K, 17 CFR 229.303(a); Instruction 6 to Item 303(b) of Regulation S–K, 17 CFR 229.303(b); and Instruction 3 to Item 5 of Form 20–F, 17 CFR 249.220f.

[135] *See* Securities Act Release No. 8056, FR–61 (Jan. 22, 2002)[67 FR 3746], Section II.B. (providing an example of a critical accounting estimate related to non-exchange-traded contracts accounted for at fair value).

and forms are necessary or appropriate to implement the objectives of the proposals. Please submit three copies of your comment letter to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609. You may also submit comments electronically to the following e-mail address: *rule-comments@sec.gov.* [136] All comments should refer to file number S7–16–02. If you are commenting by e-mail, include this file number in the subject line. We will make comments available for public inspection and copying in the Commission's public reference room at 450 Fifth Street, NW, Washington, DC 20549–0102. In addition, we will post electronically submitted comments on our Internet website (*www.sec.gov*).

V. Paperwork Reduction Act

A. Background

The proposed amendments to Regulations S–B, S–K [137] and Form 20–F contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[138] We are submitting the proposal to the Office of Management and Budget (''OMB'') for review in accordance with the PRA.[139] The titles for the collections of information are:

(1) ''Form S–1'' (OMB Control No. 3235–0065);

(2) ''Form F–1'' (OMB Control No. 3235–0258);

(3) ''Form SB–2'' (OMB Control No. 3235–0418);

(4) ''Form S–4'' (OMB Control No. 3235–0324);

(5) ''Form F–4'' (OMB Control No. 3235–0325);

(6) ''Form 10'' (OMB Control No. 3235–0064);

(7) ''Form 10–SB'' (OMB Control No. 3235–0419);

(8) ''Form 20–F'' (OMB Control No. 3235–0288);

(9) ''Form 10–K'' (OMB Control No. 3235–0063);

(10) ''Form 10–KSB'' (OMB Control No. 3235–0420);

(11) ''Proxy Statements—Regulation 14A (Commission Rules 14a–1 through 14a–15) and Schedule 14A'' (OMB Control No. 3235–0059);

(12) ''Information Statements—Regulation 14C (Commission Rules 14c–1 through 14c–7 and Schedule 14C)'' (OMB Control No. 3235–0057);

(13) ''Form 10–Q'' (OMB Control No. 3235–0070);

(14) ''Form 10–QSB'' (OMB Control No. 3235–0416);

(15) ''Regulation S–K'' (OMB Control No. 3235–0071); and

(16) ''Regulation S–B'' (OMB Control No. 3235–0417).

These regulations and forms were adopted pursuant to the Securities Act and the Exchange Act and set forth the disclosure requirements for annual and quarterly reports, registration statements and proxy and information statements filed by companies to ensure that investors are informed. The hours and costs associated with preparing, filing, and sending these forms constitute reporting and cost burdens imposed by each collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

Under the proposals, we would require companies to include a discussion of the application of critical accounting policies in the MD&A section of annual reports, registration statements and proxy and information statements and make updates to some of that disclosure quarterly. We believe that the proposed MD&A disclosure would provide investors with a better understanding of management's application of accounting policies and how those accounting policies affect the financial statements. We believe this disclosure would increase transparency regarding financial disclosure. Compliance with the revised disclosure requirements would be mandatory. There would be no mandatory retention period for the information disclosed, and responses to the disclosure requirements would not be kept confidential.

We estimate the annual incremental paperwork burden for all companies to prepare the disclosure that would be required under our proposals to be approximately 781,911 hours and a cost of approximately $98,467,000.[140] We estimated the average number of hours each entity spends completing the form and the average hourly rate for outside professionals from discussions with persons regularly involved in completing the forms.[141]

B. Registration Statements

Table 1 below illustrates the total annual compliance burden of the proposed collection of information in hours and in cost for registration statements under the Securities Act and the Exchange Act. The burden was calculated by multiplying the estimated number of responses by the estimated average number of hours each entity spends completing the form. We have based our estimated number of annual responses on the actual number of filers during the 2001 fiscal year. We have estimated that, based on a three-year sample period, the average amount of time it would take to prepare the application of critical accounting policies disclosure for registration statements would be approximately 34 hours.

To determine the average total number of hours each entity spends completing each form, we added the estimated hour increment discussed below to the current burden hour estimate for each form reported to OMB. For registration statements, we estimate that 25% of the burden of preparation is carried by the company internally and that 75% of the burden of preparation is carried by outside professionals retained by the company at an average cost of $300 per hour. The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the company internally is reflected in hours. The incremental cost of outside professionals for registration statements would be approximately $22,811,000 per year and the incremental company burden would be approximately 25,345 hours per year. For purposes of our submission to OMB under the PRA, the total cost of outside professionals for registration statements would be approximately $3,740,773,000 per year and the company burden would be approximately 4,156,415 hours per year.

To determine a new PRA burden per form that would accurately reflect the amount of respondents required to prepare the new disclosure, we adjusted the 34-hour incremental burden for some of the forms of registration statements. For the other registration statements in Table 1, we used the 34-

[136] For more information on how to submit comments electronically, *see www.sec.gov/rules/submitcomments.htm.*

[137] While we are proposing amendments to Regulations S–B and S–K, the burden is imposed through the forms that refer to the disclosure regulations. To avoid a Paperwork Reduction Act inventory with duplicative burdens, we estimate the burdens imposed by Regulations S–B and S–K to be one hour.

[138] 44 U.S.C. 3501 *et seq.*

[139] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

[140] For convenience, the estimated PRA hour burdens have been rounded to the nearest whole number, and the estimated PRA cost burdens have been rounded to the nearest $1,000.

[141] In connection with this rulemaking, we have contacted a few companies to obtain cost estimates for preparing the proposed disclosure. Also, in connection with other recent rulemakings, we have had discussions with several private law firms to estimate an hourly rate of $300 as the cost of outside professionals that assist companies in preparing these disclosures.

hour burden estimate. We adjusted the incremental burden to account for the fact that some registration statements allow incorporation by reference, and other forms would not require the company to substantially change a previously prepared MD&A.[142] We have adjusted the incremental burden for Forms S–1, F–1, S–4 and F–4 in recognition of the fact that many repeat issuers complete these forms.[143] A repeat issuer (who is already a reporting company) would not have to prepare an entirely new MD&A for each new registration statement because it would have already prepared MD&A for its periodic reports.

To account for this, we estimate that 40% of the Forms S–1, 65% of Forms F–1, 38% of Forms S–4 and 34% of Forms F–4 would be required to carry the full burden of preparing entirely new MD&A disclosure about the application of critical accounting policies.[144] To reflect the fact that the proposed disclosure would only be prepared anew for a subset of the total forms filed, yet the collection burden is calculated and submitted to OMB for 100% of the forms filed, we reduced the incremental burden hours for the above forms by the percentage of respondents who would not be required to carry the full burden of preparing new disclosure about the application of critical accounting policies. Therefore, we estimate that the average annual incremental burden for all Forms S–1 would be 14 hours per form, which is approximately 40% of the 34-hour burden estimate for preparing the disclosure. We estimate that the average annual incremental burden for all Forms F–1 would be 22 hours per form, which is approximately 65% of the 34-hour burden estimate for preparing the disclosure. We estimate that the average annual incremental burden for all Forms S–4 would be 13 hours per form, which is approximately 38% of the 34-hour burden estimate for preparing the disclosure. Finally, we estimate that the average annual incremental burden for all Forms F–4 would be 12 hours per form, which is 34% of the 34-hour burden estimate for preparing the disclosure.

TABLE 1.—REGISTRATION STATEMENTS

[Columns in bold are the PRA burdens submitted to OMB]

	Annual responses	Total hours/form	Total burden	**25% Company**	75% Professional	**$300 Prof. cost**
	(A)	(B)	(C)=(A)*(B)	**(D)=(C)*0.25**	(E)=(C)*0.75	**(F)=(E)*$300**
S–1	452	1,742	787,384	**196,846**	590,538	**$177,161,000**
F–1	48	1,905	91,440	**22,860**	68,580	**20,574,000**
SB–2	698	582	406,236	**101,559**	304,677	**91,403,000**
S–4	3,774	3,973	14,994,102	**3,748,526**	11,245,577	**3,373,673,000**
F–4	211	1,323	279,153	**69,788**	209,365	**62,810,000**
Form 10	91	126	11,466	**2,867**	8,600	**2,580,000**
10–SB	458	122	55,876	**13,969**	41,907	**12,572,000**
Total			16,625,657	**4,156,415**		**3,740,773,000**

C. Annual Reports and Proxy/Information Statements

Table 2 below illustrates the total annual compliance burden of the collection of information in hours and in cost for annual reports and proxy and information statements under the Exchange Act. The burden was calculated by multiplying the estimated number of responses by the estimated average number of hours each entity spends completing the form. We have based our estimated number of annual responses on the actual number of filers during the 2001 fiscal year. We have estimated that, based on a three-year sample period, the average amount of time it would take to prepare disclosure about the application of critical accounting policies for annual reports and proxy and information statements would be approximately 29 hours.

To determine the average total number of hours each entity spends completing each form, we added the 29-hour increment to the current burden hours estimated for each form. For Exchange Act reports and proxy and information statements, we estimate that 75% of the burden of preparation is carried by the company internally and that 25% of the burden of preparation is carried by outside professionals retained by the company at an average cost of $300 per hour.[145] The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the company internally is reflected in hours. The incremental cost of outside professionals for annual reports and proxy/information statements would be approximately $32,508,000 per year and the incremental company burden would be approximately 325,083 hours per year. For purposes of our submission to OMB under the PRA the total cost of outside professionals for annual reports and proxy/information statements would be approximately $1,738,387,000 per year and the company burden would be approximately 17,383,796 hours per year.

To determine the average total number of hours each entity spends completing each form, we added the estimated hour increment discussed above to the current burden hour estimate for each form reported to OMB. We made one exception, however, with respect to Schedules 14A and 14C. Those schedules only require MD&A in three situations: (1) The modification of any class of securities of the company; (2) the issuance or authorization for issuance of securities of the company; or (3) mergers, consolidations, acquisitions and similar matters.[146] In addition, many of these Schedules are filed by reporting companies. Because in many

[142] We have not included registration statements where a registrant fulfills its MD&A disclosure obligation entirely through incorporation by reference (such as Forms S–3 and S–2).

[143] In addition, Forms S–4 and F–4 allow for incorporation by reference when the issuer would be eligible.

[144] We derived these percentages from the proportion of new issuers to total issuers derived from our internal database.

[145] This allocation of the burden is a departure from our past PRA submissions for Exchange Act periodic reports and proxy and information statements, for which we estimated that the company carried 25% of the burden internally and 75% of the burden of preparation was carried by outside professionals retained by the company. We believe that this new allocation more accurately reflects current practice for annual and quarterly reports and proxy and information statements.

[146] *See* Items 11, 12 and 14 of Schedule 14A, 17 CFR 240.14a–101.

instances reporting companies would have previously prepared MD&A for their periodic reports, we estimate that 5% of Schedules 14A and 14C would require a company to prepare an entirely new MD&A.[147] To reflect the fact that only the above percentage would require new disclosure, yet the collection burden is calculated and submitted to OMB for 100% of the Schedules filed, we reduced the incremental burden hours for Schedules 14A and 14C by the percentage of respondents who would not be required to carry the full burden of preparing new disclosure about the application of critical accounting policies. Therefore, we estimate that the average annual incremental burden for these forms would be approximately 2 hours, which is approximately 5% of the 34-hour burden estimate for registration statements.

TABLE 2.—ANNUAL REPORTS AND PROXY/INFORMATION STATEMENTS

[Columns in bold are the PRA burdens submitted to OMB]

	Annual responses	Total hours/form	Total burden	**75% Company**	25% Professional	**$300 Prof. Cost**
	(A)	(B)	(C)=(A)*(B)	**(D)=(C)*0.75**	(E)=(C)*0.25	**(F)=(E)*$300**
20–F	1,177	1,752	2,062,104	**1,546,578**	515,526	**$154,658,000**
10–K	9,384	1,749	16,412,616	**12,309,462**	4,103,154	**1,230,946,000**
10–KSB	3,789	1,205	4,565,745	**3,424,309**	1,141,436	**342,431,000**
SCH 14A	8,239	16	131,824	**98,868**	32,956	**9,887,000**
SCH 14C	407	15	6,105	**4,579**	1,526	**458,000**
Total			23,178,394	**17,383,796**		**1,738,380,000**

D. Quarterly Reports

Table 3 below illustrates the total annual compliance burden of the collection of information in hours and in cost for quarterly reports under the Exchange Act. The burden was calculated by multiplying the estimated number of responses by the estimated average number of hours each entity spends completing the form. We have based our estimated number of annual responses on the actual number of filers during the 2001 fiscal year. We have estimated that, based on a three-year sample period, the average amount of time it would take each year to add the new disclosures would be 15 hours per form for each company.[148]

To determine the average total number of hours each entity spends completing each form, we added the 15-hour increment to the current burden hours for each form. For quarterly reports, we estimate that 75% of the burden of preparation is carried by the company internally and that 25% of the burden of preparation is carried by outside professionals retained by the company at an average cost of $300 per hour. The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the company internally is reflected in hours. Additionally, there would be no change to the estimated burden of the collection of information entitled ''Regulation S–B'' and ''Regulation S–K'' because the burdens are already reflected in our estimates for the forms. The incremental cost of outside professionals for quarterly reports would be approximately $43,148,000 per year and the incremental company burden would be approximately 431,483 hours per year. For purposes of our submission to OMB under the PRA, the total cost of outside professionals for quarterly reports and Regulation S–K and S–B would be approximately $427,395,000 per year and the company burden would be 4,273,945 hours per year.

TABLE 3.—QUARTERLY REPORTS AND REGULATIONS S–K AND S–B

[Columns in bold are the PRA burdens submitted to OMB]

	Annual responses	Total hours/form	Total burden	**75% Company**	25% Professional	**$300 Prof. Cost**
	(A)	(B)	(C)=(A)*(B)	**(D)=(C)*0.75**	(E)=(C)*0.25	**(F)=(E)*$300**
10–Q	26,746	151	4,038,646	**3,028,985**	1,009,662	**$302,899,000**
10–QSB	11,608	143	1,659,944	**1,244,958**	414,986	**124,496,000**
Regulation S–K	0	1	1	**1**	0	**0**
Regulation S–B	0	1	1	**1**	0	**0**
Total				**4,273,945**		**427,395,000**

E. Solicitation of Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), we solicit comments to: (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of our estimate of the burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection

[147] That percentage is our best estimate based on our belief that the percentage of companies that file Schedules 14A and 14C that would actually be required to carry the full burden of preparing the proposed disclosure would be minimal.

[148] That estimate assumes that all U.S. reporting companies would have material updates to disclosure about critical accounting estimates in each quarter.

techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609, with reference to File No. S7–16–02. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–16–02, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is assured of having its full effect if OMB receives it within 30 days of publication.

VI. Cost-Benefit Analysis

A. Background

The Commission is proposing disclosure rules to address investors' increasing demand for greater transparency with respect to the application of companies' accounting policies and their effects. The proposed disclosure about the application of critical accounting policies encompasses a company's critical accounting estimates and its initial adoption of accounting policies that have a material impact. While the existing disclosure requirements in GAAP result in some basic disclosure of a company's material changes in accounting estimates, initial adoption of accounting policies and risks and uncertainties that may materially affect the financial statements, the proposals would require companies to provide more comprehensive information and analysis about a company's application of critical accounting policies. Because of the potential impact of a company's critical accounting policies and the subjectivity and complexity involved, they are important for investors' understanding of a company's overall financial condition, changes in financial condition and results of operations. The proposals would require companies that are reporting, raising capital in the registered public markets or asking shareholders for their votes to identify their critical accounting estimates and their initial adoption of material accounting policies. For those applications, a company would provide a meaningful analysis of their impact in the ''Management's Discussion and Analysis'' section of the disclosure documents.

B. Objectives of Proposed Disclosure of Critical Accounting Estimates

Beyond the disclosure of the application of accounting policies provided for in the accounting literature, our proposals would provide additional key information in MD&A that enhances understanding of a company's financial statements, and provides information about the quality of, and potential variability of, a company's earnings. Our proposals would give management the impetus to discuss candidly, and provide insight into, the company's critical accounting estimates and its initial adoption of accounting policies that have a material impact. Our proposals are expected to increase investor understanding, to enhance the ability of investors to make informed investment decisions and to allocate capital on a more efficient basis.

C. Alternative Regulatory Approaches

We considered alternative regulatory actions for achieving the proposed disclosure and greater transparency of a company's application of critical accounting policies. We considered encouraging companies to provide disclosure regarding the application of critical accounting policies.[149] Although some public companies are voluntarily providing more detailed information in their financial statements, it has been noted that some companies generally have not been providing investors with the desired level of detail in their disclosure. To stimulate higher quality disclosures regarding the application of critical accounting policies, we are proposing mandated disclosures.

The proposed mandated disclosures are likely to result in a more focused and descriptive discussion of the company's critical accounting estimates and initial adoption of accounting policies that have a material impact. In addition, mandated disclosures regarding the application of critical accounting policies should benefit investors because the enumerated disclosure under the proposed rule would likely be more comparable across all firms and consistent over time.[150]

In addition to voluntary disclosure, we considered various methods of mandating this disclosure to the public. We are proposing what we believe to be the least onerous method that retains the primary benefit of increased transparency. One alternative approach we considered was to change accounting rules regarding the presentation of financial statements to require more disclosure in the financial statements with respect to the application of critical accounting policies. Another approach we considered was to require companies to file schedules of all accounting estimates as exhibits to their quarterly and annual filings. These schedules would contain a demonstration of how a company calculated each estimate.

Unlike these alternative approaches, we believe that the placement of the proposed disclosure in the MD&A would encourage management to provide more insightful disclosure in a manner more understandable to the average investor than these other disclosure alternatives.

We solicit comment with respect to alternative regulatory approaches.

- Is there evidence that market forces would elicit the disclosures we are proposing?[151]
- What are the relative costs and benefits of pursuing these or other alternative regulatory solutions to elicit disclosure of the application of critical accounting policies?

D. Potential Benefits of the Proposed Rules

The primary anticipated benefit of the proposed rules is to increase transparency of the financial condition, changes in financial condition and operating results of companies and to reduce the information asymmetry between management and investors. Current market events have evidenced a need to provide investors with a clearer understanding of where a company's accounting policies, estimates, assumptions and methodologies materially affect the financial statements

[149] *See* Securities Act Release No. 8040, FR–60 (Dec. 12, 2001) [66 FR 65013]. *See also* Securities Act Release No. 8056, FR–61 (Jan. 22, 2002) [67 FR 3746].

[150] *See generally,* Kothari, S., *Capital Markets Research In Accounting,* 31 Journal of Accounting and Economics 105 (2001). This author suggests that mandated disclosures provide useful information to markets reducing information processing costs for investors by providing for consistent, comparable disclosures.

[151] *See generally,* Healy, P. and K. Palepu, *Information Asymmetry, Corporate Disclosure And Capital Markets: A Review Of The Empirical Disclosure Literature,* 31 Journal of Accounting and Economics 405 (2001). The authors argue that one reason why firms are reluctant to disclose voluntarily is that they face significant proprietary and litigation costs.

when they are prepared.[152] The proposed disclosure is intended to enhance the quality of the disclosure in the MD&A section by providing more information about management's insight into the company. By making information about the application of critical accounting policies and their implications on the presentation of the company's financial position available and more understandable, the proposals would benefit investors both directly and indirectly through the financial analysts and the credit rating agencies whose analyses investors consider. Greater transparency would thus enable investors to make more informed investment decisions and to allocate capital on a more efficient basis.

As a secondary benefit to investors, a possible by-product of the proposed MD&A disclosure may be to deter improper accounting practices by some companies. For example, the proposed disclosure of critical accounting estimates could make inappropriate earnings management more difficult because it could be easier to detect. The proposed disclosure could also assist investors in evaluating management's performance. With the proposed disclosure, an investor may be better able to judge whether management applies the company's accounting policies either aggressively or conservatively.

Another possible beneficial by-product of the proposed MD&A disclosure could be to increase the discipline and oversight of management in their application of a company's critical accounting policies. In order to prepare the disclosure, management would be required to review and explain the company's application of accounting policies, and the reasonably likely impact. The proposed disclosure could increase management's motivation to exercise greater discipline in applying the company's accounting policies because the material assumptions and methodologies would be more transparent and subject to greater investor scrutiny. In light of this possibility, both auditors and audit committees may also improve their oversight of the application of critical accounting policies.

We solicit comment with respect to the potential benefits of the proposed MD&A disclosure.

- We solicit quantitative data to assist our assessment of the benefits of identifying critical accounting estimates and analyzing their effects on the financial statements and explaining the initial adoption of material accounting policies and their impacts in the manner proposed.
- Would the proposed disclosure serve as a deterrent for improper accounting practices?

E. Potential Costs of Proposed Rules

1. Costs of Preparing Disclosure

We estimate that proposed rules would impose a new disclosure requirement on approximately 14,000 public companies.[153] 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. We estimate that the disclosure would involve multiple parties, including in-house preparers, senior management, in-house counsel, outside counsel, outside auditors, and audit committee members. For purposes of the Paperwork Reduction Act,[154] we estimated that company personnel would spend approximately 780,000 hours per year (56 hours per company) to prepare, review and file the proposed disclosure. Based on our estimated cost of in-house staff time, we estimated the PRA hour-burden would translate into an approximate cost of $98,000,000 ($7,000 per company).[155] We also estimated that companies would spend approximately $98,000,000 ($7000 per company) on outside professionals to comply with the disclosure.[156] We also estimate that companies will incur some additional printing and dissemination costs.[157] We are unable to estimate the potential printing and dissemination costs because there is a wide possible range of paper and ink available and different companies will print a different number of reports depending on their shareholder base.

While companies may face increased costs associated with the preparation, review, filing, printing and dissemination of these disclosures, we believe our proposals would not substantially increase the costs to collect the information necessary to prepare the proposed disclosure. This information should largely be readily available from each company's books and records. Since management must calculate accounting estimates and apply initially adopted accounting policies to prepare the required financial statements, the proposed disclosure may not impose significant incremental costs for the collection and calculation of data. In addition, management is likely to already conduct analysis of the application of the company's accounting policies in the course of managing the business activities of the company. We recognize that management does not currently describe its analysis and is likely to confer with legal counsel in drafting the disclosure. Because of the wide variance among public companies, it is difficult to estimate the average cost. We did contact a few companies that voluntarily had provided information about critical accounting policies in their 2001 Form 10-Ks. They indicated that preparation of the proposed disclosure would cost from approximately $5,000 to $500,000 per year.

We solicit comment regarding the potential cost of compliance with the proposals.

- What types of expenses would companies incur in order to comply with the proposed disclosure requirements?
- What would the average printing and dissemination costs be for each firm?
- We solicit quantitative data to assist our assessment of the compliance costs of identifying critical accounting estimates and the initial adoption of accounting policies that have a material impact and analyzing their effects on the financial statements in the manner proposed.

2. Competitive Harm

There is some possibility that a company's competitors could be able to infer proprietary or sensitive information from disclosure about management's application of critical accounting policies under our proposals. To the extent that all companies make the proposed disclosure, that impact may diminish.

We solicit comment regarding possible competitive harm.

- To what degree would our proposed disclosure requirements create competitively harmful effects upon public companies?

[152] *See generally,* Marcia Vickers, Mike McNamee et. al, *The Betrayed Investor*, BusinessWeek, Feb. 25, 2002 at 105.

[153] We derived this estimate by assessing the number of registrants who filed annual reports last year, and subtracting an estimated number of small business issuers who we expect would not be required to provide the disclosure.

[154] 44 U.S.C. § 3501 *et seq.*

[155] This cost estimate is based on data obtained from *The SIA Report on Management and Professional Earnings in the Securities Industry* (Oct. 2001).

[156] To derive our estimates for the Paperwork Reduction Act, we multiplied the number of filers for each form by the incremental hours per form. The portion of the product carried by the company is reflected in hours and the portion carried by outside professionals is reflected as a cost.

[157] *See generally,* Del Jones, *Companies Beef up their Annual Reports*, USA Today, Mar. 12, 2002 at 1B.

• How could we minimize those effects?

3. Perception of Increased Liability

With any new disclosure mandate, there may be an increased chance that a company could include a materially misleading statement or a material omission in its disclosure document. A company may be concerned that it could be subjected to increased liability due to the disclosure required by the proposed rules. For example, one aspect of our proposed rules would require a quantitative and qualitative analysis to depict the effects of changing a critical accounting estimate. Companies may believe that this disclosure would subject them to potential liability if actual changes to the critical accounting estimates affect line items and overall financial performance to a greater or lesser degree than disclosed. Companies may particularly be concerned with the potential liability when required disclosure is forward-looking in nature.

In part to help alleviate this perception, we are proposing the new disclosure be included in the MD&A section—a section *not* excluded from the coverage of the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995.[158] Those safe harbors were designed to help companies reduce the costs of litigation relating to those types of statements. The PSLRA safe harbors, as well as those provided by existing Commission Rules 175 and 3b–6 and the ''bespeaks caution'' legal doctrine created by the courts, should reduce potential litigation costs of companies that craft the disclosure under the proposed rules to meet the conditions of those safe harbors and that doctrine.

We are soliciting comment with regard to the perception of increased liability.

• What are the potential litigation and liability costs that would be associated with the proposed disclosure requirements?

F. Small Business Issuers

We have proposed to require that those small business issuers that must currently make MD&A disclosure also must provide disclosure about the application of critical accounting policies. Small business issuers that are not currently required to prepare MD&A would not be subject to the proposed MD&A disclosure. Thus, only small business issuers that have generated revenues in the past two years would be required to disclose the proposed information about their application of critical accounting policies. The proposals would not impose additional costs for start-up and early stage businesses at a time when they need their resources for growth. We believe the burden on small firms may be less significant overall because these firms would be likely to have fewer critical accounting estimates. We do not have specific data, however, with respect to that assumption.

We ask commenters to provide us with data to estimate the costs of the proposed regulations for small business issuers.

• Would small business issuers on average have fewer critical accounting estimates to discuss?

• Who would prepare the disclosure for small business issuers?

• What types of expenses would be incurred to prepare this disclosure?

G. Foreign Private Issuers

We propose to apply to foreign private issuers the same MD&A disclosure requirements regarding the application of critical accounting policies that would apply to U.S. companies. Foreign private issuers, however, may present their financial statements either in accordance with U.S. GAAP, in accordance with GAAP of a foreign country, or in accordance with International Accounting Standards and International Financial Reporting Standards issued by the International Accounting Standards Committee and the International Accounting Standards Board. If financial statements are presented in accordance with non-U.S. GAAP, a reconciliation to U.S. GAAP accompanies them. If the primary financial statements were in non-U.S. GAAP, the company would have to consider the application of critical accounting policies in connection with both its primary financial statements and its reconciliation to U.S. GAAP. Therefore, foreign private issuers may incur additional costs with regard to the proposed disclosure because of possible additional disclosure regarding the reconciliation to U.S. GAAP.

Offsetting this additional cost, however, is the fact that foreign private issuers would not be required to submit quarterly reports on Form 10–Q or Form 10–QSB to the Commission. In addition, foreign private issuers are exempt from U.S. proxy and information statement disclosure requirements.[159] Thus, unless a foreign private issuer files a registration statement that must include interim period financial statements and related MD&A disclosure, it generally would not be required to update the proposed MD&A disclosure more frequently than annually. Therefore, the overall cost of compliance could be lower for foreign private issuers than for U.S. companies.

We ask commenters to provide us with data to estimate the costs of the proposed regulations for foreign private issuers.

• On average, would the U.S. GAAP reconciliation cause foreign private issuers to have more critical accounting estimates and more initial adoptions of accounting policies to discuss than a U.S. company? If so, how many more?

H. Request for Comments

To assist the Commission in its evaluation of the costs and benefits of the proposed disclosure discussed in this release, we request that commenters provide views and data relating to any costs and benefits associated with the proposed rules.

VII. Effects on Efficiency, Competition and Capital Formation

Section 23(a)(2) of the Exchange Act[160] requires us, when adopting rules under the Exchange Act, to consider the anti-competitive effects. The proposed rules are intended to make information about the application of critical accounting policies and their implications for the presentation of a company's financial condition, changes in financial condition and operating results more understandable to investors. We have identified one possible area where the proposed rules could potentially place a burden on competition. In our cost-benefit analysis above, we note that there is some possibility that a company's competitors could be able to infer proprietary or sensitive information from disclosure about management's application of critical accounting policies under our proposals. To the extent that all companies make the proposed disclosure, that impact may diminish. In our cost-benefit analysis above, we request comment regarding the degree to which our proposed disclosure requirements would create competitively harmful effects upon public companies, and how to minimize those effects. We request comment on any disproportionate cross-sectional burdens among the firms affected by our proposals that could have anti-competitive effects.

Section 2(b) of the Securities Act[161] and Section 3(f) of the Exchange Act[162]

[158] Pub. L. No. 104–67, 109 Stat. 737 (1995).

[159] *See* 17 CFR 240.3a12–3(b).

[160] 15 U.S.C. § 78w(a)(2).

[161] 15 U.S.C. 77b(b).

[162] 15 U.S.C. 78c(f).

require us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation. We believe the proposed disclosure may promote market efficiency by making information about the application of critical accounting policies, and their impact on the presentation of the company's financial position, more understandable. As a result, we believe that investors may be able to make more informed investment decisions and capital may be allocated on a more efficient basis. In addition, we believe this disclosure would assist investors in evaluating management. The possibility of these effects, their magnitude if they were to occur and the extent to which they would be offset by the costs of the proposals are difficult to quantify. We request comment on these matters and how the proposed amendments, if adopted, would affect efficiency and capital formation. Commenters are requested to provide empirical data and other factual support to the extent possible.

VIII. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. 603. It relates to proposed revisions to Item 303 of Regulation S–K,[163] Item 303 of Regulation S–B [164] and Item 5 of Form 20–F.[165] The proposals require a company to discuss the application of critical accounting policies. The new disclosure would be included in the MD&A section of a company's annual reports, registration statements and proxy and information statements. Companies would be required to update the portion of the proposed MD&A information about critical accounting estimates by disclosing material changes quarterly on Form 10–Q or Form 10–QSB.

A. Reasons for the Proposed Action

The requirements of GAAP for disclosure in financial statements and the current requirements in MD&A have not resulted in the type of discussion of the application of critical accounting policies that our proposals would require. The potential consequences of not taking this action to require disclosure regarding the application of critical accounting policies are: (a) Less transparency in the presentation of companies' financial statements and, correspondingly, a lesser understanding of companies' financial condition, changes in financial condition and results of operations when making investment decisions; and (b) a potential decrease in investor confidence in the full and fair disclosure system that is the hallmark of the U.S. capital markets.

B. Objectives

Beyond the disclosure of the application of accounting policies provided for in the accounting literature, our proposals would provide additional key information in MD&A that enhances understanding of a company's financial statements, and provides information about the quality of, and potential variability of, a company's earnings. Our proposals would give management the impetus to discuss candidly, and provide insight into, the company's application of critical accounting policies. We believe that our proposals may increase investor understanding, enhance the ability of investors to make informed investment decisions and allocate capital on a more efficient basis.

C. Legal Basis

We are proposing the amendments under the authority set forth in Sections 7, 10 and 19 of Securities Act of 1933 and Sections 12, 13, 14 and 23 of the Securities Exchange Act of 1934.

D. Small Entities Subject to the Proposed Regulation and Rules

The proposals would affect companies that are small entities. Exchange Act Rule 0–10(a) [166] and Securities Act Rule 157 [167] define a company, other than an investment company, to be a ''small business'' or ''small organization'' if it had total assets of $5 million or less on the last day of its most recent fiscal year. As of February 20, 2002, we estimated that there were approximately 2,500 companies, other than investment companies, that may be considered small entities. The proposed disclosure requirements would apply to any small entity that fulfills its disclosure obligations by either complying with our standard disclosure requirements [168] or providing the ''Management's Discussion and Analysis'' disclosure item contained in our optional disclosure system available only to small businesses.[169] If a small entity elects to fulfill its disclosure obligations pursuant to our optional disclosure system for small businesses, it would be required to comply with our proposed rule only if it had revenues during the past two fiscal years. While we believe that there are a number of small entities that therefore would not be required to comply with our proposals, we are unable to quantify that number. We request comment on the number of small entities that would not be required to comply with our proposals.

E. Reporting, Recordkeeping and Other Compliance Requirements

Small entities would either utilize existing personnel or hire an outside professional to provide the proposed disclosure. This would impose incremental costs on small entities in connection with drafting, reviewing, filing, printing and disseminating additional disclosure in annual reports, registration statements, proxy and information statements and quarterly reports. The data underlying the proposed disclosure should be readily available from a company's books and records. Thus, the proposed rules involve relatively low incremental costs for the collection and calculation of data. This belief is based on the fact that management already must calculate the critical accounting estimates and apply initially adopted accounting policies to prepare the required financial statements. In addition, the burden on small entities of disclosing the effects of those estimates and changes in them may be less because it is possible that these firms may have fewer critical accounting estimates that would be covered by the proposals.

The proposed rule was designed to reduce costs for small entities by requiring the proposed disclosure only in the event that a small business issuer has generated revenue in the past two years. Our proposals thus would avoid applying the new requirements for MD&A disclosure relating to the application of critical accounting policies to start-up or developing companies that need not provide MD&A disclosure otherwise. Those companies describe a business plan rather than the traditional MD&A. In addition, small business issuers that provide the critical accounting estimates disclosure would only be required to provide a quantitative discussion of past material changes in estimates for the last two fiscal years. This corresponds to the income statements required to be included in our small business forms.

[163] 17 CFR 229.303.

[164] 17 CFR 228.303.

[165] 17 CFR 249.220f.

[166] 17 CFR 270.0–10(a).

[167] 17 CFR 230.157.

[168] Regulation S–K, 17 CFR 229.10–229.1016.

[169] Regulation S–B, 17 CFR 228.10–228.701.

Other companies would be required to discuss this information for the past three years.

F. Duplicative, Overlapping or Conflicting Federal Rules

We believe that there are no rules that conflict with or completely duplicate the proposed rules. There is a possible partial overlap with financial statement requirements requiring disclosure about material changes in critical accounting estimates and risks and uncertainties that could materially affect the financial statements and with MD&A requirements that may require some discussion of the application of critical accounting policies if that is essential to an understanding of a company's financial condition, changes in financial condition or results of operations. However, those requirements do not include much of the information specifically targeted for inclusion in the proposed rules.

G. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposals, we considered the following alternatives:

(a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities;

(b) The clarification, consolidation, or simplification of disclosure related to critical accounting estimates for small entities;

(c) The use of performance rather than design standards; and

(d) An exemption for small entities from coverage under the proposals.

We have drafted the proposed disclosure rules to require clear and straightforward disclosure in MD&A. Separate disclosure requirements for small entities would not yield the disclosure that we believe to be necessary to achieve our objectives. In addition, the informational needs of investors in small entities are typically as great as the needs of investors in larger companies. Therefore, it does not seem appropriate to develop separate requirements for small entities involving clarification, consolidation or simplification of the proposed disclosure.

We have used design rather than performance standards in connection with the proposals for three reasons. First, we believe the proposed disclosure would be more useful to investors if there were enumerated informational requirements. The proposed mandated disclosures may be likely to result in a more focused and comprehensive discussion of the company's application of its critical accounting policies. Second, mandated disclosures regarding the application of critical accounting policies may benefit investors in small entities because the enumerated disclosure under the proposed rule would likely be more comparable across all firms and consistent over time. Third, a mandated discussion of a company's application of critical accounting policies is uniquely suited to the MD&A disclosure in light of MD&A's emphasis on the identification of significant uncertainties and events and favorable or unfavorable trends. Therefore, adding a disclosure requirement to the existing MD&A appears to be the most effective method of eliciting the disclosure.

As noted above, we have proposed not to cover small business issuers that have not generated revenue during the last two years. We have made this accommodation in recognition of the fact that a limited modified approach is consistent with the objectives underlying the small business issuer disclosure system's alteration of the MD&A requirements for these companies and reduction of compliance burdens for these small companies. We believe that exempting small entities further from coverage of the proposals would not be appropriate. Investors in smaller companies may want and benefit from the disclosures about the application of critical accounting policies just as much as investors in larger companies. We note that a study commissioned by the Committee of Sponsoring Organizations of the Treadway Commission found that the incidence of financial fraud was greater at small companies.[170] Accordingly, a possible secondary benefit to investors in small entities may be to deter improper accounting practices. For example, the proposed disclosure could make inappropriate earnings management more difficult because it could be easier to detect.

H. Solicitation of Comments

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding: (i) The number of small entities that may be affected by the proposals; (ii) the existence or nature of the potential impact of the proposals on small entities discussed in the analysis; and (iii) how to quantify the impact of the proposed revisions. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposals are adopted, and will be placed in the same public file as comments on the proposed amendments themselves.

IX. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (''SBREFA''),[171] a rule is ''major'' if it has resulted, or is likely to result in:

- An annual effect on the economy of $100 million or more;
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment or innovation.

We preliminarily believe that our proposals could constitute a ''major rule'' under SBREFA. We request comment on whether our proposals would be a ''major rule'' for purposes of SBREFA. We solicit comment and empirical data on: (a) The potential effect on the U.S. economy on an annual basis; (b) any potential increase in costs or prices for consumers or individual industries; and (c) any potential effect on competition, investment or innovation.

X. Codification Update

The Commission proposes to amend the ''Codification of Financial Reporting Policies'' announced in Financial Reporting Release No. 1 (April 15, 1982):

By adding Section 501.12, captioned ''The Application of Critical Accounting Policies,'' to include the text in the adopting release that discusses the final rules, which, if the proposed rules are adopted, would be substantially similar to Section III of this release. The Codification is a separate publication of the Commission. It will not be published in the Code of Federal Regulations.

Statutory Bases and Text of Proposed Amendments

We are proposing amendments to Commission's existing rules under the authority set forth in Sections 7, 10 and 19 of the Securities Act and Sections 12, 13, 14 and 23 of the Exchange Act.

[170] *See* Beasley, Carcello and Hermanson, Fraudulent Financial Reporting: 1987–1997, and Analysis of U.S. Public Companies (Mar. 1999).

[171] Pub. L. No. 104–121, Title II, 110 Stat. 857 (1996).

List of Subjects 17 CFR Parts 228, 229 and 249

Reporting and recordkeeping requirements, Securities.

Text of Proposed Amendments

In accordance with the foregoing, the Securities and Exchange Commission proposes to amend Title 17, chapter II of the Code of Federal Regulations as follows:

PART 228—INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

1. The authority citation for Part 228 continues to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z–2, 77z–3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78*l*, 78m, 78n, 78o, 78u–5, 78w, 78*ll*, 78mm, 80a–8, 80a–29, 80a–30, 80a–37 and 80b–11.

2. Section 228.303 is amended by adding paragraph (b)(3) and Instructions to paragraph (b)(3) and revising Instruction 2 of Instructions to Item 303 to read as follows:

§ 228.303 (Item 303) Management's Discussion and Analysis or Plan of Operation.

* * * * *

(b) * * *

(3) *The application of critical accounting policies.*

(i) *Annual reports, registration statements and proxy and information statements.* In an annual report filed under the Exchange Act, an annual report to shareholders prepared under § 240.14a–3 or § 240.14c–3 of this chapter, a registration statement filed under the Securities Act or the Exchange Act, or a proxy or information statement filed under the Exchange Act, include a separately-captioned section in ''Management's Discussion and Analysis'' setting forth the disclosure regarding the small business issuer's application of critical accounting policies required by paragraphs (b)(3)(iii) and (b)(3)(iv) of this section. Except as otherwise stated, the discussion must cover the financial statements for the most recent fiscal year and any subsequent period for which interim period financial statements are required to be included.

(ii) *Definitions.*

(A) *Accounting estimate.* As used in paragraph (b)(3) of this section, the term *accounting estimate* means an approximation made by management of a financial statement element, item or account in the financial statements.

(B) *Critical accounting estimate.* An accounting estimate recognized in the financial statements presented is a *critical accounting estimate* for purposes of this section if:

(*1*) The accounting estimate requires the small business issuer to make assumptions about matters that are highly uncertain at the time the accounting estimate is made; and

(*2*) Different estimates that the small business issuer 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 small business issuer's financial condition, changes in financial condition or results of operations.

(C) *Near-term.* As used in paragraph (b)(3) of this section, the term *near-term* means a period of time going forward up to one year from the date of the financial statements.

(D) *Reasonably possible.* As used in paragraph (b)(3) of this section, the term *reasonably possible* means the chance of a future transaction or event occurring is more than remote but less than likely.

(iii) *Disclosure regarding critical accounting estimates.* For each critical accounting estimate:

(A) Identify and describe the accounting estimate. Describe the methodology underlying the accounting estimate. Describe the assumptions underlying the accounting estimate that relate to matters highly uncertain at the time the estimate was made. Describe any other underlying assumptions that are material. Discuss any known trends, demands, commitments, events or uncertainties that are reasonably likely to occur and materially affect the methodology or assumptions described. Disclose, if applicable, why different estimates that would have had a material impact on the small business issuer's financial presentation could have been used in the current period. Describe, if applicable, why the accounting estimate is reasonably likely to change from period to period with a material impact on the financial presentation;

(B) Explain the significance of the accounting estimate to the small business issuer's financial condition, changes in financial condition and results of operations and, where material, identify the line items in the financial statements affected by the accounting estimate;

(C)(*1*) Present either:

(*i*) A quantitative discussion of changes in overall financial performance, and to the extent material the line items in the financial statements, assuming that reasonably possible near-term changes occur, both negative and positive (where applicable), in the most material assumption or assumptions underlying the accounting estimate; or

(*ii*) A quantitative discussion of changes in overall financial performance, and to the extent material the line items in the financial statements, assuming that the accounting estimate was changed to the upper end and the lower end of the range of reasonable possibilities determined by the small business issuer in the course of formulating its recorded estimate; and

(*2*) Discuss the impact, if material, on the small business issuer's liquidity or capital resources if any of the changes being assumed for purposes of satisfying paragraph (b)(3)(iii)(C)(*1*)(*i*) or paragraph (b)(3)(iii)(C)(*1*)(*ii*) of this section were in effect;

(D) Present a quantitative and qualitative discussion of any material changes made to the accounting estimate in the past two years (or in the past year for any filing made before [one year after the effective date of the final rule]), describe the reasons for the changes and discuss the effect on line items in the financial statements and overall financial performance;

(E) Disclose whether or not the small business issuer's senior management has discussed the development and selection of the critical accounting estimates, and the MD&A disclosure regarding them, with the audit committee of the small business issuer's board of directors (or the equivalent oversight group). If the senior management has not had these discussions, disclose the reasons why not; and

(F) If the small business issuer operates in more than one segment, identify the segments that the accounting estimate affects. To the extent that the disclosure under the requirements of paragraph (b)(3) of this section only on a company-wide basis would result in an omission that renders the disclosure materially misleading, include a separate discussion on a segment basis for the identified segments of the small business issuer's business about which disclosure is otherwise required.

(iv) *Disclosure regarding initial adoption of an accounting policy.* If an accounting policy initially adopted by the small business issuer (other than those solely resulting from the adoption of new accounting literature issued by a recognized accounting standard setter) had a material impact on its financial condition, changes in financial condition or results of operations, disclose:

(A) The events or transactions that gave rise to the initial adoption;

(B) The accounting principle that has been adopted and the method of applying that principle;

(C) The impact, qualitatively, of the initial adoption on the financial condition, changes in financial condition and results of operations of the small business issuer;

(D) If the small business issuer is permitted a choice between acceptable accounting principles, an explanation it made such a choice, what the alternatives were, and why it made the choice that it did (including, where material, qualitative disclosure of the impact on financial condition, changes in financial condition and results of operations that alternatives would have had); and

(E) If no accounting literature exists that governs the accounting for the events or transactions giving rise to the initial adoption, an explanation of the small business issuer's decision regarding which accounting principle to use and which method of applying that principle to use.

(v) *Quarterly reports.* In a quarterly report on Form 10–QSB (§ 249.308b of this chapter), in a separately-captioned section of ''Management's Discussion and Analysis,'' disclose:

(A) For any critical accounting estimate that was not previously discussed as a critical accounting estimate in the MD&A section of the small business issuer's last Form 10–KSB (§ 249.310b of this chapter) or any of its subsequent Forms 10–QSB, the information required by paragraph (b)(3)(iii) of this section; and

(B) For any critical accounting estimate previously discussed as a critical accounting estimate in the MD&A section of the small business issuer's last Form 10–KSB or any of its subsequent Forms 10–QSB, any material change to that prior disclosure (other than disclosure under paragraph (b)(3)(iii)(D) of this section) necessary to make that disclosure not materially misleading as of the time the small business issuer files its Form 10–QSB for the current fiscal quarter.

Instructions to paragraph (b)(3):

1. The changes being assumed in connection with paragraph (b)(3)(iii)(C)(*1*) of this section must be meaningful and therefore may not be so minute as to avoid, or materially understate, any demonstration of sensitivity.

2. For purposes of paragraph (b)(3)(v) of this section, the small business issuer preparing the disclosure required by this paragraph may presume that investors have read or have access to the discussion of critical accounting estimates in its most recently filed Form 10–KSB and any of its subsequent Forms 10–QSB.

3. All information provided under paragraph (b)(3) of this section must be presented in clear, concise format and language that is understandable to the average investor. The information provided in this section must not be presented, for example: only as a general discussion of multiple critical accounting estimates in the aggregate or of multiple new accounting policies in the aggregate; as boilerplate disclosures that do not specifically address the small business issuer's particular circumstances and operations; as lists of accounting estimates relating to each material line item in the small business issuer's financial statements; or as disclosures that consist principally of disclaimers of legal liability for the small business issuer's preparation of critical accounting estimates or initial application of an accounting policy.

4. Refer to the Commission's release number 33–_____ dated_____, 200__ (adopting paragraph (b)(3) of this section) for guidance in preparing the disclosure relating to critical accounting estimates in this MD&A.

Instructions to Item 303

* * * * *

2. Your response to this Item requires you to make certain forward-looking statements. Examples include, but are not limited to: a small business issuer's disclosure of the reasonably possible, near-term changes in assumptions underlying accounting estimates; a discussion of the assumptions underlying an estimate that involve, for example, projections of future sales; and a discussion of the expected effect if a known uncertainty were to come to fruition and result in a change in management's assumptions. If the terms and conditions of Section 27A of the Securities Act (15 U.S.C. 77z–2), Section 21E of the Exchange Act (15 U.S.C. 78u–5), § 230.175 of this chapter or § 249.3b–6 of this chapter are satisfied, forward-looking statements would be entitled to the safe harbor protection. Small business issuers are encouraged to consider the terms, conditions and scope of those safe harbors when drafting disclosure, particularly when preparing disclosure under the provisions of paragraph (b)(3) of this section.

PART 229—STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975—REGULATION S–K

3. The general authority citation for Part 229 is revised to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z–2, 77z–3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u–5, 78w, 78*ll*(d), 78mm, 79e, 79j, 79n, 79t, 80a–8, 80a–9, 80a–20, 80a–29, 80a–30, 80a–31(c), 80a–37, 80a–38(a), 80a–39 and 80b–11, unless otherwise noted.

* * * * *

4. Section 229.303 is amended by:

a. Removing the authority citation following § 229.303;

b. Removing Instruction 7 of ''Instructions to Paragraph 303(a)'' and Instruction 6 of ''Instructions to Paragraph (b) of Item 303;''

c. Redesignating Instructions 8 through 12 of ''Instructions to Paragraph 303(a)'' as Instructions 7 through 11; and

d. Adding paragraph (c).

The addition reads as follows:

§ 229.303 (Item 303) Management's discussion and analysis of financial condition and results of operations.

* * * * *

(c) *The application of critical accounting policies.*

(1) *Annual reports, registration statements and proxy and information statements.* In an annual report filed under the Exchange Act, an annual report to shareholders prepared under § 240.14a–3 or § 240.14c–3 of this chapter, a registration statement filed under the Securities Act or the Exchange Act, or a proxy or information statement filed under the Exchange Act, include a separately-captioned section in ''Management's Discussion and Analysis of Financial Condition and Results of Operations'' setting forth the disclosure regarding the registrant's application of critical accounting policies required by paragraphs (c)(3) and (c)(4) of this section. Except as otherwise stated, the discussion must cover the financial statements for the most recent fiscal year and any subsequent period for which interim period financial statements are required to be included.

(2) *Definitions.*

(i) *Accounting estimate.* As used in paragraph (c) of this section, the term *accounting estimate* means an approximation made by management of a financial statement element, item or account in the financial statements.

(ii) *Critical accounting estimate.* An accounting estimate recognized in the financial statements presented is a *critical accounting estimate* for purposes of this section if:

(A) The accounting estimate requires the registrant to make assumptions about matters that are highly uncertain at the time the accounting estimate is made; and

(B) Different estimates that the registrant 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 registrant's financial condition, changes in financial condition or results of operations.

(iii) *Near-term.* As used in paragraph (c) of this section, the term *near-term* means a period of time going forward up to one year from the date of the financial statements.

(iv) *Reasonably possible.* As used in paragraph (c) of this section, the term *reasonably possible* means the chance of a future transaction or event occurring is more than remote but less than likely.

(3) *Disclosure regarding critical accounting estimates.* For each critical accounting estimate:

(i) Identify and describe the accounting estimate. Describe the methodology underlying the accounting estimate. Describe the assumptions underlying the accounting estimate that relate to matters highly uncertain at the time the estimate was made. Describe any other underlying assumptions that are material. Discuss any known trends, demands, commitments, events or uncertainties that are reasonably likely to occur and materially affect the methodology or assumptions described. Disclose, if applicable, why different estimates that would have had a material impact on the registrant's financial presentation could have been used in the current period. Describe, if applicable, why the accounting estimate is reasonably likely to change from period to period with a material impact on the financial presentation;

(ii) Explain the significance of the accounting estimate to the registrant's financial condition, changes in financial condition and results of operations and, where material, identify the line items in the financial statements affected by the accounting estimate;

(iii)(A) Present either:

(*1*) A quantitative discussion of changes in overall financial performance, and to the extent material the line items in the financial statements, assuming that reasonably possible near-term changes occur, both negative and positive (where applicable), in the most material assumption or assumptions underlying the accounting estimate; or

(*2*) A quantitative discussion of changes in overall financial performance, and to the extent material the line items in the financial statements, assuming that the accounting estimate was changed to the upper end and the lower end of the range of reasonable possibilities determined by the registrant in the course of formulating its recorded estimate; and

(B) Discuss the impact, if material, on the registrant's liquidity or capital resources if any of the changes being assumed for purposes of satisfying paragraph (c)(3)(iii)(A)(*1*) or paragraph (c)(3)(iii)(A)(*2*) of this section were in effect;

(iv) Present a quantitative and qualitative discussion of any material changes made to the accounting estimate in the past three years (or in the past two years for any filing made before [one year after the effective date of the final rule]), describe the reasons for the changes and discuss the effect on line items in the financial statements and overall financial performance;

(v) Disclose whether or not the registrant's senior management has discussed the development and selection of the critical accounting estimates, and the MD&A disclosure regarding them, with the audit committee of the registrant's board of directors (or the equivalent oversight group). If the senior management has not had these discussions, disclose the reasons why not; and

(vi) If the registrant operates in more than one segment, identify the disclosed segments that the accounting estimate affects. To the extent that the disclosure under the requirements of paragraph (c) of this section only on a company-wide basis would result in an omission that renders the disclosure materially misleading, include a separate discussion on a segment basis for the identified segments of the registrant's business about which disclosure is otherwise required.

(4) *Disclosure regarding initial adoption of an accounting policy.* If an accounting policy initially adopted by the registrant (other than those solely resulting from the adoption of new accounting literature issued by a recognized accounting standard setter) had a material impact on its financial condition, changes in financial condition or results of operations, disclose:

(i) The events or transactions that gave rise to the initial adoption;

(ii) The accounting principle that has been adopted and the method of applying that principle;

(iii) The impact, qualitatively, on the financial condition, changes in financial condition and results of operations of the registrant;

(iv) If the registrant is permitted a choice between acceptable accounting principles, an explanation it made such a choice, what the alternatives were, and why it made the choice that it did (including, where material, qualitative disclosure of the impact on financial condition, changes in financial condition and results of operations that alternatives would have had); and

(v) If no accounting literature exists that governs the accounting for the events or transactions giving rise to the initial adoption, an explanation of the registrant's decision regarding which accounting principle to use and which method of applying that principle to use.

(5) *Quarterly reports.* In a quarterly report on Form 10–Q (§ 249.308a of this chapter), in a separately-captioned section of ''Management's Discussion and Analysis of Financial Condition and Results of Operations,'' disclose:

(i) For any critical accounting estimate that was not previously discussed as a critical accounting estimate in the MD&A section of the registrant's last Form 10–K (§ 249.310 of this chapter) or any of its subsequent Forms 10–Q, the information required by paragraph (c)(3) of this section; and

(ii) For any critical accounting estimate previously discussed as a critical accounting estimate in the MD&A section of the registrant's last Form 10–K or any of its subsequent Forms 10–Q, any material change to that prior disclosure (other than disclosure under paragraph (c)(3)(iv) of this section) necessary to make that disclosure not materially misleading as of the time the registrant files its Form 10–Q for the current fiscal quarter.

Instructions to paragraph (c) of § 229.303:

1. The changes being assumed in connection with paragraph (c)(3)(iii)(A) of this section must be meaningful and therefore may not be so minute as to avoid, or materially understate, any demonstration of sensitivity.

2. Your response to this section requires you to make certain forward-looking statements. Examples include, but are not limited to: a registrant's disclosure of the reasonably possible, near-term changes in its assumptions underlying accounting estimates; a discussion of the assumptions underlying an estimate that involve, for example, projections of future sales; and

a discussion of the expected effect if a known uncertainty were to come to fruition and result in a change in management's assumptions. If the terms and conditions of Section 27A of the Securities Act (15 U.S.C. 77z–2), Section 21E of the Exchange Act (15 U.S.C. 78u–5), § 230.175 of this chapter or § 249.3b–6 of this chapter are satisfied, forward-looking statements would be entitled to the safe harbor protection. Registrants are encouraged to consider the terms, conditions and scope of those safe harbors when drafting disclosure, particularly when preparing disclosure under the provisions of paragraph (c) of this section.

3. For purposes of paragraph (c)(5) of this section, the registrant preparing the disclosure required by this paragraph may presume that investors have read or have access to the discussion of critical accounting estimates in its most recently filed Form 10–K and any of its subsequent Forms 10–Q.

4. All information provided under paragraph (c) of this section must be presented in clear, concise format and language that is understandable to the average investor. The information provided in this section must not be presented, for example: only as a general discussion of multiple critical accounting estimates in the aggregate or of multiple new accounting policies in the aggregate; as boilerplate disclosures that do not specifically address the registrant's particular circumstances and operations; as lists of accounting estimates relating to each material line item in the registrant's financial statements; or as disclosures that consist principally of disclaimers of legal liability for the preparation of the registrant's critical accounting estimates or initial application of an accounting policy.

5. Refer to the Commission's release number 33–_____ dated_____, 200__ (adopting paragraph (c) of this section) for guidance in preparing the disclosure relating to critical accounting estimates in this MD&A.

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

5. The authority citation for Part 249 continues to read, in part, as follows:

Authority: 15 U.S.C. 78a *et seq.*, unless otherwise noted.

* * * * *

6. Form 20–F (referenced in § 249.220f), Item 5 is amended by:

a. Adding paragraph E.,

b. Adding a sentence to the end of Instruction 2 of Instructions to Item 5,

c. Removing Instruction 3 of Instructions to Item 5, and

d. Adding Instructions to Item 5.E. to read as follows:

Note: Form 20–F does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 20–F

* * * * *

Item 5. Operating and Financial Review and Prospects

* * * * *

E. The application of critical accounting policies.

1. Disclosure requirement in annual reports and registration statements. In an annual report filed under the Exchange Act or a registration statement filed under the Securities Act or the Exchange Act, include a separately-captioned section in ''Operating and Financial Review and Prospects'' setting forth the disclosure regarding the company's application of critical accounting policies required by Item 5.E.3. and Item 5.E.4. of this Form. Except as otherwise stated, the discussion must cover the financial statements for the most recent fiscal year and any subsequent period for which interim period financial statements are required to be included.

2. Definitions.

(a) *Accounting estimate.* As used in Item 5.E., the term *accounting estimate* means an approximation made by management of a financial statement element, item or account in the financial statements.

(b) *Critical accounting estimate.* An accounting estimate recognized in the financial statements presented is a *critical accounting estimate* for purposes of this Item if:

(i) the accounting estimate requires the company to make assumptions about matters that are highly uncertain at the time the accounting estimate is made; and

(ii) 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.

(c) *Near-term.* As used in Item 5.E.3., the term *near-term* means a period of time going forward up to one year from the date of the financial statements.

(d) *Reasonably possible.* As used in Item 5.E.3., the term *reasonably possible* means the chance of a future transaction or event occurring is more than remote but less than likely.

3. Disclosure regarding critical accounting estimates. For each critical accounting estimate:

(a) Identify and describe the accounting estimate. Describe the methodology underlying the accounting estimate. Describe the assumptions underlying the accounting estimate that relate to matters highly uncertain at the time the estimate was made. Describe any other underlying assumptions that are material. Discuss any known trends, demands, commitments, events or uncertainties that are reasonably likely to occur and materially affect the methodology or assumptions described. Disclose, if applicable, why different estimates that would have had a material impact on the company's financial presentation could have been used in the current period. Describe, if applicable, why the accounting estimate is reasonably likely to change from period to period with a material impact on the financial presentation.

(b) Explain the significance of the accounting estimate to the company's financial condition, changes in financial condition and results of operations and, where material, identify the line items in the financial statements affected by the accounting estimate.

(c)(1) Present either:

(i) A quantitative discussion of changes in overall financial performance, and to the extent material the line items in the financial statements, assuming that reasonably possible near-term changes occur, both negative and positive (where applicable), in the most material assumption or assumptions underlying the accounting estimate; or

(ii) A quantitative discussion of changes in overall financial performance, and to the extent material the line items in the financial statements, assuming that 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

(2) Discuss the impact, if material, on the company's liquidity or capital resources if any of the changes being assumed for purposes of satisfying paragraph 5.E.3.(c)(1)(i) or paragraph 5.E.3.(c)(1)(ii) of this Item were in effect.

(d) Present a quantitative and qualitative discussion of any material changes made to the accounting estimate in the past three years (or in the past two years for any filing made before [one year after the effective date of the final rule]), describe the reasons for the changes and discuss the effect on

line items in the financial statements and overall financial performance.

(e) Disclose whether or not your senior management has discussed the development and selection of the critical accounting estimates, and the MD&A disclosure regarding them, with the audit committee of your board of directors (or the equivalent oversight group). If your senior management has not had these discussions, disclose the reasons why not.

(f) If the company operates in more than one segment, identify the disclosed segments that the accounting estimate affects. To the extent that the disclosure under the requirements of this Item 5.E. made only on a company-wide basis would result in an omission that renders the disclosure materially misleading, include a separate discussion on a segment basis for the identified segments of your business about which disclosure is otherwise required.

4. Disclosure regarding initial adoption of an accounting policy. If an accounting policy initially adopted by the company (other than those solely resulting from the adoption of new accounting literature issued by a recognized accounting standard setter) had a material impact on its financial condition, changes in financial condition or results of operations, disclose:

(a) The events or transactions that gave rise to the initial adoption;

(b) The accounting principle that has been adopted and the method of applying that principle;

(c) The impact, qualitatively, on the financial condition, changes in financial condition and results of operations of the company;

(d) If the company is permitted a choice between acceptable accounting principles, an explanation it made such a choice, what the alternatives were, and why it made the choice that it did (including, where material, qualitative disclosure of the impact on financial condition, changes in financial condition and results of operations that alternatives would have had); and

(e) If no accounting literature exists that governs the accounting for the events or transactions giving rise to the initial adoption, an explanation of the company's decision regarding which accounting principle to use and which method of applying that principle to use.

Instructions to Item 5: * * *

2. * * * With respect to the disclosure under Item 5.E., although the discussion would focus on the primary financial statements, you also must consider any reconciliation to U.S. GAAP and include disclosure required under Item 5.E. for any critical accounting estimate that is related to the application of U.S. GAAP and for any initial adoption of an accounting policy that is related to the application of U.S. GAAP.

Instruction to Item 5.A:

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Instructions to Item 5.E:

1. The changes being assumed in connection with Item 5.E.3.(c)(1) must be meaningful and therefore may not be so minute as to avoid, or materially understate, any demonstration of sensitivity.

2. Item 5 requires you to make certain forward-looking statements. Examples of forward-looking statements include, but are not limited to: a company's disclosure of the reasonably possible, near-term changes in its assumptions underlying accounting estimates; a discussion of the assumptions underlying an estimate that involve, for example, projections of future sales; and a discussion of the expected effect if a known uncertainty were to come to fruition and result in a change in management's assumptions. If the terms and conditions of Section 27A of the Securities Act (15 U.S.C. 77z–2), Section 21E of the Exchange Act (15 U.S.C. 78u–5), § 230.175 of this chapter or § 249.3b–6 of this chapter are satisfied, forward-looking statements would be entitled to the safe harbor protection. Companies are encouraged to consider the terms, conditions and scope of those safe harbors when drafting disclosure, particularly when preparing disclosure under the provisions of Item 5.E.

3. All information provided under Item 5.E. must be presented in clear, concise format and language that is understandable to the average investor. The information provided in Item 5.E. must not be presented, for example: only as a general discussion of multiple critical accounting estimates in the aggregate or of multiple new accounting policies in the aggregate; as boilerplate disclosures that do not specifically address the company's particular circumstances and operations; as lists of accounting estimates relating to each material line item in the company's financial statements; or as disclosures that consist principally of disclaimers of legal liability for the company's preparation of critical accounting estimates or initial application of an accounting policy.

4. Refer to the Commission's release number 33–_____ dated_____, 200__ (adopting Item 5.E.) for guidance in preparing the disclosure relating to critical accounting estimates in this discussion and analysis by management of the company's financial condition, changes in financial condition and results of operations.

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Dated: May 10, 2002.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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