SEC Proposes Required Disclosure of “Critical Accounting Policies”

The Securities and Exchange Commission (the “SEC”) has proposed significant amendments to MD&A requirements in public company registration statements, annual and quarterly reports and proxy statements. The proposals codify and expand upon guidance concerning disclosure of critical accounting policies published by the SEC in December 2001.

The proposals would require disclosure concerning:

- critical accounting estimates made by companies in applying their accounting policies; and
- the initial adoption of new accounting policies that would have a material impact on a company’s financial condition, changes in financial condition and results of operations.

The proposing release, “Disclosure in Management’s Discussion and Analysis about the Application of Critical Accounting Policies,” Release No. 33-8098, is available at:

Comments on the release are due July 19, 2002. The SEC is expected to have the new rules in place for companies’ 2002 annual reports.

Critical Accounting Estimates

An accounting estimate would be considered “critical” and would be required to be disclosed if it meets two tests:

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

(ii) it must be the case that different estimates that the company reasonably could have used, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the company’s financial condition, changes in financial condition or results of operations.

For each critical accounting estimate, required disclosure would include:

- basic information needed to understand the estimate, including a description of the methodology and assumptions involved as well as the impact of the estimate on the company’s financial statements or segments;

- analysis of the sensitivity of the estimate by discussing (i) effects of reasonably possible, near-term changes in the most material assumptions underlying the estimate or (ii) substituting for the estimate the ends of the range of reasonably possible amounts; and

- whether senior management had discussed the development, selection and disclosure of the estimate with the company’s audit committee and, if not, an explanation.

In addition to identifying those segments affected by the critical accounting estimate, companies are cautioned that they should include separate discussion of critical accounting estimates for each identified segment to the extent that discussion on a company-wide basis would render the disclosure materially misleading.

The proposals would also require a quantitative and qualitative discussion of management’s history of any material changes to its critical accounting estimates in past three years, as well as discussion of whether and why any given accounting estimate is reasonably likely to change in future periods with a material impact on the company’s financial presentation.

The proposed sensitivity analysis and three-year review of the past changes in critical accounting estimates are likely to be the focus of public comment on the proposals.

The SEC expects a “vast majority” of companies to have between three and five critical accounting estimates and a “very few” to have none at all. The SEC notes that companies with key segment-related accounting policies may have more than five.
Initial Adoption of Accounting Policies

In addition, the proposals would require MD&A disclosure regarding a company’s initial adoption of an accounting policy (unless it resulted solely from newly issued accounting literature) within the past year that had a material impact on the company’s financial condition, changes in financial condition or results of operations. Companies would be required to disclose:

- events or transactions that gave rise to the initial adoption;
- the accounting principle adopted and how it is applied; and
- the qualitative impact from the initial adoption of the accounting policy on the company’s financial condition, changes in financial condition and results of operations.

Companies permitted a choice among acceptable accounting principles would also be required to explain that they had made a choice among acceptable alternatives, identifying the alternatives and describing why they made the choice that they did. In addition, companies would be required to include a qualitative discussion of the impact on financial condition, changes in financial condition and results of operations that the alternatives would have had if application of an alternative accounting policy would be material. Finally, if no accounting literature governs the events or transactions relating to the initial adoption of the accounting policy, companies would be required to explain their decisions regarding selection of accounting principles and methods of applying them.

Presentation of the New Disclosure

The proposed disclosure would be located under a separately-captioned heading, “Application of Critical Accounting Policies”, in the MD&A section of annual reports, registration statements and proxy and information statements. The disclosures would focus on the latest fiscal year and any required financial statements for subsequent interim periods. The MD&A section in quarterly reports would be required to address any material changes.

Forward-Looking Statements

The proposing release notes that the proposed MD&A disclosures will require companies to make forward-looking statements, and discusses the availability of various safe harbors. As the SEC’s proposal does not propose to expand the statutory safe harbor under the Private Securities Litigation Reform Act of 1995, the safe harbor would not apply to forward-looking statements in an MD&A in connection with initial public offerings and tender and exchange offers. This will likely be another area for public comment.

Foreign Private Issuers

The proposed rules would apply to both U.S. companies and foreign private issuers. However, the rules could potentially be more burdensome for foreign private issuers whose financial statements are presented in accordance with non-U.S. GAAP. Under the proposal, the SEC would require such foreign private issuers to address critical accounting estimates both with respect to the primary financial statements as well as with respect to their reconciliation to U.S. GAAP.