SECURITIES AND EXCHANGE COMMISSION

[Release Nos. 33-8040; 34-45149; FR-60]

AGENCY: Securities and Exchange Commission

ACTION: Cautionary Advice Regarding Disclosure About Critical Accounting Policies

SUMMARY: The Securities and Exchange Commission is issuing a statement regarding the selection and disclosure by public companies of critical accounting policies and practices.

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SUPPLEMENTARY INFORMATION:

As public companies undertake to prepare and file required annual reports with us, we wish to remind management, auditors, audit committees, and their advisors that the selection and application of the company's accounting policies must be appropriately reasoned. They should be aware also that investors increasingly demand full transparency of accounting policies and their effects.

Reported financial position and results often imply a degree of precision, continuity and certainty that can be belied by rapid changes in the financial and operating environment that produced those measures. As a result, even a technically accurate application of generally accepted accounting principles ("GAAP") may nonetheless fail to communicate important information if it is not accompanied by appropriate and clear analytic disclosures to facilitate an investor's understanding of the company's financial status, and the possibility, likelihood and implication of changes in the financial and operating status.

Of course, public companies should be mindful of existing disclosure requirements in GAAP and our rules. Accounting standards require information in financial statements about the accounting principles and methods used and the risks and uncertainties inherent in significant estimates.[1] Our rules governing Management's Discussion and Analysis ("MD&A") currently require disclosure about trends, events or uncertainties known to management that would have a material impact on reported financial information.[2]

We have observed that disclosure responsive to these requirements could be enhanced. For example, environmental and operational trends, events and uncertainties typically are identified in MD&A, but the implications of those uncertainties for the methods, assumptions and estimates used for recurring and pervasive accounting measurements are not always addressed. Communication between investors and public companies could be improved if management explained in MD&A the interplay of specific uncertainties with accounting measurements in the financial statements. We intend to consider new rules during the coming year to elicit more precise disclosures about the accounting policies that management believes are most "critical" – that is, they are both most important to the portrayal of the company's financial condition and results, and they require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

Even before new rules are considered, however, we believe it is appropriate to alert companies to the need for greater investor awareness of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation. We encourage public

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1 See, e.g., Accounting Principles Board Opinion No. 22, "Disclosure of Accounting Policies" (Apr. 1972); AICPA Statement of Position No. 94-6, "Disclosure of Certain Significant Risks and Uncertainties" (Dec. 1994).

2 The underlying purpose of MD&A is to provide investors with "information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations." Item 303(a) of Regulation S-K [17 CFR 229.303(a)]. As we have previously stated, " '[i]t is the responsibility of management [in MD&A] to identify and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the company.' " Securities Act Rel. No.

companies to include in their MD&A this year full explanations, in plain English, of their "critical accounting policies," the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. The objective of this disclosure is consistent with the objective of MD&A.

Investors may lose confidence in a company's management and financial statements if sudden changes in its financial condition and results occur, but were not preceded by disclosures about the susceptibility of reported amounts to change, including rapid change. To minimize such a loss of confidence, we are alerting public companies to the importance of employing a disclosure regimen along the following lines:

1. <u>Each company's management and auditor should bring particular focus to the evaluation of the critical accounting policies used in the financial statements.</u> As part of the normal audit process, auditors must obtain an understanding of management's judgments in selecting and applying accounting principles and methods. Special attention to the most critical accounting policies will enhance the effectiveness of this process. Management should be able to defend the quality and reasonableness of the most critical policies, and auditors should satisfy themselves thoroughly regarding their selection, application and disclosure.

2. <u>Management should ensure that disclosure in MD&A is balanced and fully responsive.</u> To enhance investor understanding of the financial statements, companies are encouraged to explain in MD&A the effects of the critical accounting policies applied, the judgments made in their application, and the likelihood of materially different reported results if different assumptions or conditions were to prevail.

6835 (May 18, 1989) [54 FR 22427] (quoting Securities Act Rel. No. 6349 (Sept. 28, 1981) [not published in the Federal Register]).

3. Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies. Consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods.[3] Proactive discussions between the audit committee and the company's senior management and auditor about critical accounting policies are appropriate.

4. If companies, management, audit committees or auditors are uncertain about the application of specific GAAP principles, they should consult with our accounting staff. We encourage all those whose responsibility it is to report fairly and accurately on a company's financial condition and results to seek out our staff's assistance. We are committed to providing that assistance in a timely fashion; our goal is to address problems before they happen.

By the Commission.

Jonathan G. Katz
Secretary

Dated: December 12, 2001

[3] See Codification of Statements on Auditing Standards, AU § 380, Communication with Audit Committees or Others with Equivalent Authority and Responsibility ("SAS 61"). 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. Among the matters to be communicated to the audit committee are: (1) methods used to account for significant unusual transactions; (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus; (3) the process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates; and (4) disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements. Id.