

December 21, 2001

SecMail@ No. 01-12-21

SEC Calls For Greater Transparency of Critical Accounting Principles

Enron's dramatic collapse will be remembered, among other things, as a defining moment for the Securities and Exchange Commission's regulatory efforts in the next few years. Last week, the SEC issued "cautionary advice" strongly encouraging public companies to identify key accounting principles and making more fulsome disclosure of the impact of those principles on reported results in their upcoming annual reports. Release No. 34-45149, (Dec. 12, 2001); <http://www.sec.gov/rules/other/33-8040.htm>

No new rules have been proposed, much less adopted. The Commission's release notes that new rules will be considered in 2002 and, until then, pointedly advises that companies consider complete disclosure of accounting policies in the Management, Discussion and Analysis (MD&A) section of their annual reports. As companies begin the process of preparing their annual reports, we recommend the following steps:

1. Companies should reassess the impact of critical accounting principles on the company's financial reporting. SEC Chairman Pitt has identified, as part of his nine-point program in response to the Enron debacle, the need for "conscientious identification and assessment by public companies and their auditors of critical accounting principles," defined as "the three, four or five most critical accounting principles upon which a company's financial status depends, and which involve the most complex, subjective or ambiguous decisions or assessments." (Pitt, "How to Prevent Future Enrons," Wall Street Journal, Dec. 11, 2001; <http://www.sec.gov/news/speech/spch530.htm>). Given the relatively short time before calendar-year registrants will need to file annual disclosure documents, early efforts to identify this information form a necessary predicate for addressing the SEC's other recommendations.

2. Develop appropriate disclosures regarding these critical accounting policies. Chairman Pitt called for concise and clear disclosure as to how key accounting principles are applied, "as well as information about the range of possible effects in differing applications of these principles." In last week's release, the SEC encouraged issuers to include in this year's MD&A "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." Achievement of this objective will require companies, their auditors and their counsel to devote focused efforts to identifying these principles and fashioning appropriate disclosures over the coming weeks.

3. *Audit committees should prepare now to review the nature and effect of critical accounting principles.* The SEC's cautionary advice alerts companies to the importance of having their audit committees engage in "proactive" discussions with company management and outside auditors regarding these key accounting judgments. As Chairman Pitt indicated, "audit committees must understand why critical accounting principles were chosen, how they were applied, and have a basis for believing the end result fairly presents their company's actual status." As a result, advisors to audit committees should immediately consider how they will approach this task, what materials they will prepare to present these issues to the directors serving on the audit committee. Like all other audit committee activities, the committee's efforts in assuring proper disclosure of the nature and impact of critical accounting principles should be well-planned, well-executed and, just as importantly, well-documented.

Given last week's warning, the SEC's focus on disclosure issues and a continuing dearth of initial public offerings, we anticipate, that compared with recent years, a significant number of 2001 annual reports will be scrutinized carefully by the SEC's staff. That probability should prompt adjustments in each issuer's reporting process. No company will want to explain why the SEC's strong suggestions were ignored.

Matt T. Morley, Washington, DC
Karl A. Groskaufmanis, Washington, DC
David L. Fenimore, Washington, DC

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SecMail@ffhsj.com

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