

PAUL, WEISS, RIFKIND, WHARTON & GARRISON

DECEMBER 2001

SEC CAUTIONS ON SELECTION AND DISCLOSURE OF CRITICAL ACCOUNTING POLICIES

As part of its increased scrutiny of the periodic disclosure regime, the SEC has formally cautioned the management of public companies, auditors, audit committees and company advisors that greater effort needs to be made to alert investors to the sensitivity of financial statements to the methods, assumptions and estimates underlying their preparation. The disclosure by public companies must make transparent the effects of the accounting policies on financial information.

The SEC observed that accounting standards require that the financial statements include descriptions of the accounting principles and methods used and the risks and uncertainties inherent in significant estimates. In addition, the SEC rules governing Management's Discussion and Analysis ("MD&A") require disclosure about trends, events or uncertainties known to management that have a material impact on reported financial information.

The SEC noted that the disclosure by a number of public companies in response to these requirements could be enhanced. For example, environmental and operational trends, events and uncertainties are typically identified in the company's MD&A, but the impact of those uncertainties on the methods and estimates used for recurring accounting measurements are often not addressed. In the absence of an explanation of the interplay of specific uncertainties with accounting measurements in the financial statements, investors cannot fully assess the company's financial status, and the likelihood and impact of changes in its financial and operating status.

The SEC announced its intention to consider new rules during 2002 that elicit more precise disclosures about the accounting policies that management deems most "critical". An accounting policy should be considered critical if it is of paramount importance to the portrayal of the company's financial condition and results, and at the same time requires 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.

In the interim, the SEC instructed public companies to employ a disclosure regimen along the following lines:

1285 Avenue of the Americas
New York, New York 10019-6064
(212) 373-3000

1615 L Street, NW
Washington, DC 20036-5694
(202) 223-7300

Alder Castle, 10 Noble Street
London EC2V 7JU England
(44-20) 7367 1600

2, rue du Faubourg Saint-Honoré
75008 Paris, France
(33-1) 53.43.14.14

Fukoku Seimei Building 2nd Floor
2-2, Uchisawaicho 2-chome
Chiyoda-ku, Tokyo 100, Japan
(81-3) 3597-8120

2918 China World Tower II
No. 1, Jianguomenwai Dajie
Beijing 100004, People's Republic of China
(86-10) 6505-6822

12th Fl., Hong Kong Club Building
3A Chater Road, Central
Hong Kong
(852) 2536-9933

- As part of the audit process, auditors must obtain an understanding of management's judgments in selecting and applying accounting principles and methods. Management should be able to defend the quality and reasonableness of the most critical policies, and auditors should satisfy themselves thoroughly regarding the selection, application and disclosure of such policies.
- Management should include in their 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.
- Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies. As required by SAS 61, audit committees should be apprised of the evaluative criteria used by management in their selection of accounting principles and practices.

The SEC reminded public companies that its accounting staff is available for consultation and is committed to providing timely assistance to management, audit committees and auditors who are uncertain as to the application of specific GAAP principles.

* * * *

Any questions concerning the foregoing should be addressed to members of the Paul Weiss Securities Group (including any of those listed below). This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. In addition, memoranda on related topics may be accessed under Securities Group publications on our web site (www.paulweiss.com).

Mark S. Bergman	(44 20) 7367 1601	John C. Kennedy	(1) 212-373-3025
Richard S. Borisoff	(1) 212-373-3153	Edwin S. Maynard	(1) 212-373-3024
Andrew J. Foley	(1) 212-373-3078	John A. Myer	(44 20) 7367 1605
Paul D. Ginsberg	(1) 212-373-3131		

PAUL, WEISS, RIFKIND, WHARTON & GARRISON