

those accounting policies that management believes are most critical to the preparation of the issuer's financial statements.<sup>204</sup> The cautionary advice indicated that "critical" accounting policies are those that are both most important to the portrayal of the company's financial condition and results and 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.<sup>205</sup> As part of that cautionary advice, we stated:

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. Proactive discussions between the audit committee and the company's senior management and auditor about critical accounting policies are appropriate.<sup>206</sup>

In May 2002, the Commission proposed rules to require disclosures that would enhance investors' understanding of the application of companies' critical accounting policies.<sup>207</sup> The May 2002 proposed rules cover (1) accounting estimates a company makes in applying its accounting policies and (2) the initial adoption by a company of an accounting policy that has a material impact on its financial presentation. Under the first part of those proposed rules, a "critical accounting estimate" is defined as an accounting estimate recognized in the financial statements (1) that requires the registrant to make assumptions about matters that are highly uncertain at the time the accounting estimate is made and (2) for which 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 registrant's financial condition, changes in financial condition or results of operations. The May 2002 proposed rules outline certain disclosures that a company would be required to make about its critical accounting estimates. In addition, under the second part of the May 2002 proposed rules, a company would be

required to make certain disclosures about its initial adoption of accounting policies, including the choices the company had among accounting principles.

Accountants and issuers should read and refer to the December 2001 Cautionary Guidance to determine the types of matters that should be communicated to the audit committee under this rule. We are not requiring that those discussions follow a specific form or manner, but we expect, at a minimum, that the discussion of critical accounting estimates and the selection of initial accounting policies will include the reasons why estimates or policies meeting the criteria in the Guidance are or are not considered critical and how current and anticipated future events impact those determinations. In addition, we anticipate that the communications regarding critical accounting policies will include an assessment of management's disclosures along with any significant proposed modifications by the accountants that were not included.

## 2. Alternative Accounting Treatments

We recognize that the complexity of financial transactions results in accounting answers that are often the subject of significant debate between management and the accountants. Some commenters<sup>208</sup> to the proposed rules suggested that this rule be restricted to material accounting alternatives. These commenters indicated that restricting these communications will assist audit committee members by focusing their attention on important accounting alternatives. One commenter<sup>209</sup> believes that only alternative treatments under GAAP that were the subject of serious consideration and debate by the accountant and management should be communicated to the audit committee.

We understand the concerns expressed and, accordingly, we have clarified the final rule. Providing audit committees with information on material accounting alternatives is consistent with the objectives of the Act and will minimize the risk that audit committee members will be distracted from material accounting policy matters by the numerous discussions between the accountant and management on the

application of accounting principles to relatively small transaction or events. Therefore, these rules require communication, either orally or in writing, by accountants to audit committees of all alternative treatments within GAAP for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm. This rule is intended to cover recognition, measurement, and disclosure considerations related to the accounting for specific transactions as well as general accounting policies.

We believe that communications regarding specific transactions should identify, at a minimum, the underlying facts, financial statement accounts impacted, and applicability of existing corporate accounting policies to the transaction. In addition, if the accounting treatment proposed does not comply with existing corporate accounting policies, or if an existing corporate accounting policy is not applicable, then an explanation of why the existing policy was not appropriate or applicable and the basis for the selection of the alternative policy should be discussed. Regardless of whether the accounting policy selected preexists or is new, the entire range of alternatives available under GAAP that were discussed by management and the accountants should be communicated along with the reasons for not selecting those alternatives. If the accounting treatment selected is not, in the accountant's view, the preferred method, we expect that the reasons why the accountant's preferred method was not selected by management also will be discussed.

Communications regarding general accounting policies should focus on the initial selection of and changes in significant accounting policies, as required by GAAS,<sup>210</sup> and should include the impact of management's judgments and accounting estimates, as well as the accountant's judgments about the quality of the entity's accounting principles. The discussion of general accounting policies should include the range of alternatives available under GAAP that were discussed by management and the accountants along with the reasons for selecting the chosen policy. If an existing accounting policy is being modified, then the reasons for the change also should be communicated. If the accounting policy selected is not the accountant's preferred policy, then we

things, trends, events or uncertainties known to management that would have a material impact on reported financial information.

<sup>204</sup> Release No. 33-8040, Dec. 12, 2001, (66 FR 65013).

<sup>205</sup> *Id.*

<sup>206</sup> *Id.* (footnotes omitted).

<sup>207</sup> Release No. 33-8090, May 10, 2002, (67 FR 35620).

<sup>208</sup> See, e.g., letter from Chamber of Commerce of the United States of America, dated January 9, 2003; letter from Battelle & Battelle LLP, dated December 20, 2002; letter from Eli Lilly and Company, dated January 9, 2003; letter from Computer Sciences Corporation, dated January 13, 2003; letter from PricewaterhouseCoopers, dated January 8, 2003.

<sup>209</sup> See, e.g., letter from Deloitte & Touche LLP, dated January 10, 2003.

<sup>210</sup> See, AU § 380.