

For the Commission, by the Division of Investment Management, under delegated authority.

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

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

### Accounting Policies; Cautionary Advice Regarding Disclosure

**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.

**FOR FURTHER INFORMATION CONTACT:** Robert A. Bayless, Special Assistant to the Chief Accountant, 202-942-4400.

**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.<sup>1</sup> 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.<sup>2</sup>

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 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

<sup>1</sup> 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).

<sup>2</sup> 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. 6835 (May 18, 1989) [54 FR 22427] (quoting Securities Act Rel. No. 6349 (Sept. 28, 1981) [not published in the **Federal Register**]).

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. Each Company's Management and Auditor Should Bring Particular Focus to the Evaluation of the Critical Accounting Policies Used in the Financial Statements

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. Management Should Ensure That Disclosure in MD&A Is Balanced and Fully Responsive

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.

#### 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.<sup>3</sup>

<sup>3</sup> 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

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.

Dated: December 12, 2001.

By the Commission.

**Margaret H. McFarland,**

*Deputy Secretary.*

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-45146; File No. SR-DTC-2001-14]

**Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing of Proposed Rule Change Relating to the Closing Down of the Mortgage-Backed Securities Division of The Depository Trust Company**

December 10, 2001.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on July 24, 2001, The Depository Trust Company ("DTC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by DTC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

**I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change**

The proposed rule change concerns the closing of DTC's Mortgage-Backed

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.*

<sup>1</sup> 15 U.S.C. 78s(b)(1)

Securities Division ("MBS Division").<sup>2</sup> To accomplish this, DTC plans to close the MBS Division's transaction processing system and to amend DTC's rules to delete the MBS Division's rules.<sup>3</sup> The securities formerly services by the MBS Division will remain eligible for processing on DTC's main processing system to the same extent that other Fedwire securities are currently processed at DTC although the issuance and the majority of clearance of these securities will be moved to the Fedwire system.

**II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

In its filing with the Commission, DTC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. DTC has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.<sup>4</sup>

**A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

The purpose of the proposed rule change is to obtain Commission approval of DTC's closing the operations of its MBS Division. Currently, among other things, the MBS Division issues and settles mortgage-backed securities that are guaranteed by the Government National Mortgage Association ("GNMA"). However, GNMA wishes to transfer the settlement of these mortgage-backed securities to the Fedwire system of the Federal Reserve Board.<sup>5</sup> GNMA plans to convert its securities to Fedwire by the end of the first quarter of 2002.

GNMA announced its plans to move its securities to Fedwire in May 2000. The conversion plans were developed in consultation with a task force organized by The Bond Market Association ("BMA") that consisted of

<sup>2</sup> The MBS Division is the successor to The Participants Trust Company, which was merged into DTC effective August 31, 1998.

<sup>3</sup> These rules are currently in Annex A of DTC's Rules.

<sup>4</sup> The Commission has modified the text of the summaries prepared by DTC.

<sup>5</sup> The Fedwire system of the Federal Reserve Board is currently used for, among other things, the issuance and settlement of U.S. Treasury securities and mortgage-backed securities guaranteed by the Federal Home Loan Mortgage Corporation ("FHLMC") and the Federal National Mortgage Association ("FNMA").

representatives from broker-dealers, custodial banks, GNMA, the Federal Reserve Banks, the Mortgage Bankers Association, DTC, and the BMA. The force formed a GNMA Conversion Subcommittee to develop a conversion plan and implementation schedule. In February 2001, the subcommittee issued its Conversion Plan.<sup>6</sup>

The conversion is taking place in phases over a series of weekends beginning October 6, 2001, and is scheduled for completion by March 31, 2002. During this period, different classes of GNMA securities will be moved electronically from the MBS Division to Fedwire in accordance with delivery instructions provided to the MBS Division by the MBS Division's participants. Other securities issued and settled on the books of the MBS Division, namely securities guaranteed by the Department of Veterans Affairs and a limited number of FNMA and FHLMC securities which are collateralized by GNMA securities, will also move to Fedwire at some time during the GNMA conversion or immediately after on dates to be determined.

Shortly after the completion of the payment of principal and interest with respect to securities last converted to Fedwire, DTC will close the transaction processing system of the MBS Division, return the MBS Division participant fund deposits to the MBS Division's participants, and amend DTC's rules to delete the rules that apply to the MBS Division. After the conversion, FNMA securities will remain eligible for processing on DTC's main system in the same manner as other Fedwire securities are currently processed at DTC. Fedwire securities processed at DTC must be deposited and withdrawn free of payment over Fedwire to and from DTC's Fedwire account. Once deposited at DTC, Fedwire-eligible securities will be processed among DTC participants subject to DTC's rules and procedures without additional restrictions.

In connection with the conversion of GNMA securities to Fedwire, DTC considered expanding its processing to permit GNMA securities to be delivered versus payment into and from DTC's Fedwire account subject to regulatory approval. DTC solicited comments from its participants, but fewer than a dozen

<sup>6</sup> The Conversion Plan is available online at <[www.frbservices.org](http://www.frbservices.org)> and at <[www.bondmarkets.com/regulatory](http://www.bondmarkets.com/regulatory)>. A copy of the Conversion Plan is also attached as Exhibit 2 of DTC's filing [DTC Important Notice No. 1483 (Feb. 15, 2001)], which is available through the Commission's Public Reference Section or through DTC.