

COMMENT LETTER

July 19, 2002

Comment Letter on SEC Critical Accounting Proposal

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Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 5th Street, NW
Washington, DC 20549-0609

Re: Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies (File No. S7-16-02)

Dear Mr. Katz:

The Investment Company Institute¹ appreciates the opportunity to comment on the Securities and Exchange Commission's proposal to enhance the disclosure provided by reporting companies in their Management's Discussion and Analysis ("MD&A"). The proposal would require a separate section within the MD&A entitled Application of Critical Accounting Policies, where companies would be required to describe both their critical accounting estimates and the initial adoption of accounting policies that have a material impact on their financial presentation.² Our members, as investors in more than \$4 trillion in U.S. corporate equity and fixed-income securities on behalf of millions of individual investors, have a significant interest in the Commission's proposal.

Under the proposal, a company would be required to disclose in its MD&A "critical accounting estimates." An estimate is a "critical accounting estimate" if it requires the company to make assumptions about matters that are highly uncertain at the time the estimate is made and if different estimates that the company reasonably could have used, or changes in estimates that are reasonably likely to occur, would have a material impact on the company's financial condition or results of operations. A company's disclosure about these estimates would include a discussion of: the methodology and assumptions underlying them; their effect on the financial statements; and the effect of changes in the estimates on the financial statements. The proposal would also require disclosure about the initial adoption of an accounting policy if the accounting policy was adopted in the past year and had a material impact on the financial statements. Under the proposal, companies would be required to describe: the transaction giving rise to the adoption of the policy; the impact of the adoption of the policy on the financial statements; and the choices it had among accounting principles.

The Institute strongly supports the Commission's proposal, particularly the proposed critical accounting estimates disclosures. This disclosure will enable investors to focus on important accounting estimates that involve significant management judgment, and to understand management's process for developing them. The proposal will facilitate investors' understanding of the impact those estimates have on the results of operations and financial position, as well as an appreciation of how different estimates could cause reported performance to change. Investors will further benefit from disclosure regarding whether senior management discussed the development, selection and disclosure of its critical accounting estimates with the audit committee.

Our comments on the Commission's proposal are set forth below. We have a general comment on the MD&A disclosure and several specific comments on the proposed critical accounting estimates disclosures.

MD&A Summary Section

The Proposing Release states that the Commission intends to continue to focus on improving disclosure to investors in the MD&A. [3](#) The Proposing Release states that the Commission is considering, among other things, a more explicit requirement for a summary of the MD&A section that would require management to identify what it considers to be the most important factors in determining its financial results and condition. Management would also be required to identify the principal factors driving financial results, the principal trends on which it focuses, and the principal risks to the business. We strongly encourage the Commission to move forward with such an MD&A summary proposal. Expansion of the MD&A to include discussion of critical accounting estimates, initial adoption of accounting policies and possibly other disclosures will necessarily lengthen the MD&A. A summary section where management is required to discuss the most important factors in determining its financial results and condition will highlight for investors key elements responsible for current performance and possible risks going forward. In addition, we are aware that concerns have been expressed that the disclosure required under the Commission's proposal could be voluminous and overwhelm other important disclosure in the MD&A. [4](#) The inclusion of a summary section would, we believe, be fully responsive to these concerns.

Sensitivity Analysis

The Institute supports the proposal to require a quantitative discussion of changes in line items in the financial statements and overall financial performance assuming changes in critical accounting estimates. We believe the proposed sensitivity analysis also will enable investors to assess the degree to which a company's reported results and financial position are susceptible to changes in critical accounting estimates. The sensitivity analysis also will provide insight on the "quality" of earnings, enabling investors to ascertain whether reported performance is dependent on subjective or volatile estimates and management assumptions. To ensure the usefulness of this information, we recommend that issuers be required to describe the likelihood of the changes in assumptions underlying estimates and the probability of the high and low end of the range of estimates used in preparing the analysis.

Alternative Available Accounting Policies

The Proposing Release requests comment on whether the scope of the proposal should be expanded to require issuers to describe in the MD&A alternative accounting policies acceptable under GAAP. This discussion would include the impact the alternative policies would have on the issuer's results of operations and financial position. We would oppose such a requirement, as it would substantially increase the MD&A disclosure without commensurate benefit to investors. MD&A disclosure regarding alternative accounting policies could easily overwhelm investors, making it more difficult for them to discern key factors affecting the company's performance. In lieu of expanding the proposal in such a broad manner, we recommend a more focused approach. Specifically, we recommend that the Commission require the MD&A to describe the effects of alternate available policies only if the accounting policies the company employs are different than those typically used by its competitors in its industry. [5](#) MD&A disclosure describing the impact of "standard" industry accounting policies on reported results would facilitate investor analysis and comparison. Investors frequently compare companies within a particular industry. However, such comparisons may be difficult where one or more companies employ accounting policies that are different from those typically employed by other issuers in that industry. Such disclosure should also promote discussion of accounting policies between senior management and the audit committee.

Auditor Examination of MD&A Disclosure Relating to Critical Accounting Estimates

We encourage the Commission to take steps to ensure the accuracy and reliability of the proposed critical accounting estimates disclosures. One possible means to accomplish this would be to require the new MD&A disclosure relating to critical accounting estimates to be examined by an independent auditor in accordance with professional standards for attestation engagements. Examination by an independent auditor would provide assurance that: the MD&A presentation includes the required disclosure elements; the historical financial amounts have been accurately derived from the company's financial statements; and the underlying information, estimates and assumptions of the company provide a reasonable basis for the MD&A disclosures. Identification of a company's critical accounting estimates and preparation of the proposed sensitivity analysis in particular are processes that will benefit from objective scrutiny provided by auditor examination. Moreover, inasmuch as the critical accounting estimates are inherent within the financial statements, the auditor should be able to examine them without undue burden.

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The Institute appreciates the opportunity to express its views on the Commission's proposal. If you have any questions, or would like additional information, please contact the undersigned at (202) 326-5815 or Greg Smith at (202) 326-5851.

Sincerely,

Craig S. Tyle
General Counsel

cc: Alan L. Beller, Director
Division of Corporation Finance

ENDNOTES

[1](#) The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,984 open-end investment companies (“mutual funds”), 504 closed-end investment companies and six sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.925 trillion, accounting for approximately 95 percent of total industry assets, and over 88.6 million individual shareholders.

[2](#) SEC Release No. 33-8098; 34-45907 (May 10, 2002); 67 Fed. Reg. 35619 (May 20, 2002) (the “Proposing Release”).

[3](#) Proposing Release at 35622.

[4](#) See Memorandum from Anita Klein, Division of Corporation Finance, regarding June 7, 2002 meeting with the American Society of Corporate Secretaries and Commission staff, dated June 12, 2002.

[5](#) We believe senior management should reasonably be expected to know when its accounting policies differ from those of its competitors in its industry. Moreover, independent accountants should be able to provide assistance in this regard.