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SEC Issues Comments on Results of Fortune 500 Project

In December 2001, the SEC's Division of Corporation Finance determined it would monitor the annual reports filed by all Fortune 500 companies with the Commission in 2002 as part of its process of reviewing financial and non-financial disclosures made by public companies. The Staff focused on disclosure that appeared to be critical to an understanding of each company's financial position and results, but which on its face seemed to conflict significantly with generally accepted accounting principles or SEC rules, or to be materially deficient in explanation or clarity. As a result of this focus, comments substantially concentrated on financial reporting, including financial statements and management's discussion and analysis.

All annual reports on Form 10-K filed with the SEC by Fortune 500 companies received a "screening" review. The Staff selected a substantial number of companies for some level of further review. Comment letter were sent to approximately 350 companies. In some cases, companies were asked to amend their filing where appropriate, while in other cases they were asked to respond to the comments in future filings.

Many of the comments provided to companies were fact specific to individual companies. While the comments addressed a variety of issues, the SEC, in a release dated February 27, 2003, provided a summary of the most common areas of comment addressed in its Fortune 500 project.

Management's Discussion & Analysis Generally

The Staff issued comments on the MD&A more than any other topic. Item 303 of Regulation S-K requires a company to discuss its financial condition, changes in financial condition and results of operations. A company must include in this section a discussion of its liquidity, capital resources and results of operations. The Staff noted, in particular, that forward looking information is required to be included where there are known trends, uncertainties or other factors enumerated in the rules that will result in, or that are reasonably likely to result in, a material impact on the company's liquidity, capital resources, revenues and results of operations, including income from continuing operations. A company must focus on known material events and uncertainties that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.

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A significant number of comments were issued generally seeking greater analysis of the company's financial condition and results of operations. The comments addressed situations where companies simply recited financial statement information without analysis or presented boilerplate analyses that did not provide any insight into the companies' past performance or business prospects as understood by management. The Staff sought information regarding the existence of known trends, uncertainties or other factors that required disclosure that was not included. The SEC also issued comments discouraging companies from providing rote calculations of percentage changes of financial statement items and boilerplate explanations of immaterial changes to these figures, encouraging them to include instead, a detailed analysis of material year-to-year changes and trends. In addition, comments addressed key areas, in particular the related topics of liquidity, cash flow and capital resources, which were given insufficient attention.

The Staff also issued a significant number of comments regarding company or industry-specific MD&A disclosure, in particular comments posing specific questions relating to information presented in the financial statements that warranted more discussion in the MD&A.

The Staff also indicated their intention to continue their focus on MD&A disclosures.

Critical Accounting Policy Disclosure

The Staff asked a number of companies to present, or expand a current presentation of, a discussion of their critical accounting policies in their MD&A. In December 2001, the Staff issued cautionary advice and indicated that companies should provide more discussion in MD&A about their critical accounting policies. Under an appropriate heading, companies are encouraged to disclose their most difficult and judgmental estimates, the most important and pervasive accounting policies they use, and the areas most sensitive to material change from external factors, and to provide a sensitivity analysis to facilitate an investor's understanding of the impact on the bottom line.

The Fortune 500 project revealed that a substantial number of companies did not provide any critical accounting policy disclosure in circumstances where the Staff cautionary advice could fairly be read as calling for this disclosure. The Staff also found that the critical accounting policy disclosure of many companies did not adequately respond to the guidance provided in its cautionary advice, including the sensitivity analysis encouraged by the Staff.

The Staff asked many companies to enhance their disclosure of critical accounting policies in one or more of the following areas:

- revenue recognition;
- restructuring charges;
- impairments of long-lived assets, investments and goodwill;
- depreciation and amortization expenses;
- income tax liabilities;
- retirement and post retirement liabilities;
- pension income and expense;
- environmental liabilities;

- repurchase obligations under repurchase commitments;
- stock based compensation;
- insurance loss reserves; and
- inventory reserves and allowance for doubtful accounts.

We expect SEC rulemaking on critical accounting policies in the next few weeks.

Non-GAAP Financial Information

The Staff addressed the use of non-GAAP financial information in a large number of comments. In general, companies were asked either:

- to remove non-GAAP financial measures, because they were believed to be misleading or susceptible to misinterpretation; or

- to present them less prominently with better explanation and disclosure that is more balanced.

The Staff indicated that many companies often gave limited prominence to GAAP financial information and provided limited discussions of GAAP-based results of operations and changes in assets and liabilities. Companies that presented alternative or pro forma statements of operations were asked to remove them. Some comments advised companies that GAAP-based financial information was required in MD&A and that they should provide GAAP-based performance discussions with equal or greater prominence than those based on non-GAAP measures.

The comments relating to non-GAAP financial information were generally consistent with the new requirements of Regulation G and Item 10 of Regulation S-K.

Revenue Recognition

The Staff frequently requested clarification of how companies recognize revenue, including how their revenue recognition specifically complies with Staff Accounting Bulletin 101, which provides guidance on how to apply GAAP to revenue recognition issues. Companies were also asked to expand significantly their revenue recognition accounting policy disclosures. In response to comments, many companies agreed to provide additional company-specific disclosure about the nature, terms and activities from which revenue is generated and the accounting policies for each material revenue generating activity.

Restructuring Charges

The Staff asked many companies to justify or explain more fully their accounting for restructuring charges and to expand their disclosure of restructuring charges in their financial statements and in their MD&A. The Staff asked companies to:

Financial Statements

- include a period-by-period analysis of restructuring charges, including the original restructuring charge, cash payments made, non-cash charges used, reversals or adjustments to the charges and non-cash write-downs (impairments, etc.), and disclosure of the adjustment or reversal for each material component of the total restructuring charges;

- describe the facts and circumstances leading to the restructuring plan, as well as a complete description of each component of total restructuring charges;

- more fully describe the timing of cash payments to be made under the restructuring plan and to disclose when they expected the restructuring plan to be complete; and

- highlight the nature and reasons for adjustments or reversals of restructuring charges; and

MD&A

- expand their MD&A to include a reasonably detailed discussion of the events and decisions that gave rise to restructuring plans, and the reasonably likely material effects of management's plans on financial position, future operating results and liquidity;

- provide a discussion of the nature, amount and description for each material component of total restructuring charges, as well as to identify the periods in which material cash outlays are anticipated, to identify the expected source of their funding, and to discuss material revisions to the plans, and the timing of the plan's execution, including the nature and reasons for any revisions; and

- discuss the reasonably likely material effects on future earnings and cash flows resulting from the plans (for example, reduced depreciation, reduced employee expense, etc.) and to quantify and disclose these effects and to disclose when they expected those effects to be realized.

Impairment Charges

The Staff issued a significant number of comments on impairment charges, focused in significant part on three distinct areas: long-lived assets, securities held for investment, and goodwill and other intangible assets.

Impairment of Long-Lived Assets

Many comments related to the timing, measurement and disclosure of impairment charges recognized for long-lived assets. Companies were asked why impairment charges were not recognized in prior periods or not yet recognized at all. Also, companies were asked to identify in their MD&A material assets analyzed for impairment for which an impairment charge had not yet been recorded. This could be related to a discussion of critical accounting policies and estimates discussed above. In addition, the Staff asked these companies to expand their disclosures in their financial statements and MD&A to describe:

- the specific assets that were impaired, including whether those assets were held for use or held for sale;

- the facts and circumstances (specific events and decisions) that led to the impairment charge; and
- the assumptions or estimates they used to determine the amount of the impairment charge.

Impairment of Securities Held for Investment

Treatment of investment securities with other-than-temporary losses was another frequent area of comment. SFAS No. 115 provides guidance on accounting for equity securities with readily determinable fair values and for all investments in debt securities. According to SFAS No. 115, companies may classify securities as held to maturity or available for sale. For these classifications of securities, unrealized losses (the difference between the current market price of the security and the carrying amount) are not recognized in net income until the loss is determined to be other-than-temporary. Many companies held investments that had significant unrealized losses for an extended period of time, and the Staff asked these companies to explain or justify how they determined that these losses were still considered temporary, referring them to Staff Accounting Bulletin 59 for additional guidance. Companies were also asked to expand their MD&A to describe the specific factors they used to determine whether unrealized losses were considered to be temporary and when they were considered other-than-temporary.

Impairment of Goodwill and Other Intangible Assets

Another prominent impairment issue dealt with the adoption of SFAS No. 142. This standard was first applied in fiscal years beginning after December 15, 2001, and requires that the carrying amount of goodwill and intangibles with indefinite lives no longer be amortized, but instead be tested at least annually for impairment. Companies were asked questions about their goodwill impairment tests and their determination that intangible assets had indefinite lives and to revise their financial statements to reflect impairments, to more clearly describe their accounting policy for measuring impairment, including how reporting units are determined and how goodwill is allocated to those reporting units, and/or to provide missing disclosures required by SFAS No. 142. The Staff also asked companies to expand their MD&A to describe the methodology and assumptions or estimates used to test goodwill and other intangible assets for impairment, and to highlight any reporting units for which goodwill impairment charges were reasonably likely to occur.

Pension Plans

Another significant area of comment related to the assumptions companies use in determining the amount of pension income or expense to recognize. The majority of the Staff's comments dealt with the long-term expected return assumption for plan assets. SFAS Nos. 87 and 106 provide guidance on accounting and disclosure for post-retirement plans. The majority of companies use an estimated return, and therefore must amortize the difference from the actual return, the unrecognized gain/loss, into income in future periods. The negative stock market returns of the last three years caused many companies to have significant unrecognized losses related to their pension plans, which are often not transparent to investors. The Staff asked companies about the basis for and the reasonableness of their expected return assumption. Additionally, many companies were asked to expand their MD&A to clearly describe:

- the significant assumptions and estimates used to account for pension plans and how those assumptions and estimates are determined, for example the method (arithmetic/simple averaging, or geometric/compound averaging) and source of return data used to determine the expected return assumption and the assumptions, estimates and data source used to determine the discount rate;

- the effect that pension plans had on results of operations, cash flow and liquidity, including the amount of expected pension returns included in earnings and the amount of cash outflows used to fund the pension plan;

- any expected change in pension trends, including known changes in the expected return assumption and discount rate to be used during the next year and the reasonably likely impact of the known change in assumption on future results of operation and cash flows;

- the amount of current unrecognized losses on pension assets and the estimated effect of those losses on future pension expense; and

- a sensitivity analysis that expresses the potential change in expected pension returns that would result from hypothetical changes to pension assumptions and estimates.

Segment Reporting

The Staff issued a significant number of comments dealing with how companies determine their operating segments in their financial statements and MD&A. Under SFAS No. 131 and SEC rules, an operating segment is a component of a business, for which separate financial information is available that management regularly evaluates in deciding how to allocate resources and assess performance. SFAS No. 131 and SEC rules specify when a company must report separate financial information about an operating segment. A number of companies inappropriately aggregated multiple segments, or did not adequately explain the basis for aggregating information.

Securitized Financial Assets and Off-Balance Sheet Arrangements

The Staff raised questions about how some companies described their sale of financial assets (such as accounts receivable, loans, and investment securities) through securitizations. While the newly created securities are sold to outside investors, companies often retain a portion of the securities or interests in obligations regarding the securitized assets. SFAS No. 140 provides guidance to companies to determine when a sale has occurred, how to account for that sale, and when to disclose information about the sale. Pursuant to that guidance, a transfer of financial assets is not considered a sale unless the company has surrendered control over those assets. The Staff asked companies questions about how they determined that they had surrendered control of the assets transferred, especially when there appeared to be substantial continuing involvement with the transferred assets. Companies were asked to expand their MD&A to describe the structure, business purpose and accounting for these transactions and to highlight in their MD&A the significant assumptions they used to determine a gain or loss from the sale of these assets, and the potential risk of loss they retained in these assets. In addition, some companies, most commonly financial institutions, were asked to expand their financial statements to provide all of the disclosures required by paragraph 17 of SFAS 140, separately for each type of asset sold in a securitization.

In the past, the SEC has encouraged companies to include expanded, as well as tabular, disclosure of off-balance sheet arrangements. The Staff asked many companies to explain more fully in their MD&A the nature and accounting for off-balance sheet arrangements and to expand their footnote disclosure to specify the accounting for those arrangements. With the SEC's recent adoption of new disclosure requirements in this area and new financial interpretations by the Financial Accounting Standards Board regarding both accounting for and disclosure regarding guarantees and variable interest entities, the Staff will continue to monitor accounting and disclosure in these areas.

Environmental and Product Liability Disclosures

The Staff issued comments relating to environmental and product liability disclosure to a number of oil and gas and mining companies, as well as to several manufacturing companies. Companies were pointed to SFAS 5, FIN 14, SOP 96-1 and SAB 92, which generally provide that companies with environmental and product liabilities must disclose:

- the nature of a loss contingency;
- the amount accrued;
- an estimate of the range of reasonably possible loss;
- significant assumptions underlying the accrual; and
- the cost of litigation.

In addition to finding that many companies did not provide adequate disclosure relating to those items, the Staff also found that companies could improve their disclosures required by SAB 92. SAB 92 provides interpretations of SFAS 5 (loss contingencies), but also includes additional specific disclosure requirements. Companies with material contingent liabilities were urged to carefully review their disclosures and ensure that they include all required information. Companies were also asked to provide in their MD&A a meaningful analysis as to why the amounts charged in each period were recorded and how the amounts were determined.

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Any questions concerning the foregoing should be addressed to any of the following. This memorandum is not intended to provide legal advice, and no legal or business decision should be made based solely on its content. In addition, memoranda on related topics may be accessed under Securities Group publications on our website (www.paulweiss.com).

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