

SEC STAFF ISSUES SUMMARY OF FINDINGS FROM REVIEW OF FILINGS BY FORTUNE 500 COMPANIES

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In December 2001, the Securities and Exchange Commission staff announced its intention to monitor the annual reports on Form 10-K filed by all Fortune 500 companies in 2002.¹ On February 27, 2003, the SEC's Division of Corporation Finance issued a brief summary of its findings based on these reviews. This summary, although general in nature, provides guidance concerning issues as to which reporting companies should be sensitive as they prepare their upcoming annual report filings.

In the summary the SEC staff briefly discusses issues which were frequently the subject of comments as a result of SEC staff reviews of annual reports on Form 10-K and other periodic reports. The major categories of disclosure addressed in the summary are as follows:

- Management's discussion and analysis of financial condition and results of operations generally;
- Critical accounting policy disclosure;
- Non-GAAP financial information;
- Revenue recognition;
- Restructuring charges (both disclosure in financial statements as well as in the MD&A);
- Impairment charges (including impairment of long-lived assets, impairment of securities held for investment and impairment of goodwill and other intangible assets);
- Pension plans;
- Segment reporting;

¹ *Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of Fortune 500 Companies*, issued on February 27, 2003.

- Securitized financial assets and off-balance sheet arrangements; and
- Environmental and product liability disclosures.

Many of these subject areas will be familiar to preparers of annual report filings as they have either been the frequent subject of comment by the SEC (e. g. , the disclosure contained in the management's discussion and analysis section of filings), and/or recent releases and rulemaking initiatives (e. g. , use of non-GAAP financial measures). We believe that particular focus on the issues identified in the summary is highly advisable, as the SEC staff has issued this summary as part of an ongoing initiative to foster better disclosure. We also anticipate that the SEC staff will be increasing its scrutiny of the disclosure contained in the management's discussion and analysis section of annual report filings and will likely be inclined to require remedial amendments in the event that the disclosure is found to be deficient. A copy of the SEC staff summary is attached for your reference as Annex A.

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This memorandum is for general information purposes only and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda regarding recent corporate governance developments, can be obtained from our website, [www. simpsonthacher.com](http://www.simpsonthacher.com).

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Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies

Monitor of the Fortune 500 by the Division of Corporation Finance

In December 2001, the 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. This summary discusses the principal subjects of comment by the Division on these 2002 reports. It is not intended to be an evaluation of the quality of disclosure, and the fact that an area of disclosure is not addressed should not be taken as an indication that we do not see issues or potential for improvement in other areas. As indicated in December 2001, the Division focused on disclosure that appeared to be critical to an understanding of each company's financial position and results, but which, at least 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.

Report of the Division of Corporation Finance

All annual reports on Form 10-K filed by Fortune 500 companies received a preliminary review, which we have sometimes referred to as a screening. Based on that process, we selected a substantial number of companies for some level of further review. Comment letters have been sent to more than 350 of the Fortune 500 companies. As in the past, we asked companies to amend their filing where appropriate; in many cases, we asked companies to respond to our comments in future filings. We expect to selectively review future filings of these companies to ensure continued compliance with our comments and with the federal securities laws. It is important to note that our work on this project is not yet complete - we continue to work with many companies as they respond to our comments, and we continue to send comments to companies who filed their annual reports in the later part of 2002.

Many of the comments we provided to companies were fact specific to individual companies. While we addressed a variety of issues in our comments, we have identified certain general areas of comment where we believe disclosure could be significantly enhanced. We also discovered that the comments raised on the Fortune 500 companies are consistent with the comments we issue generally in our review of periodic filings. We are providing in this document a summary of the most common areas of comment addressed in our Fortune 500 project. While all of the comments discussed in this report were issued frequently, they are not

discussed in any particular order. We put them forth to assist all companies as they prepare documents that they will file with the Commission.

Management's Discussion & Analysis Generally

We found that we issued comments on the MD&A discussions of the Fortune 500 companies 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. In particular, forward looking information is required 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.

We issued a significant number of comments generally seeking greater analysis of the company's financial condition and results of operations. Our 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. In this vein, we sought information regarding the existence of known trends, uncertainties or other factors that required disclosure that was not included. We 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, we issued comments addressing key areas, in particular the related topics of liquidity, cash flow and capital resources, which were given insufficient attention. We will continue to focus on this section of disclosure documents in our review efforts and encourage all companies to present useful and meaningful disclosure of their financial condition and results of operations.

In addition to these general areas, we 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 we believed warranted more discussion in the MD&A.

Critical Accounting Policy Disclosure

We 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 Commission released FR-60 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.

In our review of the Fortune 500 companies, we noted a substantial number of companies did not provide any critical accounting policy disclosure in circumstances where FR-60 could fairly be read as calling for this disclosure. We also found that the critical accounting policy disclosure of many companies did not adequately respond to the guidance provided in FR-60. We also found that many companies failed to provide the sensitivity analysis the Commission encouraged in FR-60.

Many of the areas identified below could have been made more transparent as a result of a more thoughtful discussion of assumptions and estimates. We found that we 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.

Non-GAAP Financial Information

In a large number of comments, we addressed the use of non-GAAP financial information. In general, we asked companies either to remove non-GAAP financial measures, because we believed they were misleading or susceptible to misinterpretation, or to present them less prominently with better explanation and disclosure that is more balanced. We found that we directed many of these comments to financial services companies since they often presented "managed basis" or "normalized" financial information and related discussions in the MD&A. "Managed basis" information is GAAP-based information adjusted to reverse the sale of loans

and other assets under securitization arrangements. 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. We also issued comments advising 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.

In January 2003, the Commission adopted rules implementing Section 401(b) of the Sarbanes-Oxley Act of 2002 (Release No. 33-8176). Generally, the new rules require that where non-GAAP financial information is presented in periodic reports filed with the Commission, the company must also include:

a presentation with equal or greater prominence of the most directly comparable financial measure presented in GAAP;

- a reconciliation to the comparable GAAP measure;
- a statement of the reasons why management believes that the non-GAAP presentation is useful; and
- a statement disclosing the additional purposes, if any, for which management uses the non-GAAP financial measure that are not otherwise disclosed.

The Commission's rules also amended Regulation S-K to codify certain staff positions regarding filings. Companies' 2002 filings, of course, pre-dated these requirements. We believe that comments we issued on 2002 filings have been generally consistent with the new rules. We recognize that the new disclosure requirements may affect how companies respond to comments we have issued in this area. We will continue to monitor disclosure in this area, especially in light of these new rules that will be in effect beginning March 28, 2003.

Revenue Recognition

We 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 general accepted accounting principles to revenue recognition issues. We also asked companies to expand significantly their revenue recognition accounting policy disclosures. In response to our 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.

In certain industries, we noted common disclosure and comment themes, including the following:

- *Computer software, computer services, computer hardware and communications equipment.* We issued comments requiring expanded disclosure regarding the revenue recognition accounting policy for software and multiple element arrangements (providing software, hardware and services under the same agreement) to a number of companies in these industries.
- *Capital goods, semiconductor, and electronic instruments and controls.* Our comments demonstrated that the accounting policy disclosure for deferred revenue, revenue recognition for products with return or price protection features, requirements for installation of equipment and other customer acceptance provisions could be improved in the filings of a number of companies in these industries.
- *Energy.* We found that many companies in this industry did not adequately disclose the material terms of energy contracts.
- *Pharmaceutical and retail.* We found that many pharmaceutical companies did not adequately disclose the revenue recognition policy in respect of product returns, discounts and rebates. In addition, we issued comments requiring improved disclosure of their arrangements for co-op advertising arrangements with retail companies.

Restructuring Charges

We asked many companies to justify or explain more fully their accounting for restructuring charges. We also issued a significant number of comments asking companies to expand their disclosure of restructuring charges in their financial statements and in their MD&A. We commented on this topic throughout many of the industries represented in the Fortune 500. Set forth below is a summary of some of the more common types of comments we issued on this topic.

Financial Statements

- We asked companies to include a period-by-period analysis of restructuring charges. We asked that this analysis include 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.
- We asked companies to describe the facts and circumstances leading to the restructuring plan. We asked companies to provide a complete description of each component of total restructuring charges.

- We asked companies to 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.
- In several instances, we asked companies to highlight the nature and reasons for adjustments or reversals of restructuring charges.

MD&A

- We asked companies to 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.
- We asked companies to provide a discussion of the nature, amount and description for each material component of total restructuring charges. We also asked companies 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.
- We asked companies to discuss the reasonably likely material effects on future earnings and cash flows resulting from the plans (for example, reduced depreciation, reduced employee expense, etc.). We asked companies to quantify and disclose these effects and to disclose when they expected those effects to be realized.

Impairment Charges

We 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 of our comments related to the timing, measurement and disclosure of impairment charges recognized for long-lived assets. We asked companies why impairment charges were not recognized in prior periods or not yet recognized at all. We also asked companies 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, we 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. We noticed that many companies held investments that had significant unrealized losses for an extended period of time. We 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. We also asked companies 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 into expense, but instead be tested at least annually for impairment. We asked companies questions about their goodwill impairment tests and their determination that intangible assets had indefinite lives. We asked companies 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. We 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 our 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. We asked companies about the basis for and the reasonableness of their expected return assumption. We also asked many companies 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

We 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 our 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 our rules specify when a company must report separate financial information about an operating segment. We asked companies questions about their segment reporting disclosure. A number of companies inappropriately aggregated multiple segments, or did not adequately explain the basis for aggregating information. We also asked questions about the various aspects of SFAS No. 131 that specify specific disclosure requirements once the operating segments are identified.

Securitized Financial Assets and Off-Balance Sheet Arrangements

We 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. We 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. We asked companies to expand their MD&A to describe the structure, business purpose and accounting for these transactions. We also asked companies 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, we requested some companies, most commonly financial institutions, 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.

Although the technical literature governing special purpose or variable interest entities is different, we found the disclosure issues and our general areas of comment to be similar. In FR 61, we encouraged companies to include expanded, as well as tabular, disclosure of off-balance sheet arrangements. We 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 Commission'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, we will continue to monitor accounting and disclosure in these areas.

Environmental and Product Liability Disclosures

We 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. In these comments, we pointed the companies to the guidance in 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, we also found that companies could improve their disclosures required by SAB 92. SAB 92 provides interpretations of SFAS 5, but also includes additional specific disclosure requirements. We urged companies with material contingent liabilities to carefully review their disclosures and ensure that they include all required information. We also urged companies 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.