January 2007
Weil, Gotshal & Manges

Preparing the MD&A in 2007

The SEC has issued no new rulemaking on the MD&A section of periodic reports since publication of its December 2003 interpretive release (the "2003 MD&A Interpretive Release").[1] Repeated statements from at least one Commissioner and members of the SEC's senior staff, made over the course of 2006 as the staff communicated its conclusions regarding the results of its review of approximately 4,485 issuers' periodic reports and other filings as of the SEC's fiscal year ended September 30, 2006,[2] nevertheless underscore the SEC's view that the 2003 MD&A Interpretive Release remains the benchmark against which the quality of MD&A disclosure will be judged in 2007.

Commissioner Glassman (who since left the SEC) set the tone early in 2006, urging an audience of corporate counsel to encourage their clients to provide better explanations of trends and uncertainties and to discuss in more detail the key company value drivers – both important messages conveyed by the 2003 MD&A Interpretive Release.[3] As the year progressed, in a series of speeches and an updated version of the Division of Corporation Finance's Accounting and Disclosure Issues outline posted on the SEC's website in December 2006 ("2006 Staff Outline"),[4] the staff reiterated and refined its evolving perspective on application of the guidance set forth in the 2003 MD&A Interpretive Release. Through these various, less formal means of communication, the staff has identified recurring areas of MD&A disclosure in need of improvement, and also has highlighted important areas to address in the 2007 MD&A with respect to the impact on the company's financial statements of current year or impending adoption of newly issued or revised accounting standards and interpretations, such as those relating to pensions and post-retirement benefits (FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, or "SFAS 158") and uncertain tax positions (FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, or "FIN 48").

Along with this forward-looking focus, the staff has continued to emphasize the importance of identifying and correcting errors in historical financial statements – even those that may have been deemed immaterial during prior reporting periods but which, in the staff's view, continue to detract from the accuracy and completeness of current corporate financial statements. One need only consider in this connection the SEC's multi-front approach to the unfolding option "backdating" controversy. The Enforcement Division's vigorous investigation (in many cases conducted in conjunction with Department of Justice-initiated criminal inquiries) of option grant processes seems to cover practices spanning the past decade or more, prompting many companies to announce their own internal investigations of option grant activities going back a decade or more. In July 2006, the PCAOB issued its first Practice Alert ("PCAOB Audit Practice Alert No. 1"), warning auditors planning or performing an audit to be alert to the risk that the issuer may not have properly accounted for stock option grants and, as a result, may have materially misstated its financial statements or may have deficiencies in internal control over financial reporting covered by Section 404 of the Sarbanes-Oxley Act of 2002 ("SOXA")."[5] In September 2006, the SEC's Chief Accountant published a letter providing guidance on the

application of the measurement provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB 25") – the generally accepted accounting standard that governed recognition of equity compensation expense before mid-2002, when the bulk of the questionable practices occurred.[6]

Against this background of intense law enforcement and regulatory scrutiny, some companies already have decided to restate previously filed financial statements. Newly published guidance from the Division of Corporation Finance accounting staff will enable these and other similarly situated companies to effect their restatements as part of a "clean-up" Form 10-K (either the upcoming Form 10-K if to be filed within the next two weeks, or an amendment to the most recent Form 10-K) that would reflect (among numerous other disclosure items) in an audited footnote to the financial statements the year-by-year impact of improperly recorded employee stock-option expense and the related tax effects. The MD&A section would have to explain in detail, "based on the restated annual and quarterly financial information [presented in the financial statements and elsewhere in the 10-K], . . . the company's operating results, trends and liquidity during each interim and annual period presented."[7]

Consistent with this retrospective focus on correction of deficient historical financial statements, but aimed at a far broader spectrum of past accounting errors than those relating to option expense, the staff published long-promised guidance in the form of Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (Sept. 13, 2006) ("SAB 108"), available at http://www.sec.gov/interps/account/sab108.pdf. This guidance adopts a dual-method approach – involving both the balance sheet and income statement – to quantifying unadjusted errors in historical financial statements, while providing specific transition relief allowing for correction of errors properly considered immaterial under the company's historical approach, pursuant to a one-time cumulative adjustment in lieu of amending the affected prior period financial statements. There has been no change to Staff Accounting Bulletin No. 99, *Materiality* (Aug. 12, 1999) ("SAB 99"), available at http://www.sec.gov/interps/account/sab99.htm, which governs analysis of the materiality of financial statement errors once quantified. However, the SEC staff did offer some insight into how materiality should be analyzed in a situation not specifically addressed in SAB 99 – where an issuer is weighing qualitative factors in the case of a quantitatively large error.

We also summarize major accounting "hot buttons" identified by senior SEC staff at conferences in late 2006 and in the 2006 Staff Outline, and illustrated by several enforcement proceedings. At the risk of stating the obvious, the staff's views on proper application of accounting principles influence not only the preparation of the fiscal 2006 financial statements themselves, but also management's discussion and analysis of the cash flows, results of operations and financial condition presented in those financial statements (including, but not confined to, disclosure on management's choice of critical accounting estimates and assumptions). If anything, the SEC as a body more strongly regards the MD&A, along with the financial statements themselves, as the essence of the Forms 10-K and 10-Q to which the CEO and CFO must certify, as evidenced by enforcement cases instituted against Raytheon Company and McAfee, Inc. last year. Two notable MD&A enforcement proceedings brought in 2005 – against The Coca Cola Company and two former Kmart executives – are highlighted for a second year (in the 2006 Staff Outline) and therefore are of continuing significance to those drafting the 2007 MD&A. The bottom line:

the SEC and its staff are in no mood to be flexible in considering whether a company's MD&A accurately and fully explains the story behind the numbers.

1. Important Developments in Evaluating Materiality

The same test for "materiality" is central to decisionmaking in both the legal (securities law disclosure obligations) and accounting (analyzing the need to correct financial statement errors under FASB Statement No. 154, *Accounting Changes and Error Corrections* ("SFAS 154")) spheres: whether there is a "'substantial likelihood'" that a misstated or omitted fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." SAB 99 (quoting from the U.S. Supreme Court's decision in *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). With respect to errors in the financial statements, or in any other corporate disclosure of financial information made to the investing public such as the MD&A, "the 'total mix' includes the size in numerical or percentage terms of the misstatement [*i.e.* the error] . . . [as well as] the factual context in which the user of financial statements would view the financial statement item [and/or the MD&A's explanation of the company's historical or future financial performance]." *Id.*

- As reflected in speeches delivered at the AICPA conference this past December, the SEC's accounting staff continues to wrestle with application of the amorphous materiality concept in the wake of SAB 99's adoption. Among the most significant questions in this area that were addressed by members of the staff in 2006, and thus are highly relevant to preparation of the 2007 MD&A and underlying financial statements, were the following:

  - **When can qualitative considerations render immaterial a quantitatively large error?** It depends. SAB 99 helps answer the question of when quantitatively small errors are material because of qualitative considerations such as management integrity or association with hitting analysts' estimates, but does not tackle what is perhaps a tougher question from the staff's perspective: when can a quantitatively large error be deemed immaterial for qualitative reasons? As explained by senior Corporation Finance Division accountant Todd Hardiman, the staff believes it is possible in certain circumstances for a large error to be immaterial, "[b]ut the reality is that we just don't see those circumstances all that often."[8] Where a quantitatively large error is found, it is not enough to cite the absence of the illustrative qualitative factors identified in SAB 99 in arguing that this large error is not material. Instead, companies "need to look beyond the qualitative considerations listed in the SAB that identify when a small error may be material . . . to identify the considerations that cause the financial statements to be reliable notwithstanding the large error."

  - Mr. Hardiman explained that the staff "took a stab at trying to identify the types of considerations that might cause a large error to be immaterial . . . . [and] could only come up with two examples": (a) a break-even year in a turnaround context, unless the company regularly has razor-thin margins

or net income; and (2) a large error occurred with respect to a discontinued operation that has been sold, which would not have affected the seller's "representations and obligations or the selling price it received"; however, the staff seemed skeptical that such situations could occur, because errors in discontinued operations "can [be] and often have been material."[9]

- **Can an individual error be immaterial, regardless of its magnitude, simply because of the existence of an offsetting error of equal magnitude?** No. SAB 99 does require that errors be evaluated both individually and in the aggregate, but this does not mean that an individual error can be deemed immaterial simply because of the existence of an offsetting error of equal magnitude – *e.g.*, a company has two errors considered material – one error that overstates net income by 30% and another that understates net income by 28%, meaning that combined net income is overstated by 2%. The company could not treat the resultant 2% error as immaterial and avoid correction; rather, the company would have to evaluate separately the effect of each error on each financial statement line item (including subtotals and totals) and, if it then "concludes that an individual error is material, irrespective of its effect when combined with other errors, . . . [the company] would need to restate . . . [its] financial statements."[10] Note that a restatement likewise would be necessary where individual errors considered immaterial when analyzed on a stand-alone basis are material on a combined basis.

- **Should the materiality of errors in quarterly financial statements, whether originating errors or prior period errors, be evaluated against quarterly or annual amounts?** The SEC staff isn't sure of the answer yet. The staff recognizes that one of the first steps companies take in assessing quantitative materiality of a given error is to consider the relative size of that error by comparison with a financial statement line item, such as pre-tax income. The question becomes whether to use an annual financial statement line item for this purpose, as the relevant accounting literature can be read to suggest in the case of a prior period error, or instead use the quarterly period as a reference point. The staff rejected the proposition, espoused by some in the financial reporting community, that errors in quarterly financial statements should always be assessed relative to annual amounts. Otherwise, "[a]ny error that is immaterial to the year is fair game to book in a quarter, or even leave uncorrected, regardless of how it distorts or misstates quarterly results . . . for that reason, we do not believe it complies with GAAP."[11] At the other extreme lies the school of thought positing that, because "quarters matter," quarterly errors – regardless of whether they originate in the current quarter or in prior periods for which annual financial statement amounts are available for comparison purposes – must be assessed relative to quarterly amounts. Somewhere in between on this analytical spectrum, there may be arguments in favor of permitting comparisons of prior period errors, or errors that arose in a previously reported quarter, with annual

amounts (coupled with full disclosure of the quarterly impact, if material when compared to the previously reported quarter), while comparisons of errors that originated in the current quarter would be made only to that quarter's financial-statement amounts. At first, the staff had been inclined to take this third position, but ultimately opted instead to encourage continued deliberation in deference to the concerns of "non-accountant" investors who might well disagree that an error can be immaterial to a quarter simply because it is expected to be immaterial to the year.

- As part of the evaluation of the materiality of a financial statement error, the magnitude of the error must be quantified. This fall, the SEC accounting staff finally resolved – in SAB 108 – the thorny question of "how the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement." 2006 Staff Outline, Section 1.C.

  - ➢ For some years the staff had voiced concern about the deficiencies inherent in both of the two common methods employed by registrants to quantify financial statement errors that were not corrected in previous years: (a) the "income statement" or "rollover" approach, which quantifies the error in terms of the amount by which the current year's income statement is misstated but can lead to the accumulation of uncorrected errors in the balance sheet; and (b) the "balance sheet" or "iron-curtain" approach, which quantifies the error as the cumulative amount by which the current year balance sheet is misstated but can lead to a material misstatement in the current year's income statement as a result of correcting prior year errors. Because exclusive reliance on one or the other approaches leaves some errors uncorrected, companies now must apply both approaches – in a so-called "dual approach."

  - ➢ The staff has encouraged companies to begin to apply SAB 108 early in any report for an interim period of the first fiscal year ending after November 15, 2006. SAB 108 is effective for the first fiscal year ending after November 15, 2006, which means the December 31, 2006 audited financial statements for a calendar year company, absent early adoption in the third quarter financial statements filed as part of that quarter's Form 10-Q (*see* SAB 108, Question 3). In the initial year of its application, SAB 108 allows companies a one-time opportunity to correct, via a cumulative-effects adjustment rather than revision of historical financial statements, prior period errors deemed immaterial under whatever method the company had previously applied but material under the "dual method." This transitional relief is available only "if management properly applied its previous approach, either iron curtain or rollover, [and] all relevant qualitative factors were considered." SAB 108, Question 3. A company eligible to record a cumulative-effect adjustment in its 2006 financial statements upon initial application of SAB 108 (by reporting the effect of this application in the carrying amounts of assets and liabilities as of the beginning of the fiscal year, *i.e.*, January 1, 2006

for calendar year companies, with an offsetting adjustment made to the opening balance of retained earnings for the year), should disclose the nature and amount of each individual error being corrected in the cumulative adjustment, including when and how each error being corrected arose and the fact that the errors had previously been considered immaterial. Calendar year companies that initially apply the guidance in Question 3 of SAB 108 to effect the permitted cumulative effect adjustment in the 2006 audited financial statements filed with the upcoming Form 10-K – which we strongly recommend if the conditions for reliance on this one-time reprieve can be met – should make the requisite disclosure in the MD&A as well as the financial statements.

- SAB 108 in no way modifies SAB 99's materiality analysis. And SAB 108 reminds us that a change from an accounting principle that is not generally accepted to one that is generally accepted will be treated as correction of an error. *See* SAB 108, Question 2, citing SFAS 154, paragraph 2h.

- During the 2006 AICPA Conference, the staff[12] addressed the following two questions raised by companies and their auditors relating to treatment of immaterial errors in prior year financials (as reproduced verbatim from the staff's speech, posted on the SEC's website):

> *In the first year of application, can prior year errors that were determined to be immaterial after being quantified under a SAB 108 approach be included in a beginning of the year cumulative effect adjustment?*
>
> *Although not directly on point, SAB Topic 5F indicates that accounting changes not retroactively applied due to immateriality can be effectuated either by retroactive adjustment of prior period financial statements or in the current statement of income if the correction is immaterial to that period. Practically, registrants typically elect to correct immaterial errors in current period income.*
>
> *However, what may not be clear is whether those particular immaterial errors would be considered material in the aggregate under SAB 99. If the registrant and the auditor determine that the immaterial error, when aggregated with other material or immaterial errors, is material, then inclusion in the cumulative effect adjustment may be appropriate. Of course, the registrant would still need to disclose each and every error and, by virtue of using the cumulative effect mechanism, would be asserting that the errors are material, at least in the aggregate,*

If a registrant elects to retroactively adjust prior period financial statements for immaterial errors, are those financial statements required to be labeled as restated with mention in the auditor's report, and, is the filing of an Item 4.02 Form 8-K required?

This question is more subjective and there is limited guidance that serves as a foundation. However, if you consider that immaterial errors by definition are errors that are believed not to effect [sic] the decisions made by current and past investors, then the registrant, in conjunction with its legal counsel and auditors, could make a reasoned judgment about whether each or any of those communications are required or would provide useful information to the financial statement users. It seems the real question is how to meet the objective of clear and transparent financial reporting providing sufficient disclosure of the changes and the reasons why the changes are necessary.

2. Highlights of the SEC's 2003 MD&A Interpretive Guidance, as Reaffirmed or Amplified in 2006

The 2003 MD&A Interpretive Release focuses on helping companies prepare clearer and more understandable MD&As with information that "more completely satisfies" the SEC's longstanding core regulatory objectives to:

- Provide a narrative explanation of company financial statements enabling investors to view the company through the eyes of management.
- Enhance the overall financial disclosure and furnish a context within which that disclosure can be analyzed by investors.
- Provide information regarding the quality and potential variability of a company's earnings and cash flow, in order to allow investors to assess the likelihood that past performance is indicative of future performance.

To meet these objectives, senior managers are urged to become involved early in the MD&A drafting process to help identify the "key disclosure themes and items." Consistent with this "top-down" approach, the SEC calls on senior management to "take a fresh look at MD&A with a view toward enhancing its quality." Companies should move away from assigning more junior personnel to prepare MD&A and other critical disclosures made in periodic reports by reference to last year's 10-K, and providing only final or near-final drafts to the CEO and CFO who must certify to the accuracy and completeness of the particular report to be filed.

The SEC's 2003 MD&A guidance identifies four major areas for management attention: (1) overall presentation; (2) focus and content; (3) liquidity and capital resources; and (4) critical accounting estimates and assumptions. We address each area briefly below. It is worth noting that the Division of Corporation Finance first identified many of these concerns in February 2003 in connection with the staff's report on the results of its targeted review of MD&A and financial

statements contained in Fortune 500 companies' 10-Ks and 10 Qs ("Fortune 500 Review").[13] We recommend that you review this report, given that so many of the problematic areas discussed there remain SEC "hot-buttons" as reflected, for example, in the 2006 Staff Outline.

Other SEC interpretive guidance of continuing relevance may be found in the SEC's December 2001 "Cautionary Advice Regarding Disclosure About Critical Accounting Policies"[14] and its January 2002 "Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations" (the latter, "2002 MD&A Statement").[15] The 2002 MD&A Statement offers valuable insights into the SEC's expectations regarding the use of non-exchange traded commodity contracts with no quoted market price and related risk management activities. Another subject covered in the 2002 MD&A Statement, which we believe is still relevant notwithstanding the new "principles-based" related-person transaction disclosure required by amended Item 404 of Regulation S-K (***see Tab 7***) – the disclosure of "almost related party (or person)" transactions or relationships that may raise conflict of interest concerns even though they do not fall within the express requirements of Regulation S-K Item 404 and FASB Statement No. 57 ("SFAS 57") governing related party disclosures in the financial statements.

A final source of information regarding the staff's perspective on MD&A disclosure, at least with respect to individual companies, can be found in the staff comment letters that are now made publicly available through the SEC's EDGAR website. It is often helpful to review comment letters issued to peer companies, or to companies dealing with similar accounting judgments or problems, to gain a sense of how others are resolving comments similar to those your company may have received from the staff.

Overall Presentation

- *SEC Concern*: MD&As have become too lengthy, complex and confusing, and contain excessive boilerplate.
- *Solution*: Make MD&A clearer, as well as more concise and meaningful, by considering the benefits to investors of:
    - Using more tables (in addition to the mandatory tabular presentation of contractual obligations). Two examples given:
        - Tabular comparison of results in different periods, including line items, percentage changes and other useful information, followed by a narrative discussion and analysis of known changes, events, trends, uncertainties and other matters.
        - Tabular summary, in a single location, of the company's various material interest and discount rate assumptions, to enhance understanding of fair value calculations or discounted cash-flow figures.
    - Using better and/or additional headings to facilitate comprehension (some headings are mandated, *e.g.*, off-balance sheet arrangements). In this

regard, the staff has observed a continuing failure to use the requisite separate sub-heading for disclosure of "material" off-balance sheet arrangements. (For more on this topic, ***see Part 3***, ***below***.)

- Using a more "layered" approach that "emphasizes, within the universe of material information that is disclosed, the information and analysis that is most important."

- Adding an introductory section or executive-level overview to MD&A. Although this is not mandatory, the SEC staff believes these overviews are helpful to investors and has noted with approval that some companies have improved their overview sections by adding descriptions of the company's industry, what the company does (rather than how it performed) and how it makes money. In other words, at least some companies have heeded SEC repeated admonitions to include more information on their essential "value-drivers," or those elements of financial and non-financial performance that enhance shareholder value.[16]

- Avoiding duplication by identifying only "the most important matters on which a company's executives focus" in evaluating financial condition and operating performance.[17] The SEC staff has been critical of how some companies have continued to ignore admonitions in the 2003 MD&A Interpretive Release to jettison immaterial disclosure and focus investors' attention on what really matters – information on how well a company performed year-over-year that can be compared with performance of competitor companies.

- Beginning each section containing detailed analysis, such as period-to-period comparisons, with a statement of the principal factors, trends or other matters that are covered in more detail in the section.

- In a speech delivered before the 2005 AICPA's National Conference on Current SEC and PCAOB Developments,[18] Carol Stacey, the Chief Accountant of the SEC's Division of Corporation Finance, distilled much of this guidance into the following "nugget" of practical advice that is well-illustrated by her inclusion of a specific example:

  - There are several ways that preparers can reduce the volume of filings, and we pointed out some of those things in the 2003 MD&A interpretive release. They are things such as – Prioritize disclosure for investors. Introduce MD&A with those important issues that keep the CEO up at night. Eliminate the boilerplate in MD&A – rather than just disclosing the calculated changes in various line items, actually discuss the analysis of the underlying reasons for the changes, such as volume and price changes. Discuss the real drivers of changes in results of operations as management sees them. Communicate in plain English. Eliminate

redundant or non-value added disclosure. Disclose whatever will help investors understand what happened. For example, certain disclosure is required by GAAP in the audited financial statements for a restructuring. Don't repeat the very same disclosure in MD&A. Rather, MD&A is the place to discuss:

- ♦ the reasons for the restructuring – is the company consolidating or eliminating operations?
- ♦ what the effect will be on the registrant's operations – are any facilities being closed? are any products being discontinued?
- ♦ the impact the restructuring has had, and is expected to have, on results of operations, financial condition, liquidity and cash flows – are there significant uncertainties that will be resolved in the future in the form of further charges? will there be significant cash outflow related to the plan?, and
- ♦ any other relevant forward-looking information.

Focus and Content

- *SEC Concern*: MD&As often contain so much immaterial and/or outdated information that important information regarding company value-drivers – both historical and prospective – has become obscured.[19]
- *Solution*: Highlight material information that is required or otherwise promotes investor understanding of a company's financial condition and operating performance, as well as its future prospects. Focus on materiality – whether the material information is mandated by line-item provision or otherwise necessary to render the required disclosure, in light of the circumstances under which it is made, not misleading.
  - ➢ Focus on the need for management discussion and analysis of known material trends and uncertainties, including an explanation of the underlying reasons for, or implications of, a particular contingency. Again, the SEC staff will be seeking a more thoughtful analysis of results and known trends that could significantly impact the company's performance, operations or liquidity, as opposed to a mere regurgitation of disclosures made in the financial statements. In particular, disclose all material "known" events, trends and uncertainties (an example often given is off-balance sheet arrangements), providing the reader with an analysis and not just a description of said events.

- The need for disclosure of decisions concerning known trends, demands, commitments, events and uncertainties compels management consideration of whether the foregoing, once identified, will have or are reasonably likely to have a material impact on the company's liquidity, capital resources and results of operations. For an object lesson on the importance attached by the SEC to "meaningful" MD&A disclosure of "known risks, trends and uncertainties" – in a case involving the company's failure to flag therein the deteriorating performance of a key operating segment that ultimately had a material negative impact on the consolidated entity's results of operation – *see* In the Matter of Raytheon Co., SEC Rel. No. 33-8719 (June 28, 2006), discussed in greater detail in ***Part 7*** of this outline.

- Senior Division of Corporation Finance accountant Sondra Stokes indicated, during the December 2006 Conference on SEC and PCAOB Developments held by the AICPA in Washington, D.C. ("2006 AICPA Conference"), that the Kmart proceeding brought and settled in 2005 (discussed in ***Part 7***, ***below***) aptly illustrates the importance of fulsome "known trends, demands and uncertainties" disclosure when it comes to the liquidity section of the MD&A. Kmart involved a failure to disclose the "real reasons" behind management's excessive inventory purchases, management's plans for remediation and the potential effect of this problem on the company's future liquidity.

- Commissioner Glassman offered this MD&A critique in March 2006, which was notably silent with respect to companies' well-founded liability concerns about voluntary disclosure of forward-looking information that goes beyond what Item 303 calls for under the "known trends and uncertainties" prescription: "Management's story would be more complete if it contained more forward-looking information, better explained trends and uncertainties that affect the business, and discussed in more detail the business' key drivers. While forward-looking statements generally are not required, they help investors understand where the company is going, and they complement the historical financial statements, which tell where the business has been."[20]

- Quantification of the material effects of known trends and uncertainties is encouraged, and is even required if quantitative information is reasonably available.

- For example, if management knows that it is reasonably likely that increasing fuel costs may have a material impact on the company's earnings, management should "connect the dots" on how those increased costs will affect earnings, including, to the extent it is

available, quantification of that impact. If management knows that it is reasonably likely that a key fuel source may become scarce and potentially have a material effect on operations (*e.g.*, force the company to cut production), then management should explain that trend and the potential impact, including quantification of the impact if that is reasonably available.

- MD&A disclosure of loss contingencies may be necessary even where the amount potentially involved cannot reasonably be quantified. Common loss contingences include product warranties, debt guarantees, indemnification provisions, claims or assessments, environmental contamination, and other pending or threatened litigation. Over the course of at least two years, the Division of Corporation Finance staff has expressed serious concern regarding the practice of some companies of not previewing in the MD&A the likelihood of a loss contingency until it becomes probable and the amount of loss is reasonably estimable – the test for accounting recognition of such a loss as set forth in FASB Statement No. 5, *Accounting for Contingencies* ("SFAS 5"). For the first time, however, the staff has memorialized its views, in new Section II.I.2 of the 2006 Staff Outline. There, the staff states its belief "that the need to discuss such matters in MD&A will often precede any accounting recognition when the registrant becomes aware of information that creates a reasonable likelihood of a material effect on its financial condition or results of operations, or when such information is otherwise subject to disclosure in the financial statements, as occurs when the effect of a material loss contingency becomes reasonably possible. If a registrant is unable to estimate the reasonably likely impact, but a range of amounts are determinable based on the facts and circumstances surrounding the contingency, it should disclose those amounts." Where individual loss contingencies have divergent characteristics and levels of uncertainty, making "aggregated disclosure insufficient to provide material information necessary to an understanding of the loss contingency position[,]. . .[c]ompanies should consider whether it is necessary to discuss loss contingencies on both an aggregated and a disaggregated basis." Companies are well-advised to consult this section, which contains further detailed guidance on MD&A disclosure of loss contingencies.

    - Companies involved in governmental or self-investigations of option grant practices should be aware that the PCAOB has flagged the potential applicability of SFAS 5 to companies involved in governmental or self-investigations of option grant practices. *See* PCAOB Audit Practice Alert No. 1 ("If the consequences of the issuer's practices for

stock option grants or its accounting for, and disclosure of, option grants result in legal or other contingencies, the application of SFAS No. 5, Accounting for Contingencies, may require that the issuer record additional cost or make additional disclosures in financial statements.").

- Corporate income tax contingencies are no longer covered by SFAS 5, but instead by FASB Statement No. 109, *Accounting for Income Taxes* ("SFAS 109"), and FIN 48, which became effective in late 2006 and must be adopted by calendar year companies in the first quarter of 2007. You should give careful thought to the need for 2006 Form 10-K disclosure of the potential effects of such adoption in Q1 of 2007, in accordance with Staff Accounting Bulletin No. 74, *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period* ("SAB 74"). In this regard, be aware of the possibility that prior period tax positions (including accrued interest and penalties) may have to be re-evaluated in light of new information and, if deemed not to meet the "more likely than not to be sustained by relevant tax authorities" standard of FIN 48 for recognition (in the year it is taken or expected to be taken), these positions would have to be "derecognized." Any such derecognition could result in significant changes to the company's financial statements and, as a result, should be "previewed" appropriately in the MD&A section. For more on loss contingencies generally, and tax contingencies in particular, ***see Part 6*, *below***.

  - Calendar year companies should press on with their FIN 48 implementation initiatives, given the FASB's rejection on January 17, 2007, of requests from the preparer community to delay the effective date for at least a year. An archived audiocast of the FASB's January 17 meeting, during which Board members voted to deny various delay requests, is available at http://www.trz.cc/fasb/archive.html; *see also* FASB Action Alert No. 07-02 (Jan. 11, 2007), Notice of Meetings, available at http://www.fasb.org/action/aa011107.shtml (disclosing FASB's intent to consider such requests at its January 17, 2007 meeting). Media and investor attention to this issue may have made it more difficult for the FASB to delay effectiveness. *See*, *e.g.*, G. Morgenson, "*A Tax Secret Emerges From the Murk*," N.Y.T., Sun., Jan. 14, 2007, at p. 1 of the Business Section.

- Craig Olinger, the Deputy Chief Accountant of the Division of Corporation Finance, cautioned companies against confusing forward-looking information prescribed by MD&A with the pro-

forma information required by Article 11 of Regulation S-X. The distinction is this – MD&A calls for disclosure of prospective information regarding known trends, events and uncertainties that are reasonably expected to have a material effect in the future, whereas Article 11 deals with recording adjustments relating to known transactions in calculating mandated pro-forma disclosure. One way to avoid generating any such confusion on the part of investors is to make separate presentations of the two types of financial information, which clearly have different purposes.

- Focus on material information; de-emphasize or eliminate outdated or otherwise immaterial information that does not advance readers' understanding of the company's financial condition, liquidity and capital resources, changes in financial condition and results of operations, *both in the context of profit and loss and cash flows*.

- Identify and discuss key indicators of financial condition and operating performance; disclose key variables and other factors that senior management decision makers use to run the business that are material to investors, including non-financial business and operational data. These may be macro-economic and/or industry-specific, as well as company-specific.

  - Pay attention to the need for segment data in order to provide a meaningful analysis of the consolidated financial condition and operating performance of the company. *See*, *e.g.*, In the Matter of Raytheon, *supra* (Raytheon, together with its CEO and CFO, settled charges arising in part from inadequate MD&A disclosure relating to its aircraft subsidiary's deteriorating condition, and the negative impact such deterioration was having on the operating results of both the subsidiary, which was treated as a separate segment for accounting purposes, and the consolidated entity). At the same time, segment discussion and analysis should avoid unnecessary duplication and immaterial detail that detract from investors' understanding of the company's overall financial condition and operating performance.

- In assessing materiality, consider the "total mix" of information about the company, whether historical or forward-looking, that is not presented in the company's SEC-filed documents (*e.g.*, the company's earnings releases, publicly accessible analyst/investor conference calls and website postings) to determine whether MD&A is complete or, instead, misleading by omission of material information. (The staff will examine non-filed sources of company information, such as its website, as well as information published by analysts and other third parties, in evaluating the adequacy and completeness of a company's MD&A.) A careful re-reading of SAB 99, which as discussed above (in ***Part 1***) summarizes the

relevant case law and other guidance on "materiality" judgments that must be made in both the accounting and legal spheres, will enhance this assessment. Keep in mind that the SEC may bring suit for financial reporting fraud even where a misstatement is not quantitatively material, but has the qualitatively material effect of enabling a company to meet the Street's earnings expectations and/or management compensation performance targets. *See*, *e.g.*, "SEC Sues Huntington Bancshares, Inc., its CEO, Former CFO, and Former Controller for Accounting Misstatements that Enabled the Bank to Meet or Exceed Analysts' Expectations and Internal Bonus Targets," SEC Lit. Rel. No. 19243 (June 2, 2005), available at http://www.sec.gov/litigation/litreleases/lr19243.htm. It goes without saying that the company's management also should review last year's quarterly reports on Form 10-Q and current reports on Form 8-K to assure that all material developments bearing on liquidity and capital resources arising after last year's Form 10-K are adequately identified and analyzed in this year's annual report.

- Use of disclaimers and risk factors

  - The staff has found language used in disclaimers (which are not favored under the federal securities laws in any event) and risk factors included in (or accompanying) the MD&A to be so overbroad and opaque as to be completely unilluminating to investors. Note that the failure to provide "meaningful cautionary statements" ultimately could result in the loss of the statutory safe harbor for forward-looking information that does extend to such information contained in the MD&A. (For an example of judicial rejection of safe-harbor coverage under the PSLRA due to inadequate risk-factor disclosure, *see Asher v. Baxter Int'l*, 377 F.3d 727 (7th Cir. 2004), *cert. denied*, 125 S. Ct. 1639 (U.S., Mar. 21, 2005).) Companies should alert investors to the actual risks currently facing them in specific areas, rather than using the same old boilerplate language.

  - A number of companies that have been disclosing deficiencies in internal control over financial reporting throughout the year rather than waiting until the management report on the effectiveness of this control as of fiscal year end, have included related risk factor disclosure in or around the MD&A section of their quarterly reports. Because of the variety of deficiencies that may be addressed, the risks – and therefore the tailored risk factor language – necessarily vary from company to company. The SEC staff will disapprove of such language if it believes that the company's management is attempting to avoid articulating the conclusion that its internal control structure is ineffective. In other words, the SEC has made very clear that qualifications and

disclaimers cannot be used in the context of any control-related disclosure (including, but not limited to, the MD&A) to justify an otherwise unsupportable conclusion that a company's internal control over financial reporting is effective. (In this regard, you should be aware that the staff has been challenging management conclusions that a company's disclosure controls and procedures are effective for a given period despite the existence of one or more disclosed material weaknesses that, if not satisfactorily remediated by fiscal year end, would compel management to report that the company's internal control over financial reporting is not effective.)

- CEO/CFO Certifications – Bear in mind the central role that the MD&A plays in analyzing whether the report "fairly present[s] in all material respects the financial condition, results of operations and cash flows" for the periods presented for purposes of the CEO/CFO certifications under SOXA Sections 302 and 906. The SEC has taken the position that strict compliance with GAAP and line-item disclosure requirements may not be sufficient if the resulting information is materially misleading or omits to state a material fact necessary to make the required statements, in light of the circumstances under which they were made, not misleading as mandated by Section 10(b) of the Securities Exchange Act of 1934, as amended ("Exchange Act"), and Exchange Act Rules 10b-5 and 12b-20. Accordingly, the MD&A disclosure supplementing the financial statements, footnotes and other information in the report is essential not only to investors, but also to the certifying officers.

Liquidity and Capital Resources

- *SEC Concern*: Deficiencies in this area of disclosure that were identified first in the SEC's January 2002 statement, then underscored in the staff's Fortune 500 review and further recapitulated in the 2003 MD&A Interpretive Release, nevertheless persisted in 2006 and must be corrected.

- *Solution*: The key concern is the disclosure of a company's ability to generate cash and to meet existing and known or reasonably likely future cash requirements not only in the short term (the next 12 months), but also in the long term.

- It is insufficient merely to state that a company has adequate resources to meet its short-term and/or long-term cash requirements *unless* no additional, more detailed or nuanced information is material. In particular, such a statement would be insufficient if there are any known material trends or uncertainties relating to cash flow, capital resources or requirements, or liquidity. The SEC believes that too many companies have underemphasized the importance of cash flows and liquidity in their past filings.

- Sources and uses of cash – MD&A should focus on the primary value-drivers and other material factors necessary to an understanding of the company's cash flows and the indicative value of historical cash flows, rather than a recitation of the items in the cash flow statements. Both internal and external sources of liquidity should be specified.

  - A company using the indirect method of reporting net cash flow from operating activities (by adjusting net income to reconcile it to net cash flow from operating activities under SFAS No. 95), should pay particular attention to disclosure and analysis of matters not readily ascertainable from the cash flow statements.[21] (The staff has a clear preference for the direct method, but acknowledges that most companies use the indirect method as permitted under GAAP.).

  - Proper classification of cash flows remains a staff accounting "hot button." *See* 2006 Staff Outline at Section II.C.; *accord* Remarks of Joel Levine, Associate Chief Accountant, Division of Corporation Finance, U.S. Securities and Exchange Commission, Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments (Wash. D.C., December 6, 2005) ("Levine Remarks"), available at http://www.sec.gov/news/speech/spch120605jl.htm. For more on the staff's views regarding cash flow statement classification, ***see Part 6 below***. A particular area of concern flagged in the staff's outline (as first articulated in the Levine Remarks) involves MD&A disclosure of financial statement treatment of cash flows from discontinued operations – the staff having observed an increased number of companies applying FASB Statement No. 144, *Accounting for the Impairment or Disposition of Long-Lived Assets* ("SFAS 144"), to report such operations. The staff's advice on MD&A presentation in this situation (set forth in Section II.C.1. of the 2006 Staff Outline) bears repeating here:

    > Registrants who have discontinued operations should carefully consider how to present disclosures about their cash flows within the Liquidity and Capital Resources section of MD&A. Management should pay particular attention to describing how cash flows from discontinued operations are reflected in their cash flow statements, and, if material, they should quantify those cash flows if they are not separately identified in those statements. In addition, management should describe how it expects the absence of cash flows, or absence of negative cash flows, related to the discontinued operations to impact the company's future liquidity and capital resources, and

should discuss any significant past, present, or upcoming cash uses as a result of discontinuing the operation.

- The staff also urged companies to discuss in the MD&A any material cash settlements received under insurance policies. Specifically, the MD&A should explain how much and why the company was paid in connection with an insurance claim, what the proceeds will be used for, how the cash will be presented in the cash flows statement, and the impact if any on reported earnings. *Id.* at II.C.2.

➢ Cash management – disclose known material effects/trends of current business decisions that entail future shift of cash resources.

➢ Consider the necessity of discussion and analysis of material covenants relating to outstanding debt, as well as guarantees and other contingent obligations. If a breach has occurred, or is reasonably likely to occur, disclose material information regarding the circumstances of a breach, potential for cure or waiver and analysis of potential material impact (*e.g.*, cross-acceleration triggers). In this regard, consider the impact of potentially material changes in pension plan funding obligations driven by adoption of SFAS 158, and the need for compliance with the Pension Protection Act of 2006 – both topics are discussed in ***Part 6***, ***below***.

Critical Accounting Estimates

- *SEC Concern*: Companies continue to replicate without analysis the description of accounting policies already provided in the footnotes to the financial statements. In 2006, SEC staff members described this as an area in need of considerable improvement.

- *Solution*: Disclose accounting estimates or assumptions that are material due to the levels of subjectivity and judgment required of management to account for highly uncertain matters or the susceptibility of such matters to change, and that would have a material impact on financial condition or operating performance.

  ➢ During the late 2006 conferences, the staff expressed disappointment with the quality of MD&A disclosure of critical accounting estimates and assumptions. In the staff's view, this disclosure should supplement and enhance – not merely regurgitate – the description of accounting policies provided in the footnotes to the financial statements. Instead, this disclosure should offer greater insight into the quality and variability of information on financial condition and operating performance, and should analyze the uncertainties inherent in applying a particular principle at a given time, or the variability reasonably likely to result from application of the principle over time.

- Address specifically why accounting estimates or assumptions are subject to the risk of change. Is it because there is an uncertainty attached to the estimate or assumption, or is it simply difficult to measure or value?

  - Address the questions that arise once a particular critical accounting estimate or assumption is identified, analyzing, to the extent material, factors such as how the estimate/assumption is calculated, how accurate it has been in the past, how variable it has been in the past, and whether it is reasonably likely to change in the future.

  - In what eventually may prove to be an important reference to the sensitivity analysis proposed in the still-pending May 2002 proposing release, the SEC noted (in the 2003 MD&A Interpretive Release), "[s]ince critical accounting estimates and assumptions are based on matters that are highly uncertain, a company should analyze their specific sensitivity to change, based on other outcomes that are reasonably likely to occur and would have a material effect. Companies should provide quantitative as well as qualitative disclosure when quantitative information is reasonably available and will provide material information for investors."

  - We urge you to re-examine and test management's judgments with respect to critical accounting estimates and assumptions in light of these recurring staff criticisms, as well as the messages conveyed by relevant Enforcement proceedings such as SEC v. McAfee, Inc., SEC Lit. Rel. No. 19520 (Jan. 4, 2006) (as discussed later in ***Part 7***, the SEC settled antifraud, books-and-records, and various other charges brought against McAfee based not only on materially false financial statements, but also inaccurate MD&A disclosure regarding its aggressive revenue recognition practices). Here are just a few additional examples of staff concerns you should consider during the MD&A drafting and review processes:

    - The staff appears to favor treating revenue recognition as a critical accounting estimate, perhaps because this area continues to be a focal point for Enforcement actions and Division of Corporation Finance comments in connection with periodic report reviews. According to the 2006 Staff Outline, at Section II.F.3, "[s]ince revenue recognition is often a critical accounting policy,

registrants should review the completeness and accuracy of disclosures concerning their sources of revenue, method of accounting for revenues, and material considerations in evaluating the quality and uncertainties surrounding the revenue generating activity. . . . Descriptive information about the effects of variations in revenue generating activities and practices, or changes in the magnitude of specific uncertainties, is most appropriate in MD&A."[22] A similar message was delivered by the senior accounting staff at the 2006 AICPA Conference, amplified by these additional points: (a) disclosures relating to revenue recognition should be consistent throughout the periodic report – that is, in the financial statements and accounting policy (and any other relevant) footnote, the business description section, and the MD&A discussion of critical accounting estimates; (b) the MD&A should identify material amounts of deferred revenue, and disclose when such amounts will be recognized and under what conditions; and (c) the MD&A should continue to focus on the accuracy of revenue-based estimates that demand a high degree of management judgment, such as treatment of rebates, returns/warranties and allowances. For more on revenue recognition, ***see Part 6*, *below***.

- Another area companies with large equity compensation programs should consider for critical accounting treatment is the obligation to recognize the costs of such programs in the financial statements under FASB Statement No. 123R, *Share-Based Payment* ("SFAS 123R") (discussed in greater detail in ***Part 3 below***). Because of the many estimates and assumptions that must be made in connection with determining the grant-date fair value of stock options and other equity securities issued under employee benefit plans, the SEC staff has urged companies to pay special attention to the applicability of the critical accounting disclosure requirements. *See*, *e.g.*, Section D, Question 5, Staff Accounting Bulletin No. 107 (March 29, 2005) ("SAB 107"), available at http://www.sec.gov/interps/account/sab107.pdf.

- A third candidate for critical accounting estimate treatment, according to the staff, is the identification of reporting units (*i.e.*, either segments or one level below, as discussed in **Part 6 below**) for purposes of testing goodwill impairment under FASB Statement No. 142, *Goodwill and Other Intangible Assets* ("SFAS 142"). "Given the impact the identification of reporting units can have on the determination of a goodwill impairment charge, registrants should consider providing disclosure in the critical accounting estimates section of MD&A. This disclosure may be particularly important when the amount of goodwill is material. The disclosure should address how the reporting units were identified, how goodwill is allocated to the reporting units, and whether there have been any changes to the number of reporting units, or the manner in which goodwill was allocated. If such changes have taken place, they should be explained." 2006 Staff Outline, Section II.L.5.

- Finally, the staff encourages disclosure in the MD&A's critical accounting estimates section when hedge accounting, which is governed by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133"), "has a material impact on a registrant." 2006 Staff Outline, Section II.M.1. For further discussion of the SEC accounting staff's views on various issues raised by SFAS 133, ***see Part 6***, ***below***.

- Revenue recognition, stock-option expensing, segments, hedge accounting, and other accounting "hot buttons" that impact the MD&A, are discussed in ***Parts 4*** (SFAS 123R only) ***and 6***, ***below***.

♦ Yet another helpful example of what the SEC deems effective disclosure of critical accounting estimates and judgments is set forth in the 2003 MD&A Interpretive Release itself: if it is reasonably likely that changes in the long-term rate of return used in accounting for a company's pension plan would have a material effect on the financial condition or operating performance of the company, disclose and (because of the nature of estimates of long-term rates of return) quantify the impact that could result given the range of reasonably likely outcomes. Note that pension and other post-retirement benefits accounting – in

particular, management's choice of estimates and assumptions – are among the SEC's accounting "hot buttons," discussed below in ***Part 6***.

- o Companies with large pension and/or other post-retirement obligations arising from defined benefit plans should give careful consideration to whether their application of GAAP in these areas involves significant management estimates and assumptions. There appears to be some SEC bias in favor of "critical accounting" treatment (for MD&A disclosure purposes) of the estimates necessary to quantify these benefit obligations under GAAP, assuming the materiality hurdle is cleared. *See*, in this regard, the 2006 Staff Outline at Section II.J ("MD&A should identify the following: material assumptions underlying the accounting for benefit plans; and changes to those assumptions having a material effect on financial condition and operating performance. Registrants should ensure that the disclosure of their accounting policies and other footnote disclosure in the financial statements are comprehensive and minimize unnecessary repetition of information in the MD&A.").

- o Senior SEC staff continue to urge companies to remember the fundamental purpose of critical accounting estimates disclosure: to enable investors to get a sense that, although the financial statements are full of seemingly "hard" numbers, there are sometimes many judgments and estimates underpinning those results. A sensitivity analysis should be used where appropriate to help investors understand that a particular reported result may be the product of several estimates/judgments and therefore might well vary if those estimates and/or judgments were to be altered – meaning ultimately that where sensitivity analyses are reasonably available and would be useful to investors, they should be applied and a range of values disclosed. The idea is to let investors know that you could have ended up at several different places within a given range, not just the single data point produced by your selected estimates and assumptions.

♦ The importance of these points is underscored by the discussion of critical accounting estimates and assumptions

contained in Corporation Finance Chief Accountant Carol Stacey's December 2005 speech (mentioned earlier) to the AICPA's National Conference, which we believe is of continuing importance in guiding those responsible for drafting the MD&A.[23] Noting the current trend toward greater reliance on the use of estimates and assumptions, as both the FASB (and thus the SEC) increasingly shift away from historical cost in the direction of fair value accounting (*see*, for example, SFAS 123R, discussed in ***Part 3***, ***below***; *see also* FASB Statement No. 157, *Fair Value Measurements* ("SFAS 157"), establishing a single authoritative definition for fair value together with a measurement framework, effective for financial statements issued for fiscal years beginning after November 15, 2007, with highly limited provision for early adoption[24]), Ms. Stacey warned that, "[t]he result will be more estimates and assumptions and greater use of financial models. Since management is responsible for the financial statements, they need to ensure that they have a solid foundation upon which to base the estimates and assumptions they use. Management also needs to describe for the user how they arrived at the estimate or assumption, what events may occur that could force changes in the estimate or assumption, and what their history is with the accuracy of prior estimates or assumptions. Sounds just like the critical accounting estimate . . . rule proposal [published in May 2002, but never adopted], and discussion in the 2003 MD&A interpretive release – don't forget to consider that guidance for those estimates and assumptions that have a material effect on results of operations."

3. MD&A Disclosure of Off-Balance Sheet Arrangements and Aggregate Contractual Obligations

The MD&A must provide information on "off-balance sheet arrangements" and certain contractual obligations, aggregated by category of obligation, for specified time periods.[25] Under these requirements, the company must include in its MD&A:

- A separately-captioned section that describes and explains the company's "off-balance sheet arrangements," including the business purpose of each such arrangement and the nature and scope of any contingent obligations under certain guarantees and indemnification agreements. Note that the staff found in 2006 that companies still scatter this disclosure – which is often "boilerplate" in any case – throughout the MD&A and the footnotes to the financial statements, despite the explicit requirement of the rule that this disclosure be consolidated in the MD&A under a special caption (with some latitude afforded per Instruction 4 for cross-reference to the financial statement footnotes). 2006 Staff Outline, Section II.N.

- Disclosure must be provided for off-balance sheet arrangements that either have, or are reasonably likely to have, a current or future *material* effect on the company's financial condition (including changes in condition), revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. Cross-referencing from the MD&A to the financial statement footnotes is permitted with respect to these arrangements, provided the footnotes themselves are clear and understandable. (Note that this more flexible position on cross-referencing is in contrast to the staff's general disapproval of fragmented MD&A presentations.)

- Examples include certain guarantee contracts, retained or contingent interests in assets transferred to an unconsolidated entity, derivative instruments that are classified as equity, or material variable interests in unconsolidated entities that conduct certain activities.

- As the staff explained in a special report mandated by Congress (under SOXA Section 401(c) and released in mid-2005 (the "2005 Off-Balance Sheet Report"), "[d]isclosure is required to the extent necessary to provide an understanding of the issuer's material off-balance sheet arrangements as well as the material effects of these arrangements on financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources."[26]

- A tabular summary of payment obligations due within specified groupings of years under various categories of contractual obligations, such as long-term debt, capital and operating leases, purchase obligations and other long-term liabilities reflected on the company's balance sheet under GAAP.

  - While not mandatory (unlike the off-balance sheet disclosure), presentation of this table under a separate caption may help to facilitate investor understanding.

Off-Balance Sheet Arrangements

As part of the SEC staff's preparation of the 2005 Off-Balance Sheet Report, the staff reviewed a sample of 2004 filings by 200 issuers of varying sizes. Because the SEC accounting staff reaffirmed (at the December 2006 AICPA Conference) the current validity of the report's observations with respect to the quality of MD&A disclosures, and cites to it in the 2006 Staff Outline, we have incorporated what we believe are the most relevant of the report's observations in the following discussion of off-balance sheet arrangements. The full report detailing the results of the staff's in-depth review, which identifies areas of needed improvement in the MD&A presentation of off-balance sheet arrangements, is available on the SEC's website at http://www.sec.gov/news/studies/soxoffbalancerpt.pdf. Another source that should be consulted in preparing the 2007 MD&A off-balance sheet disclosures is new Section II.N. of the 2006 Staff Outline, which is discussed below in relevant part.

As noted above, we recommend that, as you prepare this year's MD&A, you review carefully all 8-K disclosures made during the year that relate to material off-balance sheet arrangements and direct financial obligations. The latter may or may not be disclosed on an individual basis in the contractual commitments table. Under the enhanced and accelerated 8-K reporting scheme, U.S. companies have been required since late August 2004 to disclose such arrangements on a disaggregated basis between quarters if material. The SEC expects companies to address the liquidity impact of these arrangements – past, present and future (under the "known trends and uncertainties" rubric) – in the MD&A, having already alerted investors in "real-time," via 8-K, to their entry into, and/or increase or acceleration of, these arrangements on an individual basis where material.

The SEC broadly defined "off-balance sheet arrangements" ("OBSAs") to include any contractual arrangement with an unconsolidated entity under which the company has *any* of the following:

- An obligation under certain types of guarantee contracts as defined in FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* ("FIN 45").

- An arrangement (such as a retained or contingent interest in assets) that provides credit, liquidity or market risk support to the unconsolidated entity.

- An obligation under certain types of derivative instruments. These are instruments that satisfy the definition of a "derivative," but because they are indexed to the company's stock and classified in stockholders' equity, are excluded from the provisions of SFAS 133 based on the scope exception in Paragraph 11a. The staff recently observed that "[w]hile it is not uncommon for registrants to enter into share based contracts that are not accounted for as derivatives because of the [SFAS 133] scope exception, the staff has noted limited discussion of equity-linked derivatives in the off-balance sheet arrangement section [of MD&A]." 2006 Staff Outline, Section II.N. (more on this below).

- An obligation that is material to the company, and arises from a variable interest as defined in FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, as revised ("FIN 46R") pursuant to which the entity (which is not consolidated with the company and otherwise need not be so consolidated under FIN 46R) assists the company with financing, liquidity, or market-risk or credit-risk support, or engages in leasing, hedging or research and development services with the company. At the 2006 AICPA Conference, the staff specifically addressed certain limited partnership consolidation practices that the staff believes reflect a misapplication of FIN 46R. For more on this, *see* Mahar Remarks (cited in full in note 12, below).

The company must disclose the following information about off-balance sheet arrangements:

- the nature and business purpose of the arrangements – the SEC staff indicated at the 2006 AICPA Conference that it expects to see a discussion of the pros and

cons that the company considered before entering into each transaction, along with disclosure of any risk of "material" loss associated with that transaction. A similar message is transmitted in the 2006 Staff Outline, in new Section II.N.;

- the importance of the arrangements to liquidity, capital resources, market- and/or credit-risk support, or other benefits;

- the financial impact of the arrangements on the company (*e.g.*, revenues, expenses, cash flows or securities issued) and the attendant risks (*e.g.*, retained interests or contingent liabilities) – in short, the risk of material loss; and

- known events, demands, commitments, trends or uncertainties that affect the availability or benefit of such arrangements to the company.

The SEC permits aggregation of these arrangements for disclosure purposes to minimize repetition and immaterial information, but requires that disclosure be succinct and understandable to the non-expert reader. *See* Instruction 2 to Item 303(a)(4). With respect to why, in light of this dispensation, the staff has called in speeches for disclosure regarding individual off-balance sheet transactions, we assume the staff was relying on Rule 12b-20 – which codifies the basic antifraud concept that companies should disclose any additional information, even if not specifically prescribed by a line-item, where such additional information is necessary or appropriate to prevent the required disclosure from being deemed materially misleading.

In the 2005 Off-Balance Sheet Report, the SEC staff cautioned that it expected to concentrate on the following areas of identified weaknesses in future filing reviews (as noted above, we repeat them here because the SEC staff stated, in early December 2006, that these observations have continuing validity):

- Too many companies' reports failed to discuss in the MD&A off-balance sheet arrangements disclosed in the notes to the financial statements. While recognizing that there may be a good reason for this in the case of FIN 45 guarantees (not all of which are covered by the MD&A line-item requirements), the staff nevertheless observed that "it appears that issuers may not have identified all of the off-balance sheet arrangements that are required to be discussed in the OBSA section of MD&A."[27]

- Those disclosures that were made in the MD&A section of sample company reports "sometimes appear[ed] haphazard, with the disclosure required by each rule or standard [*e.g.*, in the basic financial statements vs. the MD&A] developed independent of other disclosures. While it was observed that disclosures made by issuers did in fact often provide information about the potential variability of estimates, alternate measurement attributes, assumptions used by management, and detail of summarized financial statement captions, it was not always clear why particular disclosures were included in various situations, or, in some cases, what the purpose of the disclosures was."

- Citing Rule 12b-20, the staff emphasized that "it is important that issuers take the time and make the effort to prepare disclosures in a meaningful way and to provide sufficient disclosures to allow investors to understand the substance of the issuer's situation and activities."[28] In other words, companies should anticipate far less patience and understanding from the staff in connection with the next round of staff reviews of the prescribed off-balance sheet disclosures. For example, if a company is using "non-traditional" financing arrangements that meet the OBSA definition, management should explain why it chose such structures in the MD&A (this example is based on oral remarks made by Sondra Stokes, a senior Corporation Finance accountant, at the 2006 AICPA Conference).

Companies should be aware of these additional areas of heightened staff scrutiny flagged in the 2006 Staff Outline, Section II.N.:

- **Equity-linked Contracts**: The staff made this important recommendation to MD&A preparers –"[R]egistrants should carefully consider whether there are any outstanding contracts indexed to their own stock and classified as stockholders' equity that are reasonably likely to materially impact the registrant's financial condition, liquidity or capital resources." A "simple" example given by the staff is "outstanding convertible debt that is reasonably likely to be converted and could result in significant dilution that would be reasonably likely to limit the ability of the registrant to raise additional capital."

  Another, "more complex" example of an equity-linked contract susceptible to disclosure is an issuer accelerated share repurchase program ("ASR"). Several companies received staff comments in 2006 asking for better disclosure of such programs in the off-balance sheet section of the MD&A. We repeat the staff's guidance in full: "A typical ASR involves the combination of a buyback of common stock from an investment bank, which typically borrows the shares from investors, and a forward contract indexed to the company's common stock. Although an ASR is intended primarily to boost earnings per share for stock still outstanding, the ASR subjects the registrant to the risk of significant additional payments resulting from an increase in the share price of the registrant's common stock and therefore needs to be discussed in the off-balance sheet section of MD&A if reasonably likely to have a material effect."

- **Material Variable Interests in Unconsolidated Entities**: The staff pointed out that this type of arrangement could cover "a variety of fact patterns," including situations in which a company has a material variable interest in an unconsolidated entity that engages in leasing, hedging or research and development services with the company, along with the more conventional scenario in which such an entity provides financing, liquidity, market risk or credit support to the company. "In this context, a variable interest refers to an investment in an unconsolidated entity that would meet the FIN 46 definition of a variable interest, because the investment absorbs expected losses and residual returns that occur in the unconsolidated entity, but the entity in which the interest

is held DOES NOT need to meet the FIN 46 definition of a variable interest entity." (Emphasis added).

- **<u>Consider Disclosure of the Fact that You Don't Have any Material Off-Balance Sheet Obligations</u>**: "To increase transparency for investors, registrants should also consider disclosing that they have no material off-balance sheet arrangements, if that is the case." This is sound advice, as the absence of any disclosure has often invited staff comment.

Table of Contractual Obligations

This companion requirement is intended to consolidate in MD&A the disclosure of contractual commitments falling within specified categories. Some of these commitments already should be disclosed in GAAP-compliant financial statements (except purchase obligations, which must be included in the table even if executory and therefore not recognized as a GAAP liability).

Companies have found that perhaps the most difficult requirement relates to disclosure of purchase obligations, which some have argued is overly broad. The staff has recommended liberal use of footnotes to explain a company's purchase obligations, and emphasized that it does not necessarily seek comparisons with other companies, but rather a clearer year-to-year picture of a company's long-term debt obligations. While not explicitly endorsing the use of a materiality threshold for measuring different types of purchase obligations, the staff does not appear to have objected to this approach provided it is "reasonable" and promotes transparency and thereby enhances investor understanding of the full spectrum of a company's cash commitments.

A sampling of common staff comments in this area:

- The staff has taken note of costs, such as restructuring costs, discussed in the Liquidity section of the MD&A, asking whether these costs are reflected in the contractual commitments table and, if not, why not.

- The staff has asked for additional narrative detail on purchase obligations, such as any limitations on quantities to be purchased, the terms of the particular arrangement, and information as to how purchases in the prior year compare to production capacity and continuing purchase requirements.

- The staff has requested amendment of the table to add certain employment arrangements discussed in the proxy statement that constitute long-term obligations of the company – *e.g.*, pension or deferred compensation obligations reflected in the company's balance sheet.

- Another comment called for revision of the table of contractual cash obligations to include the following: (a) estimated interest payments on the company's debt; (b) estimated payments under interest-rate swap agreements; and (c) planned funding of pension and other post-retirement benefit obligations. The comment went on to state: "Because the table is aimed at increasing the transparency of

cash flow, we believe these payments should be included in the table. Please also disclose any assumptions you made to derive these amounts."

Various staff members have provided the following additional guidance regarding the type of obligations the table should capture –

- The purchase obligations category does encompass supply contracts and other "ordinary-course" arrangements. This is because the purpose of the table is to show investors "how many checks for how much $" the company is going to have to write to satisfy these obligations. Of course, the staff understands that it may be difficult to identify all of these contracts, but companies usually have a pretty good idea of how to ball-park the total number using some kind of reasonable materiality analysis. Companies should just pick a reasonable approach to calculating this number and disclose the methodology employed.

- The staff continues to believe that employee compensation obligations must be disclosed in the table to the extent they represent material long-term balance-sheet items – again, pension and deferred compensation obligations. Calendar year companies with large defined benefit plan obligations in particular should think carefully about the need to disclose pension and other post-retirement employee benefit plan obligation amounts in the table – both for the next 12 months and beyond, as demanded by the staff – because of the heightened attention likely to be paid by the SEC and the investing public to disclosure of the potentially material impact of adoption of SFAS 158 in the fourth quarter of 2006. (As explained later in ***Part 6***, the passage in August of 2006 of the Pension Protection Act also may have implications for the tabular disclosure of pension obligations). Although SFAS 158 does not change the method of accounting for and reporting pension and other post-retirement benefit obligations in the income statement, it does compel recognition of the funded status of a company's various employee benefit plans as a net liability or asset on its balance sheet. Such recognition will result in an offsetting adjustment to accumulated other comprehensive income ("OCI") in shareholders' equity, in many cases with collateral tax consequences recognition of a benefit liability could trigger an increase in deferred tax assets and/or decrease to deferred tax liabilities). Because balance sheet recognition in turn could affect the company's compliance with debt/equity ratio covenants in loan documents and, therefore, its credit rating, those responsible for crafting the MD&A should give careful thought to the need for discussing the repercussions of possible covenant violations, if material. For further discussion of this area, ***see Part 6***, ***below***.

- Material contingent obligations reportable and/or accruable under SFAS 5 – such as the cost of senior executive change of control benefits – need not be disclosed in the table. (Note that change-in-control and other post-termination benefits owed to senior executive officers now must be quantified and disclosed for the CEO, CFO and "Named Executive Officers" as defined by Item 402 of Regulation S-K; for more on this, ***see Tab 4***). Still, we believe that these material contingent obligations should be dealt with in the liquidity section and/or other

portions of the narrative text of the MD&A (and, where necessary or appropriate, the risk factors) to assure full presentation of the ultimate (and aggregate) liquidity impact of such obligations.

4. Disclosure Relating to Application of SFAS 123R, Expensing Stock-Based Compensation

Most calendar year reporting companies became subject in 2006 to SFAS 123R, the FASB accounting standard requiring companies to expense the grant-date fair value of employee stock options and other forms of equity-based compensation. In SAB 107,[29] the SEC accounting staff offered guidance on the interaction of SFAS 123R and several SEC rules and regulations. SAB 107 addresses such topics as how to value share-based payment arrangements – perhaps the thorniest issue facing public companies – as well as the use of non-GAAP financial measures to exclude this new expense (we discuss this topic below in ***Part 5***) and, last but not least for our purposes, disclosures required in the MD&A section of periodic reports and other filings.

Turning to the MD&A disclosure issues relevant to preparation of the 2006 Form 10-K, the staff has flagged the following issues in SAB 107 and the 2006 Staff Outline (at Section I.B.).

- Companies with large equity compensation programs will have to help investors understand the "significant differences" likely to be seen in their financial statements for periods before and after adoption, paying "particular attention to their disclosures to ensure that investors and other users of their financial statements are able to understand the transition that the company has gone through and the financial statement impact of these differences in the past, present and in the future." Even those companies that previously adopted the fair-value method for financial statement recognition using a permitted "prospective method" may be changing their estimates and assumptions (*e.g.*, depending on which valuation model they use, they may change assumptions relating to volatility, expected option term, etc.) and/or modifying their plans or individual outstanding awards.

- As the staff points out, each of these changes may affect the comparability of financial statements issued pre- and post-adoption. To facilitate investor understanding, the staff urges companies to consider including in MD&A material qualitative and quantitative information about any of the following, as well as other information that could affect comparability of financial statements from period to period:

    - Transition method selected under SFAS 123R (*e.g.*, modified prospective application or modified retrospective application) and the resulting financial statement impact in current and future reporting periods;

    - Method utilized by the company to account for share-based payment arrangements in periods prior to adoption of SFAS 123R and the impact, or lack thereof, on the prior period financial statements;

- Differences in valuation methodologies or assumptions compared to those that were used in estimating the fair value of share options under SFAS 123 (SFAS 123R's predecessor, which did not require expensing but did require assignment of fair value). We believe this disclosure will be of significant interest to the accounting staff, who have been addressing somewhat cautiously companies' proposals to use newly created market instruments to estimate the grant-date fair value of employee stock options. 2006 Staff Outline, Section I.B.3. For more information regarding the staff's views in this area, *see* SAB 107, Section C, and the 2005 statements made by the SEC's Chairman and Chief Accountant, respectively, available at http://www.sec.gov/news/press/2005-129.htm and http://www.sec.gov/news/speech/spch090905dtn.htm. A helpful analysis of valuation methodologies is contained in a memorandum prepared by the SEC's Office of Economic Analysis, which can be found at http://www.sec.gov//news/extra/memo083105.htm.

- Changes in the quantity or type of instruments used in share-based payment programs, such as a shift from share options to restricted shares;

- Changes in the terms of share-based payment arrangements, such as the addition of performance conditions; and

- Total compensation cost related to nonvested awards not yet recognized and the weighted average period over which it is expected to be recognized.

• Many companies took action before December 31, 2006 to mitigate potentially adverse tax consequences to their employees under Section 409A of the Internal Revenue Code, by repricing stock options discovered to have been "discounted to raise the exercise price to the fair market value of the underlying stock on the original grant date. (Depending on the relevant facts and circumstances, such an employee-wide repricing or other material modification of outstanding options may be deemed an issuer tender offer. *See* SEC Division of Corporation Finance Exemptive Order, Issuer Exchange Offers Conducted for Compensatory Purposes (Mar. 21, 2001), http://www.sec.gov/divisions/corpfin/cf-noaction/repricingorder.htm). Such material modifications of outstanding awards trigger an obligation to assess whether any incremental fair value has been provided to employees (particularly if the employer made cash payments to employees in compensation for the increased exercise price). *See* Paragraph 56 of SFAS 123R ("incremental compensation cost shall be measured as the excess of the fair value of the replacement award or other valuable consideration over the fair value of the cancelled award."). Careful consideration therefore should be given to the need for MD&A disclosure of the reasons for, and impact of, such material option modifications.

• Although your auditors do not "audit" the MD&A absent a special engagement for that purpose, they must read the MD&A because of its importance in

presenting management's explanation of the audited financial statements. Hence your discussion of these issues in your MD&A will be very important to them in evaluating the application of SFAS 123R – with a particular focus on management's estimates and assumptions in connection with valuation – as reflected in your financial statements. We further predict that the injection of SFAS 123R grant-date equity valuations into the Summary Compensation Table, the Grants of Plan-Based Awards Table, and the Director Compensation Table, as well as the Compensation Discussion and Analysis section of your proxy statement – all of which are incorporated into the Form 10-K from the proxy statement unless you choose to include the full panoply of executive and director compensation information directly in your Form 10-K – similarly will be of great interest to your auditors, particularly this first year.

- At the 2006 AICPA Conference, an SEC accounting staff member warned of a potential trap for the unwary relating to option grant practices. Even though the staff has acknowledged that it may have been possible under now-superseded APB No. 25 to reach a measurement date in advance of completing all of the administrative requirements necessary to effect an option grant (*see* the Hewitt Letter, note 6 and accompanying text, above), no such latitude exists under SFAS 123R. According to the staff, "some companies continue to grant options pursuant to processes that almost ensure that all required corporate governance procedures will not be complete by the date that the company uses to set the exercise price of the option [*i.e.* the grant date], and questions have arisen with respect to the impact of administrative delay on the determination of the grant date of an award under Statement 123R."[30] However, "[u]nlike Opinion No. 25, Statement 123R is quite clear on the importance of completing certain corporate governance procedures when determining when a grant date has occurred. When an option is subject to approval by the Board of Directors, Statement 123R states that a grant date is not reached until that approval is obtained." Ending his remarks on a somewhat ominous note, this staff member noted:

> [T]hese accounting questions rarely arise when a company grants options pursuant to a well-controlled process. In light of the recent events surrounding past stock option grants, the staff believes it would be prudent for companies to revisit their stock option granting processes and ensure such processes are in full compliance with the company's corporate governance provisions, the terms of its stock option plans, and all applicable laws. Given the risks associated with the options granting processes that have become all too clear in recent months, companies may need to pay additional attention to their internal controls in this area.

5. *Disclosure Requirements Relating to Non-GAAP Financial Measures – Both Within and Outside the MD&A*

Although not specifically addressed in the 2003 MD&A Interpretive Release, companies must be mindful of the SEC's requirements on the use of non-GAAP financial measures in preparing MD&A.[31] All public disclosure that includes financial performance data, whether made in SEC filings or elsewhere, must be evaluated to determine whether such data have been calculated and presented on a basis not in accordance with GAAP. If a company uses a non-GAAP financial measure in any public disclosure – and assuming such use is otherwise permissible under GAAP – it also must identify the most directly comparable GAAP measure and include a reconciliation of the non-GAAP financial measure to the GAAP measure.

In situations where a non-GAAP financial measure appears in an SEC periodic report (or other filed document), the stricter standards outlined in Item 10(e) of Regulation S-K apply, prohibiting the use of certain non-GAAP financial measures entirely and, where the use is permitted, requiring disclosure of the reasons for using the non-GAAP financial measure. However, the SEC does not want companies to avoid using non-GAAP financial measures because of these added strictures – rather, the staff has insisted that if management is using a non-GAAP measure to assist in running the company's business, this measure must be disclosed in the company's MD&A. Among the topics covered by frequently issued staff comments in this area are the following:

- One of the biggest problems the staff has observed is management's characterization as non-recurring of costs and other items that in fact do recur. In this regard, companies that make extensive use of stock-based compensation should continue to expect searching staff scrutiny of how they are justifying subtracting the expense of share-based payments from net income now that SFAS 123R has taken effect. More on this below.

- Regulation S-K Item 10(e) says that, provided a particular non-GAAP measure is not otherwise prohibited by SEC rule or GAAP (two examples of such prohibited measures are per-share measures of cash flow or liquidity), management must explain why such performance measures are useful to them in running the business and to investors in understanding the business. The staff has issued many comments to this effect, but indicates that it is not attempting in this manner to force companies to exclude non-GAAP performance measures from periodic reports, but rather to get them to explain why such measures are useful, and is surprised to hear that some auditors have recommended such exclusion to their audit clients.

  - At the 2006 AICPA Conference, Corporation Finance Division Deputy Chief Accountant Craig Olinger made two important observations:

    - Although there is no prohibition per se against elimination of a non-recurring item in calculating a non-GAAP financial measure, companies must be prepared to demonstrate the usefulness of this measure, especially if used to evaluate performance. Companies

are reminded to comply with the guidance contained in FAQ No. 8 of the SEC staff's Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures (June 2003), available at http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm.

- Citing with disapproval a trend among some companies of presenting a GAAP-compliant income statement followed by a column of adjustments to arrive at a complete non-GAAP income statement, Mr. Olinger made clear that the staff will object to such presentations regardless of whether included in an SEC periodic report or other filing, or a press release.

- The staff may seek supplemental production of board books and other non-public items to support a company's contention that non-GAAP measures are in fact used to run the business.

- Senior staff members have warned repeatedly that they do not want to see non-GAAP measures appearing on company websites and in earnings presentations (webcasts and/or Form 8-K Item 2.02-furnished releases), but not in the MD&A. In other words, if you don't use them to manage, then don't post them; and expect comments asking about the ostensible disconnect if you do post them while excluding them from the MD&A. Such disclosures in any case must comply with Regulation G.

We provide in the attached ***Appendix A*** an outline of the rules on use of non-GAAP financial measures together with an outline of Item 2.02 of Form 8-K, which is triggered upon public disclosure of material non-public information regarding results of operations or financial condition for a completed quarter or year. We also summarize some of the more significant of the SEC Staff's Frequently Asked Questions regarding non-GAAP financial measures and Item 2.02 of Form 8-K.[32]

Companies with large equity compensation programs will have strong incentive, now that they have adopted SFAS 123R, to exclude these newly recognized compensation costs from net income. We have reproduced in its entirety, in ***Appendix B*** hereto, Section G of SAB 107 outlining (in question-and-answer format) the staff's views on the application of Item 10(e) and Regulation G to disclosure of performance measures that exclude share-based payments that must be expensed under SFAS 123R. *See also* Shan Benedict, Professional Accounting Fellow, SEC's Office of the Chief Accountant, Remarks Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments (Wash., D.C., Dec. 5, 2005) ("Benedict Remarks"), available at http://www.sec.gov/news/speech/spch120505sb.htm. To give you an idea of how important this guidance is to the many companies using equity compensation that adopted SFAS 123R in 2006, Question 3 of Section G asks how companies "should demonstrate the effect of accounting for share-based payment transactions in accordance with Statement 123R and Regulation G and Item 10(e) of Regulation S-K in . . . [their] Form 10 K[s]?" The staff's response provides:

- that including a discussion in MD&A addressing significant trends and variability of a company's earnings and changes in the significant components of certain line items is important to assist an investor in understanding the company's performance. The staff also understands that expenses from share-based payments might vary in different ways and for different reasons than would other expenses. In particular, the staff believes that . . . [a company's] investors would be well-served by disclosure in MD&A that explains the components of the company's expenses, including, if material, identification of the amount of expense associated with share-based payment transactions and discussion of the reasons why such amounts have fluctuated from period to period.

Keep in mind that this particular Q & A assumes that the company decides to disclose in its MD&A use of a performance measure that excludes equity compensation. We do not believe that the staff is suggesting that the foregoing disclosure, or that discussed immediately below, must appear in the MD&A. Many companies in fact may elect not to use such a non-GAAP performance measure, whether in an SEC filing, an earnings release furnished under Form 8-K Item 2.02, or otherwise. (Of course, as explained in ***Part 3 above***, a company still may be obligated to make some MD&A disclosure relating to the impact (in the past fiscal year and in the future) of adoption of SFAS 123R – *e.g.*, under the "known trends and uncertainties" disclosure element of the MD&A line-item requirement, and/or Exchange Act Rule 12b-20, requiring disclosure of any additional information not specifically compelled by line-item that is necessary to render what is disclosed not materially misleading. Moreover, "critical accounting estimate" disclosure may be warranted, as previously discussed in ***Part 2***, ***above***.)

Assuming a company is disclosing in its MD&A the impact of adoption of SFAS 123R, and wishes to include in this context a non-GAAP measure that carves out share compensation expense, that company will have to explain in the MD&A "the usefulness of any [such] measure that excludes recurring items." *See* Benedict Remarks, *supra*. "[T]o overcome this burden, we [the staff] would expect a company to be able to demonstrate that it utilizes the non-GAAP financial measure to internally evaluate performance. Stating that others evaluate the performance of the company using this measure would not meet this standard." *Id.*, citing SAB 107, Section G. For more on the specifics of what disclosure the staff expects in these circumstances, *see* Question 2 of SAB 107, Section G (at ***Appendix B***).

6. SEC Accounting "Hot Buttons"

The SEC's accounting staff has identified a number of problematic accounting practices that bear directly on the preparation of this year's MD&A and financial statements. Important guidance has been provided – most prominently, in the 2006 Staff Outline and in the course of the AICPA National Conference on SEC and PCAOB Developments held in early December 2006 – on appropriate MD&A and/or financial statement disclosure of several of these "hot-button" items, signaling in our view the staff's intent that these matters be treated as critical accounting estimates absent a compelling reason to the contrary. The stakes are particularly high given that the outside auditors must discuss with the audit committee the merits of managements' choice of accounting policies – including those deemed (or not deemed) "critical" by management for MD&A purposes – and the NYSE listing standards underscore the need for direct audit committee involvement in review of the MD&A.

Outlined below are what we consider to be the highlights of the various staff pronouncements in 2006:

Revenue Recognition

This area remains at the top of the list of accounting "hot buttons" for both the Corporation Finance and Enforcement Divisions, with the possible exception these days of option backdating. According to a senior SEC accounting official, "a significant portion of the SEC's financial fraud cases [continue to] involve revenue recognition. The abuses range from improper bill and hold transactions, to so-called "round-tripping," to various forms of premature revenue recognition."[33]

At the Corporation Finance Division level, the staff will review the accounting policy footnote to the financial statements to gauge whether it is sufficiently detailed to cover all of the company's revenue-generating activities, as reflected in the MD&A and Business Description sections of periodic reports, along with relevant disclosures contained in website and other, less formal company communications to the markets, and analyst reports and presentations. Vague discussions of how the company recognizes revenue in the MD&A will invite staff comments. This fall, the Division's Chief Accountant, Carol Stacey, warned that critical accounting estimate discussions of revenue recognition that described the company's approach as "we generally recognize revenue as follows . . . ." will draw a staff comment seeking more information on the exceptions to such general principles. Ms. Stacey indicated that these comments often elicit information on complex multi-element and buy/sell arrangements that can result in more extensive disclosure as part of the company's critical accounting estimates.

Senior SEC accountants have urged companies to reassess their revenue recognition policies and develop procedures for evaluating the potential impact on these policies of changes in the company's business and/or contractual obligations. The staff believes that reviews may be necessary more often here than with respect to other critical accounting estimates and/or accounting policies requiring financial statement footnote disclosure, because of the complexity of many revenue arrangements. Companies in the high-tech industry are especially prone to change and enter into some of the most complicated of revenue arrangements – *see*, *e.g.*, the multi-element revenue arrangements discussion below.

Detailed staff advice on proper MD&A and financial statement footnote disclosure in this area is set forth in the 2006 Staff Outline, at Section II.F – we strongly urge those responsible for drafting and reviewing the MD&A to consult the staff's guidance.

Particular topics of concern identified by the staff in 2006 include:

- **Buy/Sell Arrangements:** In February 2005 the staff issued letters to oil-and-gas companies involving several issues, one of which the staff believes is of general applicability – the accounting, presentation and disclosure of buy/sell transactions. (A representative letter is posted at http://www.sec.gov/divisions/corpfin/guidance/oilgas021105.htm). Other companies also may engage in these transactions, which typically involve contractual arrangements establishing the terms of agreements to buy and sell a commodity, either jointly in a single contract, or separately in individual contracts entered into concurrently or in

contemplation of one another with a single counterparty (or even multiple counterparties). For example, such arrangements may be used to facilitate the procurement of feedstock for a refinery operation, or otherwise to manage the supply chain or inventory for a business. Because the EITF and the FASB, respectively, since have addressed the areas of buy/sell transactions in general (EITF No. 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparts*) and capitalization of exploratory drilling costs in particular (FSB No. FAS 19-1, *Accounting for Suspended Well Costs*), the staff indicated that the related guidance set forth in the 2005 letter is no longer applicable. *See* 2006 Staff Outline, Sections II.F.1., II.D. However, companies are advised to continue to consider the need for disclosure of such arrangements in the financial statement footnotes and MD&A. *Id*. at II.D. (discussing the oil and gas industry). And the February 2005 letter's guidance on the proper accounting for a property disposition using the full-cost method resulting in a less than 25% alteration of proved oil and gas reserve quantities within a cost center, continues to be viable. *Id*.

- **<u>Service Contracts and the Use of SOP 81-1</u>**: AICPA Statement of Position 81-1, *Accounting for Performance of Construction/Production Contracts*, specifically "scopes out" most service, with footnote 1 dealing specifically with the SOP's application to separate contracts to furnish services that are deemed essential to the construction or production of tangible property (*e.g.*, design, engineering, procurement and construction management. 2006 Staff Outline, Section II.F.2. Still, the staff points out that "these long-term service contracts are not substantially different from other revenue arrangements." This means that companies, in deciding whether delivery of services has occurred, "should pay careful attention to the terms of the arrangement, specifically the rights and obligations of the service provider and the customer. Provided all other revenue recognition criteria have been met, the revenue recognition method selected should reflect the pattern in which the obligations to the customer re fulfilled [*e.g.*, as the service is performed, using a proportional performance model per SAB Topic 13].

- **<u>Multi-Element Arrangements</u>**: These arrangements are often seen in the high-tech sector, where companies sell bundled software, boxes and services. The question is how companies recognize revenue when software is embedded in a company's product, or software is used to provide a service. The staff is aware that these arrangements involve complicated assumptions and judgments, which should be disclosed to investors along with what the company's experience has been in relying on these assumptions and judgments and what might cause them to change. Quantification may be helpful where feasible, though it is not mandated.

  - The Division of Corporation Finance's Chief Accountant gave an example of situations in which multi-element arrangements may exist outside of the software industry, during remarks at a November 2006 securities law conference in New York sponsored by the Practising Law Institute: the

myriad contractual relationships that exist between big pharmaceutical companies and small research-and-development companies. Such R&D companies may derive revenue from multiple activities performed under these arrangements, such as licensing fees, R&D funding, etc. Again, the key is disclosure that consists of more than mere repetition of the accounting policy footnote to the financial statements, focusing on such matters as when revenue is recognized vs. actually received, and from what sources, even if paid in a single lump sum under a given contract.

- Issues were raised this past year with respect to complex multiple element arrangements falling outside the revenue recognition area, in circumstances where such arrangements contained multiple elements that were not otherwise subject to specific authoritative accounting literature. Examples included executory contracts that may have required an upfront payment, contract termination agreements, and litigation settlements requiring future services or other concessions between the parties. Whatever the type of contract or transaction involved, two basic questions must be resolved – (1) should the arrangement be separated into two or more elements for accounting purposes; and (2) if so, how should the different elements be measured?[34]

  - On the first question, the accounting will "obviously" depend on the pertinent facts and circumstances. In this regard, the staff has asked companies to consider the following factors, none of which would be determinative: whether the elements involved had independent economic value or substance; whether any of the elements separately would meet the definition of an asset or liability; whether there are instances in which similar elements would be purchased or sold on an individual basis; and whether the company has a reasonable basis for making an allocation among the elements.

  - As to the second question relating to measurement, the staff recommends that companies focus on the substance of the particular agreement, regardless of whether the particular arrangement specifies amounts for given elements. "We generally believe that fair value is a more appropriate allocation basis than the stated amounts in the contract."[35]

Segment Identification and Disclosure (SFAS 131)

The staff continued to question the definition and aggregation of operating segments under SFAS 131 during the 2006 review and comment process. In fact, the Corporation Finance Division's Chief Accountant, Carol Stacey, said this fall that segments follow revenue recognition as the most common subject of staff comments. The staff may believe that a particular segment is overbroad, based in some instances on a comparison of a company's

segment disclosure with information derived from staff review of analyst reports, the company's website, and management interviews with the press. In such circumstances, the staff may request copies of all reports given to the chief operating decision maker(s) or to the board of directors "if the reported segments did not appear realistic for management's assessment of a registrant's performance or conflicted . . . with [the company's own] public statements describing the registrant." 2006 Staff Outline, Section II.L.1. Citing the FASB, the staff takes the position that the burden of demonstrating proper aggregation under FAS 131, paragraph 17, is substantial, erecting a "high hurdle" for companies to surmount. 2006 Staff Outline, at Section II.L.2.

Other noteworthy points made in the 2006 Staff Outline:

- Proper identification of operating segments is critical not only to accurate financial statement footnote and MD&A disclosure, but also to proper allocation of goodwill and goodwill impairment testing as prescribed by FAS 142. Paragraph 18 of SFAS 142 calls for goodwill to be tested at the reporting unit level; reporting units are defined in Paragraph 30 of SFAS 142 as an operating segment for purposes of SFAS 131 or one level below such a segment, referred to as a "component." Companies must test at the component level if the particular component is a business, discrete financial information is available, and segment management regularly reviews the operating results of this component. The staff recommends consultation of EITF Topic D-101, *Clarification of Reporting Unit Guidance in Paragraph 30 of FASB Statement No. 142*, for further guidance on such issues as when components can be aggregated.

- If management either changes or intends to change the structure of its internal organization after fiscal year end, the new segment structure should NOT be presented in financial statements until the company reports operating results managed on the basis of the new structure. The staff indicates that "[d]isclosures based on the historical reportable segments should be presented until financial statements for periods managed on the basis of the new organizational structure are presented," although "supplemental disclosure of the future effects of the changes may be helpful." Section II.L.4.

  If annual financial statements are required in a registration statement (including a Form S-8 for employee benefit plans) or a proxy statement that includes post-fiscal year end periods that are managed under the reorganized segments, the annual audited financial statements "should include a revised segment footnote that reflects the new reportable segments . . . [and] [t]he registrant's Description of Business and MD&A should be similarly revised." *Id.* While the company should not go back and amend prior reports that reflect the "old" segments, it should be aware that if it files a new Form S-3 or S-8 that incorporates its most recent Form 10-Ks and 10-Qs before the new organizational structure must be presented in the financial statements, management must consider whether the change in segments is "material" for purposes of Item 11 of Form S-3 or General Instruction G.2. of Form S-8. If the segment change is deemed material, the

company must report recast segment information prior to the effective date of the S-3 or S-8.

Contingencies and Loss Reserves

Accounting for, and related disclosure of, the nature and scope of loss contingencies is attracting significant staff attention, particularly with respect to three items – allowances for loan losses, estimating potential losses attendant to pending litigation and income tax provisions. The staff again expressed concern that companies are not providing adequate pre-accrual disclosure of potential losses where required, noting that significant accrued amounts for probable losses are often disclosed without previous disclosure of any loss contingency, including the amount that might be paid once a loss became at least reasonably possible. According to the staff, "[c]ircumstances where a loss was accrued for a claim without disclosure in prior filings of the nature of the claim and the range of reasonably possible loss amounts should be rare due to the nature of most contingencies." 2006 Staff Outline, at Section II.I.1.

- **Allowance for Loan Losses**: As the staff observed, the determination of allowances for loan losses demands significant judgment. In the staff's view, "[t]he balance in the allowance for loan losses should reflect management's best estimate of probable loan losses related to specifically identified loans as well as probable incurred loan losses in the remaining loan portfolio." 2006 Staff Outline, at Section II.P. (citing SFAS 5 and FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* ("SFAS 114")). The staff has included in this section of the Outline extensive and very useful guidance on appropriate disclosure relating to loan loss allowances in both the financial statements and the MD&A.

- **Litigation**: As discussed above, the SEC staff remains skeptical of companies that suddenly announce large monetary settlements of long-pending litigation after years of disclosing that they were unable reasonably to estimate losses in advance of the settlement. In this connection, the staff is urging auditors to look more carefully at company counsel's SFAS 5 letters on pending litigation and to push back on both counsel and the company if the letters are uninformative and/or do not contain some quantified estimate of potential losses. Perhaps most importantly, the staff has reminded companies that they should be evaluating and, where appropriate, disclosing in the MD&A, not only the liquidity impact of accruals for probable losses, but also any information "that creates a reasonable likelihood of a material effect [stemming from a possible, but not-yet probable] on its financial condition or results of operations . . . ." 2006 Staff Outline, Section II.I.2.

- **Income Taxes**: Income tax contingencies are no longer covered by SFAS 5, but instead by SFAS 109 and new FIN 48, which interprets SFAS 109. Effective as of the beginning of fiscal years that start after December 15, 2006 (which means Jan. 1, 2007, for all calendar year reporting companies), FIN 48 contains detailed requirements relating to recognition, measurement and disclosure of uncertain tax positions accounted for under SFAS 109, and fixes a clear threshold for

recognition of uncertain tax benefits – a particular tax position must have at least a "more-likely-than-not," or greater than 50% chance of being sustained by the Internal Revenue Service (or other relevant tax authority) on its technical merits. For its part, SFAS 109 dictates financial-statement disclosure of income tax items arising as a result of temporary differences. (Note that the staff has challenged disclosure of ongoing legal expenses associated with the resolution of tax claims, stating that disclosure of the accrual itself is not enough, and that companies should not be burying related legal costs as unidentified expenses in their financial statements.). Calendar year companies should be sensitive to the need for disclosure of the anticipated impact of FIN 48's adoption in their 2006 Form 10-Ks, as well as their Q1 Form 10-Qs. *See* SAB 74.

- During the 2006 AICPA Conference, the SEC's accounting staff gave helpful guidance on FIN 48 adoption and implementation issues, in the form of a speech delivered by an OCA senior accountant (Remarks by Jenifer Minke-Girard, Senior Associate Accountant, Office of the Chief Accountant, U.S. Securities and Exchange Commission, Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments (Wash. D.C., Dec. 13, 2006), available at http://www.sec.gov/news/speech/2006/spch121306jmg.htm, as follows:

  - **Interim Period Disclosures** – The staff will not require a rollforward, or tabular reconciliation of the total amounts of unrecognized tax benefits as prescribed by Paragraph 21a of FIN 48, in the interim period of FIN 48's adoption (*i.e.*, the Form 10-Q for a calendar year company's first fiscal 2007 quarter). However, companies should disclose any material changes in the subsequent 2007 Form 10-Qs filed before the expected annual rollforward data are provided in the annual financial statements for this fiscal year. *Accord* 2006 Staff Outline, Section II.A. ("Any material changes to the unrecognized tax benefits that occur during subsequent interim periods should be disclosed pursuant to Item 10-01(a)(5) of Regulation S-X and discussed in MD&A.").

  - **Need for Preferability Letters** – "[B]ecause FIN 48 fundamentally changes the accounting model for uncertain tax positions and related interest, we [the staff] do not see the need for a preferability letter in situations where, upon adoption of FIN 48, a public company changes its policy on income tax statement classification of interest and penalties on income tax deficiencies." This is a one-time "pass" – a preferability letter will be necessary if the company "materially changes its income statement classification policy for interest and penalties after the adoption of FIN 48 . . . ." *Accord* 2006 Staff Outline, Section II.A.("If the registrant's accounting change includes changing its policy on classification of interest and penalties, it should provide the disclosure required by SFAS 154 (note that no preferability letter is required for the classification change related to the adoption of FIN 48, but would be required if a change in classification is made after adopting FIN 48).").

- **Evidence and Documentation Related to Technical Merits of Tax Positions** – Noting that FIN 48 doesn't contain specific guidance on either the quantity or type of documentation that has to be maintained by a company to satisfy FIN 48's recognition (or measurement) provisions nor, for that matter, imposes any limits on what evidence the company can look to in making a "more-likely-than-not" determination, the staff urged financial statement preparers and auditors to exercise reasonable judgment and common sense. To illustrate, the staff suggested that the level of documentation necessary to support a position that is consistent with formal guidance published by the relevant tax authorities (or otherwise deemed "well-accepted"), might be less than that called for in the absence of such persuasive evidence.

Pension, Post-Retirement and Post-Employment Benefits

There were several significant developments in 2006 that will affect preparation of the 2007 MD&A. First, prodded by the 2005 Staff Off-Balance Sheet Report, the FASB adopted SFAS 158, amending SFAS 87, *Employers' Accounting for Pensions*, SFAS 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, SFAS 106, *Employers' Accounting for Postretirement Benefits Other than Pensions*, and SFAS 132R, *Employers' Disclosures about Pensions and other Postretirement Benefits*. SFAS 158 requires calendar year companies with publicly traded equity securities to recognize, on their fiscal 2006 balance sheets, a net liability or asset depending on the funded status of their defined benefit pension and other postretirement benefit plans. An offsetting adjustment will have to be recorded in accumulated other comprehensive income in shareholders' equity. Now that this information has been removed from the financial statement footnotes, FASB will consider whether and how to reflect benefit costs in the income statement. For more information on this project, *see* the FASB's website at http://www.fasb.org.

The second major development in the past year affecting pension-plan accounting was the enactment in August of 2006 of the Pension Protection Act of 2006, which imposes new funding targets for plan years beginning after December 31, 2007, sets forth guidelines for measuring the fair value of pension plan assets and obligations for funding purposes, and establishes benefit limitations for underfunded plans. Although these requirements technically do not affect the fiscal 2006 financial statements, registrants should consider whether to include future material funding contributions in the upcoming MD&A's contractual commitments table, given the SEC staff's expectation that reasonable estimates of pension costs for at least the following year (*i.e*. 2007) and, if known, for subsequent years, should be reported here. Moreover, if your company is a calendar year registrant, be prepared for your auditors to ask whether the effects of anticipated changes in measurement of the company's accumulated benefit obligation and the projected benefit obligation, each as prescribed by SFAS 87, should be reflected in the 2006 financial statements. Note that the SEC's accounting staff will be watching: "[R]egistrants should provide transparent disclosure in Management's Discussion and Analysis of the [Pension Protection] Act's anticipated impact on the company's liquidity and capital resources. Although in some circumstances it will be difficult to forecast precise funding requirements due to the annual recomputation required by the Act, it will often be possible to provide disclosure of the

magnitude of cash commitments for future annual periods assuming present market conditions remain constant."[36]

In the meantime, the SEC staff will continue to scrutinize the accounting-related disclosures of companies' future benefit obligations; more specifically, disclosures of the estimates and assumptions embedded in the application of GAAP – both with respect to pension (*i.e.*, defined benefit) plan obligations (SFAS 87) and other post-retirement benefits (SFAS 106). Areas under particular scrutiny include long-term rates of return (deemed potentially too high), as well as discount rates and retiree medical cost estimates (each too low, possibly understating contingent liabilities). The 2006 Staff Outline (which, interestingly enough, is silent with respect to SFAS 158 and the Pension Protection Act of 2006) contains a detailed directive on what it deems to be adequate disclosure in the financial statement footnotes as well as the MD&A. To illustrate the level of staff attention to such disclosures, note the following excerpt from the 2006 Staff Outline (at Section II.J.1.):

> The staff expects a registrant with material defined benefit plans to include clear disclosure of how it determines its assumed discount rate, either in the financial statement footnotes or in the critical accounting estimates section of MD&A. That disclosure should include the specific source data used to support the discount rate. If the registrant benchmarks its assumption off of published long-term bond indices, it should explain how it determined that the timing and amount of cash outflows related to the bonds included in the indices matches its estimated defined benefit payments. If there are differences between the terms of the bonds and the terms of the defined benefit obligations (for example if the bonds are callable), the registrant should explain how it adjusts for the difference. Increases to the benchmark rates should not be made unless the registrant has detailed analysis that supports the specific amount of the increase.

Cash Flows Statements: Classification Issues

For the second year running, the Division of Corporation Finance has emphasized the importance of proper classification of cash flows – as operating, financing and investing – in company statements of cash flows. Underscoring this theme, several companies restated their financial statements in 2006 at least in part because of material errors in cash flows classification. MD&A preparers therefore should pay special attention to Section II.C. of the 2006 Staff Outline, given the Division's view that companies "should put sufficient time and effort into ensuring that the statement of cash flows, and related disclosure in the financial statement footnotes and in MD&A, is meaningful and useful to users of the financial statements." (For more on MD&A presentation of cash flows, ***see Part 1***, ***above***). By way of explanation of its firm stance in this area, the staff observed that the "statement of cash flows is one of the primary statements required with a full set of financial statements . . . .[and] is relied upon by analysts and investors as much, if not more in some instances, as the statement of net income. The importance of appropriate classification and presentation of items in the consolidated statement of cash flows cannot be overstated. Registrants should give sufficient attention to the preparation of their

consolidated statement of cash flows in order to ensure that it provides an accurate presentation of their actual cash receipts and cash payments based on activity (operating, investing and financing), which in turn assists the reader in determining the registrant's ability to meet its obligations, pay dividends, generate cash flows sufficient to grow its business, etc."

While some diversity in practice in classification of cash flows relating to certain activities under SFAS No. 95, the relevant accounting standard, may be permissible (including in particular in the areas of discontinued operations and insurance proceeds, discussed below), a company that believes it has "chosen an acceptable classification but has identified diversity in practice or believes a different classification may also be acceptable . . . should provide quantified disclosure that is sufficient to inform investors of the classification chosen and the alternative classification considered and rejected." As discussed above, the staff prefers the direct method of classification and presentation of cash flows as yielding more useful information to investors, but has come to terms with the reality that "most registrants use the indirect method."

Two areas of diversity in classification of cash flows have attracted the staff's attention: reporting cash flows from discontinued operations and proceeds from insurance settlements. The staff's positions on each are set forth in Sections II.C.1. and II.C.2., and are summarized below:

- **Discontinued Operations**: According to the staff, an increasing number of companies are reporting discontinued operations ("disc ops") based on application of SFAS No. 144, which has led to an observable variation in reporting practices reflected in cash flow statements. The guiding principle of SFAS 95 that must be applied here, per the staff, is whether cash flows generated from discontinued operations are reported as relating either to operating, investing and financing activities. According to the staff, SFAS 95 "does not appear to support aggregating operating, investing and financing cash flows from discontinued operations into a single line item, as some registrants have presented." 2006 Staff Outline, Section II.C. Nor does the staff think SFAS 95 supports combining disc op cash flows from the three relevant categories into the operating cash flow category.

  Practices apparently considered acceptable by the staff are: (1) combining cash flows from disc ops with cash flows from continuing operations, broken out into operating, financing and investing activities; (2) separately identifying the cash flows relating to disc ops within each of the three key categories, or just separately for operating cash flows; and (3) displaying the cash flows from disc ops separately for operating, investing and financing activities near the bottom of the cash flows statement, immediately before net increase or decrease in cash and cash equivalents.

- **Insurance Proceeds**: Companies that receive cash payments pursuant to recovery on claims made under various insurance policies often confront the question of how to classify these payments; *i.e.* in accordance with the activity that resulted in the insurance proceeds or the activity for which the proceeds will be used? The staff reads SFAS 95 to "suggest that proceeds from insurance settlements should be classified based on the nature of the insurance coverage

> which resulted in the right to receive payment . . . [that is] the nature of the loss covered by the particular insurance policy." 2006 Staff Outline at Section II.C.2. How the company plans to spend the proceeds does not affect classification, in other words (although disclosure of such plans is warranted, as discussed above in ***Part 1***). Thus, proceeds paid under a business interruption policy would fall within operating activities, whereas classification of proceeds received under a property damage or loss policy would depend on the nature of the covered property – *e.g.*, if fixed assets owned or leased under capital leases, the appropriate category would be cash from investment activities, whereas settlements relating to inventory would be placed in the operating cash category.

Business Combinations and Goodwill Impairment (SFAS 141 and SFAS 142)

One area of concern involves the required allocation of the purchase price of an acquired entity to the assets acquired and liabilities assumed based on fair value at acquisition date, and use of the so-called residual method for computing goodwill. Staff reviews have detected improper allocation of excess purchase price to an intangible asset other than goodwill in reliance upon this so-called "residual" method, which the staff states does not comply with SFAS 141. EITF D-108 announces the staff's position that the residual method should not be used to value intangible assets other than goodwill. *See* Section II.G.1. of the 2006 Staff Outline.

Another area of concern relates to the application of SFAS 142 to goodwill testing which, generally speaking, must occur annually unless more frequent testing is demanded by changed circumstances. Although a company may change the annual impairment testing date from one year to the next, it must disclose the reasons for this change in the method of applying an accounting principle, in accordance with SEC and GAAP requirements. *See* Section II.G.2. of the 2006 Staff Outline. Note also senior SEC staff's emphasis on the importance of proper segment definition in this area (*see* the discussion of SFAS 131, above).

Off-Balance Sheet Arrangements and Deconsolidation (FIN 46R)

One of the less prominent aspects of FIN 46R has been the deconsolidation of certain subsidiary trusts used by public companies to issue trust preferred securities. The staff has indicated that these finance subs may continue to rely on Rule 3-10(b) of Regulation S-X and Exchange Act 12h-5 to "piggyback" on affiliated companies' Exchange Act reports even after FIN 46R-prescribed deconsolidation, subject to specified disclosure and other conditions (for example, they must be 100% owned by the reporting company). For more on this, *see* Section II.K. of the 2006 Staff Outline.

Derivatives and Hedge Accounting

There continued to be much discussion in 2006 regarding the complexity of the FASB's standard for more favorable hedge accounting treatment, SFAS 133, and the SEC staff's dissatisfaction with how companies have been applying this standard. In the 2006 Staff Outline and at the 2006 AICPA Conference, the staff stressed the need for rigorous adherence to the requirements of SFAS 133, including but not limited to those relating to documentation and hedge effectiveness

assessment. For a detailed discussion of the staff's views in this area, as presented during the 2006 AICPA Conference, *see* McGrath Remarks (cited in full in note 24, below).

- Formally document the hedging relationship at its inception. This documentation must identify the company's risk management objectives and strategies for establishing the hedge, the nature of the hedged risk, the derivative hedging instrument, the hedged item or forecasted transaction, the method the company will use – both retrospectively and prospectively – to assess the effectiveness of the hedge throughout its life span (both at its inception and on a continuing basis), and the method to be used to measure hedge ineffectiveness (including those situations in which the change in fair value method described in SFAS 133 Implementation Issue No. G7 will be used; *see* EITF D-102). *See* 2006 Staff Outline, Section II.M.1.

- Although the FASB allows use of a shortcut method as an exception to the periodic assessment and measurement requirements relating to effectiveness of a particular hedging relationship—with use limited to "straightforward hedges of interest rate risk" – the staff construes this limited exception narrowly. For more information on staff-defined examples of mistaken use of the shortcut method, *see* Section II.M.2. of the 2006 Staff Outline, and Remarks of Timothy S. Kviz, Professional Accounting Fellow, Office of the Chief Accountant, U.S. Securities and Exchange Commission, Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments (Wash. D.C., Dec. 11, 2006), available at http://www.sec.gov/news/speech/2006/spch121106tsk.htm.

- The 2006 Staff Outline offers guidance (in Section II.M.3.) on financial statement presentation and disclosure of the results of hedging relationships, recognizing that SFAS 133 as yet does not cover these topics. (You should be aware of, and review, a FASB proposal that "specifically addresses constituents' concerns that existing disclosure statement associated with [FAS 133] . . . do not provide adequate information to financial statement users." FASB News Release issued December 8, 2006, announcing publication of an exposure draft that day (No. 1510-100) "that would enhance the current disclosure framework by requiring that objectives and strategies for using derivative instruments be discussed in terms of underlying risk and accounting designation," among other reforms, which together with the exposure draft is available at http://fasb.org/news/nr120806.shtml. As proposed, these requirements would be effective for financial statements issued for fiscal years and interim periods ending after December 15, 2007, with early application encouraged.). Noting that there is no required income-statement classification under GAAP for the gain or loss recognized for hedge ineffectiveness or, for that matter, for any gain or loss that is excluded from the hedge effectiveness assessment itself, the staff made clear that the amount of any net gain or loss and its income statement classification must be disclosed. "Consistent classification should be observed in each period," and "[d]erivative assets and liabilities may be offset only to the extent permitted by FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts."

- Nor does SFAS 133 deal with classification of derivatives that do not qualify for hedge accounting. Given this seeming vacuum, the staff "encourage[s] disclosure of the location in the income statement where the changes in the fair value of non-hedge accounting derivatives are reflected as well as the amount." In the staff's view, "a presentation that splits the components of a derivative into different line items on the income statement or that reclassifies realized gains or losses of a derivative out of the line item that included unrealized gains and losses of the same derivative is inappropriate." To illustrate, the staff offers this hypothetical: "[I]f a registrant classifies changes in fair value of economic hedges (unrealized gains and losses), in a single line item such as 'risk management activities,' a registrant should not reclassify realized gains and losses (the periodic or final cash settlements from these economic hedges) in the period realized out of risk management activities and into revenue or expense lines associated with the related exposure." 2006 Staff Outline, Section II.M.3.

- Companies trying to determine what the staff would consider to be "good" disclosure in this area should note that the staff recommends (2006 Staff Outline, Section II.M.3.) that they focus "on the clarity of their disclosures when they use hedges, both those that qualify for hedge accounting under SFAS 133 and those that don't." Registrants should provide transparent, "plain English" disclosures related to derivatives, including reasons for their use, associated hedging strategies, and methods and assumptions used to estimate fair value, as required by SFAS 107 and SFAS 133, and Item 305 of Regulation S-K [market risk disclosures regarding derivatives and other financial instruments, discussed in Section II.O. of the 2006 Staff Outline]. Furthermore, when hedge accounting has a material impact on the registrant, registrants should ensure that they have disclosures, for each type of fair value and cash flow hedge, that clearly describe the specific type of asset or liability (or identified portion thereof) being hedged and the derivatives used for that type of hedge. Registrants should also consider providing disclosures regarding their use of SFAS 133 elections."

- During 2006, the staff observed in the course of filing reviews that some companies may be misclassifying warrants and other instruments with embedded conversion features. This matters because instruments that fall within the scope of SFAS 133 (or SFAS 150, as we next explain) will not qualify for treatment as equity under EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*. Before a company may apply the guidance in EITF 00-19, which basically provides that settlement in company shares and satisfaction of certain other criteria would permit classification of such equity-linked instruments as warrants, convertible preferred or debt as equity on the balance sheet, that company first must consider whether any such instrument falls within the scope of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* ("SFAS 150"). Only then may a company analyze the instrument under SFAS 133 and, if a scope exception is applicable, proceed to apply EITF 00-19. For further detailed guidance on the staff's expectations regarding appropriate classification and measurement of freestanding warrants

and embedded conversion features, including the significance of registration rights, *see* Section II.B. of the 2006 Staff Outline, and the Division of Corporation Finance's presentation (by senior staff accountant Stephanie L. Hunsaker) at the 2006 AICPA Conference (full citation set forth in note 2, below).

7. *Notable MD&A Enforcement Proceedings in 2006 and 2005*

The SEC continues to pursue a vigorous, two-pronged approach to policing in this area – bringing suits against major companies and/or their senior managers based on allegedly misleading MD&A disclosures, as well as issuing hundreds of comment letters (many of which are publicly available) requesting that companies amend and expand their MD&A filings. Such amendments themselves can have serious consequences, as they will require new CEO/CFO certifications on the accuracy and completeness of financial information that could raise questions about the adequacy of the previous disclosures to which these senior officers certified.

We thought it would be useful to distill for you here the lessons to be learned from key MD&A enforcement proceedings brought by the SEC in 2006 and 2005. Among the more significant, in our view, were proceedings instituted against and settled by Raytheon Company and McAfee, Inc. Two other proceedings, both brought in 2005 – relating to the MD&As of Kmart and Coca Cola Company ("Coke") – are discussed in the latest Corporation Finance outline as exemplars of what NOT to do in connection with MD&A preparation (2006 Staff Outline, at Section I.N.). One could reasonably infer, from the foregoing, that the Divisions of Enforcement and Corporation Finance will be paying close attention to whether companies whose MD&As are reviewed in 2007 have gotten the "no-spin" message.

2006 MD&A Cases

McAfee, Inc.: Fraud Charged in Connection with Improper Revenue Recognition, Manipulation of Reserve Accounts and Other Conduct

Although described in the 2006 Staff Outline as an "improper GAAP" case (at Section I.M.1.), we believe the SEC's complaint against McAfee (which settled the case without admitting or denying the allegations when the complaint was filed in federal district court in California) also illustrates the SEC's sharp focus on the MD&A as an important medium for clarifying and explaining the information disclosed in the financial statements. SEC v. McAfee, Inc., SEC Lit. Rel. No. 19520, AAER No. 2360 (Jan. 4, 2006), available at http://www.sec.gov/litigation/litreleases/lr19520.htm. The company was charged with fraud, books-and-records, internal controls and reporting violations of the federal securities laws based on a scheme to overstate revenues and earnings by hundreds of millions of dollars over a period spanning 1998 - 2000. Specifically, the company aggressively oversold its product to distributors (channel stuffing) in amounts that far exceeded customer demand, offering distributors lucrative sales incentives such as deep price discounts, and paying them to hold excess inventory rather than returning it for a refund. Other charges included using a subsidiary to fraudulently repurchase inventory (leading to a restatement of financial results for 1997 through 2003), improperly recording payments and discounts offered to distributors, improperly inflating inadequate sales reserves to cover these payments, and reporting materially false and misleading financial and other information in periodic reports, financial statements, registration

statements, press releases and other public statements. One of the key allegations in the complaint asserted that throughout the relevant period, the company "filed annual and periodic reports that not only contained materially false financial statements, but . . . also failed to include accurate disclosures concerning McAfee's business practices and results of operations in the . . . MD&A . . . and elsewhere. For example, in its annual report for the year ended December 31, 1998, McAfee stated in the MD&A section that growth in net revenue" was due to an increase in customer demand for certain products and certain other factors, but "[n]otably . . . omitted any mention of its aggressive channel stuffing, which improperly allowed it to increase the revenues that it reported to investors." McAfee was similarly remiss in failing to disclose that its actual business practices did not conform to its stated revenue recognition policies. Such omissions resulted in materially misleading disclosures that deceived investors, in the SEC's view.

McAfee consented to entry of a permanent injunction, a $50 million civil penalty to be distributed to injured investors (under SOXA's Fair Funds provision), and the appointment of an independent consultant to examine and recommend improvements to the company's internal accounting controls and revenue recognition and reserves practices.

Raytheon Co.: Raytheon, its Former CEO and Former Deputy CFO Settle Civil and Administrative Charges Arising From Fraudulent Disclosure and Improper Accounting Practices

Last June, the SEC simultaneously instituted and settled civil injunctive and administrative proceedings charging Raytheon, Daniel P. Burnham, its former CEO, and Aldo R. Servello, the former Deputy CFO who also served as controller of Raytheon's commercial aircraft subsidiary, Raytheon Aircraft Company ("RAC"), with filing materially false and/or misleading periodic reports covering the periods between 1997 to 2001. RAC constituted an operating segment of its parent company. As is typical in such proceedings, the company and its former officers – who were charged with causing or otherwise facilitating certain securities violations by the Company – neither admitted nor denied culpability on the charges filed administratively and in federal district court, and consented to entry of an civil injunction, a cease-and-desist order, a penalty of $12 million and disgorgement of $1.00 (to be paid by Raytheon), and disgorgement of certain past bonus amounts, pre-judgment interest and penalties of approximately $1.24 million (Burnham) and $34,628 (Servello). Interestingly enough, the SEC did not bring a *scienter*-based fraud claim under Section 10(b) and Rule 10b-5 under the Exchange Act, but did allege violations of Sections 17(a) (2) and (3) of the Securities Act of 1933, as amended, which creates a negligence-based fraud cause of action enforceable only by the SEC (because Raytheon had offered and sold securities under various registration statements and prospectus supplements during this period), as well as Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder (requiring the filing of "true and correct" periodic reports), Exchange Act Section 13(b)(3)(A) and Rule 13b2-1 (accurate books and records) and Exchange Act Section 13(b)(2)(B) (adequate internal accounting controls). *See* SEC v. Raytheon Company, Daniel P. Burnham, and Aldo R. Servello, SEC Lit. Rel. No. 19747 (June 28, 2006), available at http://www.sec.gov/litigation/litreleases/2006/lr19747.htm (civil complaint), and In the matter of Raytheon Company, Daniel P. Burnham, and Aldo R. Servello, SEC Rel. No. 33-8715, AAER Rel. No. 2449 (June 28, 2006), available at http://www.sec.gov/litigation/admin/2006/33-8715.pdf. *See also* 2006 Staff Outline, Section I.M.6.

According to the SEC's findings (to which the parties consented without admission or denial of the allegations made), Raytheon improperly recognized revenue on RAC's sale of unfinished aircraft through so-called "bill-and-hold" sales transactions in 1997 and 1998 that did not comply with applicable GAAP. The resulting material overstatements of RAC's reported annual net sales revenue and operating income in each of 1997 and 1998 enabled both Raytheon and RAC to meet external and internal earnings targets. Although the company did restate for these material errors in 1999, it was charged with misleading investors by failing to attribute the restatement to RAC's improper revenue recognition practices. Between 1997 and 2001, moreover, Raytheon was found to have violated Item 303 of Regulation S-K by failing fully to disclose, in the MD&A sections of Exchange Act reports for these periods (among other items), known material risks, trends and uncertainties (and other information) associated with the deteriorating state of RAC's commuter aircraft business and the negative impact this decline was having on the results of operations of both parent and subsidiary. In addition, Raytheon used improper accounting practices to delay and mischaracterize known losses relating to RAC's commuter line between 1997 and 2001.

<u>2005 MD&A Cases</u>

Kmart: Former CEO and CFO Charged With Fraud

In late August 2005, the SEC filed fraud and related charges in a Michigan federal district court against the former CEO and CFO of Kmart for allegedly misleading investors regarding the company's financial condition in the months leading up to its bankruptcy filing in early 2002. The SEC clearly sees this as a "message" case, as the words of its Enforcement Division Director, Linda Chatman Thomsen, underscore: "The SEC has repeatedly emphasized the important role MD&A disclosure is intended to play in giving shareholders the ability to examine a corporation 'through the eyes of management.' Kmart senior management deprived its shareholders of that opportunity."[37]

According to the SEC's complaint seeking a permanent injunction, disgorgement, civil penalties and officer-and-director bars, the former CEO and CFO failed to disclose in the MD&A section of the company's Form 10-Q for the third quarter of fiscal 2001, the true reasons for a significant inventory increase that summer – *i.e.*, a "massive [$850 million], unauthorized inventory overbuy" – and the impact this excess inventory had and would have on liquidity. Instead, the MD&A for Q3 attributed the significant build-up to mere "seasonal inventory fluctuations," and failed to disclose how the company dealt with the resulting liquidity problem – by delaying payments to vendors. Essentially the company had borrowed $570 million from its vendors by the end of the third quarter. The damage was compounded during a conference call held in November 2001, when the CEO and CFO falsely attributed the company's non-payment of its vendors to "glitches" in implementing changes to its inventory and payables software. Vendors were unhappy and some stopped shipping product after the quarter's end, heightening the company's impending financial crisis immediately before the Christmas holiday shopping season.

The complaint makes clear that, in addition to misleading investors about the real reason for the inventory build-up during the quarter, Kmart's MD&A was deficient in failing to identify "any known trends or any known demands, commitments, events or uncertainties that will result in or

that were reasonably likely to result in the Company's liquidity increasing or decreasing in any material way." In the SEC's view, Kmart should have described in the MD&A the course of action the company had taken and/or would take to remedy the liquidity problem and also should have identified separately both internal and external sources of liquidity. The vendor borrowing scheme itself was deemed a "material deficiency at quarter end that should have been identified in the MD&A," and also described as the true source of liquidity upon which the company was primarily relying to pull itself out of the liquidity crunch.

The 2006 Staff Outline indicates that, at least as of November 30, 2006, the SEC's Kmart investigation is continuing.

The Coca-Cola Co.: Settled Administrative C&D Proceeding

In April 2005 the SEC filed and simultaneously settled an administrative cease-and-desist proceeding against Coke that arose from the company's failure to disclose the existence and impact, on current and future earnings, of certain end-of-quarter sales practices in the MD&A section of 10-Ks and 10-Qs (as well as various other filings, including Form S-8 registration statements) for the reporting periods between 1997 and 1999.[38] During this period, Coke implemented in Japan an undisclosed practice of "channel-stuffing," also known as "gallon pushing," to enable the company to record sales as made to bottlers in a current period that otherwise would not have occurred until future periods. Specifically, Coke offered Japanese bottlers of its product extended credit terms to induce them to buy more product sooner, which in turn allowed Coke to continue to meet internal business planning targets and external earnings expectations (EPS). Eventually, the company's Japanese affiliate indicated in the fourth quarter of 1999 that it could not sustain gallon pushing at existing levels and would have to slow it down.

The SEC based its fraud charge on Coke's allegedly false and misleading statements in a Form 8-K (filed in early 2000) announcing the company's plans to reduce inventory of its product among bottlers in countries around the world, including Japan. The SEC faulted Coke for incorrectly describing the reasons for and contours of the inventory reduction plan in this 8-K, and for failing truthfully to attribute to the Japanese affiliate the disproportionate earnings impact of the gallon pushing and its cessation. But it is worth noting that the agency did not criticize the appropriateness of this undisclosed revenue recognition practice under GAAP. Perhaps we can reasonably infer, therefore, that the case reinforces (however indirectly) the SEC's longstanding position that even a showing of compliance with GAAP will not protect a company against antifraud enforcement action.[39]

Interestingly enough, the SEC's order did not charge Coke with fraud based on its MD&A disclosures for 1997-1999 – by contrast with the Form 8-K discussed above. Instead, the company was deemed to have violated the MD&A line item requirements by failing to disclose, in the MD&A sections of reports covering that period, "the existence of gallon pushing, the impact of gallon pushing on current earnings, and the likely impact of gallon pushing on future earnings."[40] Nor did the company appropriately disclose "the material impact of gallon pushing on current and future income."[41]

In addition to consenting to this cease-and-desist order finding violations of antifraud (the Form 8-K) and periodic reporting (the MD&A) provisions – arising, it is important to emphasize, from pre-SOXA revenue recognition practices – Coke agreed to undertake a number of remedial measures relating to its internal reporting controls. Among these measures are: (a) to maintain its recently established Disclosure Committee to assist the CEO and CFO in fulfilling their responsibilities for accurate and timely reporting; (b) to maintain its recently established Ethics and Compliance Office to continue to administer its Code of Business Conduct and to ensure, among other things, that the company conducts its business in compliance with this Code and with applicable laws; (c) to continue to require its divisions to certify quarterly that they have not changed or extended credit terms for any bottler or customer, or granted any special or unusual credit terms or incentives without approval; and (d) to have the Audit Committee continue to employ independent and experienced legal counsel to assist it in implementing certain "voluntary" control-related undertakings. Several of these undertakings contemplate extensive Audit Committee involvement in the preparation of the MD&A itself and in adopting criteria governing the role of the new Disclosure Committee in operating disclosure controls and procedures that focus heavily on the MD&A and adherence to appropriate revenue recognition practices.

ENDNOTES

[1] Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, SEC Rel. No. 33-8350 (Dec. 19, 2003), *available at* http://www.sec.gov/rules/interp/33-8350.htm.

[2] *See* Remarks of Craig C. Olinger, Deputy Chief Accountant, Division of Corporation Finance, U.S. Securities and Exchange Commission, Current Developments in the Division of Corporation Finance, 2006 AICPA National Conference on Current SEC and PCAOB Developments (Wash. D.C., Dec. 12, 2006). Although no written transcript of Mr. Olinger's presentation is available, the data he provided are reflected in the Division's slide presentation, which is *available at* http://www.sec.gov/news/speech/2006/slides121206teh.pdf ("Corp Fin. Slide Presentation at 2006 AICPA Conference") (Slide No. 5).

[3] Remarks of Commissioner Cynthia A. Glassman, U.S. Securities and Exchange Commission, Before the Tenth Annual Corporate Counsel Institute: Priorities and Concerns at the SEC (Wash. D.C., March 9, 2006) ("Glassman Remarks"), *available at* http://www.sec.gov/news/speech/spch030906cag.htm. Commissioner Glassman did compliment companies on improvement shown in some areas which we discuss above in the text.

[4] *See* U.S. Securities and Exchange Commission, Accounting and Disclosure Issues: Current Accounting and Disclosure Issues in the Division of Corporation Finance (Nov. 30, 2006) ("2006 Staff Outline"), *available at* http://www.sec.gov/divisions/corpfin/cfacctdisclosureissues.pdf.

[5] Public Company Accounting Oversight Board, Staff Audit Practice Alert No. 1, "Matters Related to Timing and Accounting for Option Grants" (July 28, 2006), *available at* http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2006/07-28_APA_1.pdf.

[6] *See* Letter from Conrad Hewitt, Chief Accountant, U.S. Securities and Exchange Commission, to Lawrence Salva, Chairman, Committee on Financial Reporting, Financial Executives International, and Sam Ranzilla, Chairman, Center for Public Company Audit Firms, AICPA, dated September 19, 2006 ("Hewitt Letter"), *available at* http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm.

[7] *See* Division of Corporation Finance, U.S. Securities and Exchange Commission, Sample Letter Sent in Response to Inquiries Related to Filing Financial Statements for Errors in Accounting for Stock Options (January 2007), *available at* http://www.sec.gov/divisions/corpfin/guidance//oilgasltr012007.htm. The staff's letter is highly limited, in the sense that it makes clear that restating prior periods affected in accordance with the letter's guidance would neither insulate the company from further Division of Corporation Finance comment that might require amendment, nor foreclose either that Division or the Division of Enforcement from concluding that the company had failed to comply with its disclosure obligations under the federal securities laws.

[8] Remarks of Todd E. Hardiman, Associate Chief Accountant, Division of Corporation Finance, U.S. Securities and Exchange Commission, Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments (Wash. D.C., Dec. 12, 2006) ("Hardiman Remarks"), *available at* http://www.sec.gov/news/speech/2006/spch121206teh.htm.

[9] *Id.*

[10] *Id.*.

[11] *Id.*

[12] Remarks of Mark Mahar, Associate Chief Accountant, Office of the Chief Accountant, U.S. Securities and Exchange Commission, Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments (Wash. D.C., Dec. 11, 2006) ("Mahar Remarks"), *available at* http://www.sec.gov/news/speech/2006/spch121106mm.htm.

[13] Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies (Feb. 27, 2003), *available at* http://www.sec.gov/divisions/corpfin/fortune500rep.htm.

[14] SEC Rel. No. 33-8040 (Dec. 12, 2001) ("2001 Cautionary Advice"), *available at* http://www.sec.gov/rules/interp/33-8350.htm.

[15] SEC Rel. No. 33-8056 (Jan. 22, 2002), *available at* http://www.sec.gov/rules/other/33-8056.htm.

[16] Commissioner Glassman indicated, in a March 2006 speech (cited in full in note 3, above), that "the staff [*i.e.*, of the Division of Corporation Finance] has observed that many companies are making their executive summaries and results of operations more informative. The better executive summaries furnish investors with information and guidance that provide context, and make the details that follow easier to understand. Regarding the results of operations, I am encouraged that, consistent with our guidance, many companies are explaining why the results of operations are what they are – rather than merely repeating what GAAP says they are."

[17] In an apparent effort to preempt criticisms that such a distillation of important information might provoke antifraud litigation, the SEC stated that "the failure to include disclosure of every material item in an introduction or overview should not trigger automatically the application of the 'buried facts' doctrine, in which a court would consider disclosure to be false and misleading if its overall significance is obscured because material is 'buried,' such as in a footnote or an appendix." 2003 MD&A Interpretive Release, *supra* note 1, at text accompanying footnote 23.

[18] Remarks by Carol A. Stacey, Chief Accountant, Division of Corporation Finance, U.S. Securities and Exchange Commission, Before the 2005 AICPA National Conference on Current SEC & PCAOB Developments (Wash., D.C., Dec. 5, 2005) ("Stacey Speech"), *available at* http://www.sec.gov/news/speech/spch120505cas.htm.

[19] *See*, *e.g.*, Remarks of Commissioner Glassman (*supra* note 3) ("some companies' MD&A is still unnecessarily lengthy and not focused on telling the story clearly.")

[20] Glassman Remarks, *supra* note 3.

[21] *See* 2006 Staff Outline, *supra* note 4, at Section II.C.

[22] The Division of Corporation Finance staff has provided highly detailed guidance on disclosure of revenue recognition in the MD&A and/or the footnotes to the financial statements, as appropriate. *See* 2006 Staff Outline, *supra* note 4, at Section II.F. We strongly recommend that you review this guidance as you prepare this year's annual report on Form 10-K.

[23] Stacey Speech, *supra* note 18. *See also* Speech by Alan L. Beller, Director, Division of Corporation Finance, SEC, the Alan B. Levenson Memorial Lecture, Glasser LegalWorks: 6th Annual SEC Disclosure, Accounting and Enforcement Conference (New York, May 18, 2004), *available at* http://www.sec.gov/news/speech/spchalb051804.htm.

[24] *See* Remarks of Joseph D. McGrath, Professional Accounting Fellow, Office of the Chief Accountant, U.S. Securities and Exchange Commission, Before the 2006 AICPA Conference on SEC and PCAOB Developments (Wash. D.C., Dec. 11, 2006) ("McGrath Remarks"), *available at* http://www.sec.gov/news/speech/2006/spch121106jdm.htm. Mr. McGrath addressed recognition of inception gains upon adoption of FAS 157, and fair-value measurements in respect of multiple element arrangements and inventory, among other topics.

[25] The most recent written treatment of these twin disclosure requirements is contained in the 2006 Staff Outline, *supra* note 4, at Section II.J.

[26] Office of the Chief Accountant, Office of Economic Analysis, Division of Corporation Finance, U.S. Securities and Exchange Commission, Report and Recommendations pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special-Purpose Entities, and Transparency of Filings, to the President of the United States, the Committee on Banking, Housing and Urban Affairs of the U.S. Senate and the Committee on Financial Services of the U.S. House of Representatives (2005), at 97, *available at* http://www.sec.gov/news/studies/soxoffbalancerpt.pdf.

[27] *Id.* at 98.

[28] *Id.* at 103 (footnote omitted).

[29] ***See Part 2*, *above***.

[30] Remarks of Joseph B. Ucuzoglu, Professional Accounting Fellow, Office of the Chief Accountant, U.S. Securities and Exchange Commission, Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments (Dec. 11, 2006) ("Ucuzoglu Remarks"), *available at* http://www.sec.gov/news/speech/2006/spch121106jbu.htm.

[31] Conditions for Use of Non-GAAP Financial Measures, SEC Rel. No. 33-8176 (Jan. 22, 2003), *available at* http://www.sec.gov/rules/final/33-8176.htm.

[32] Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures (June 13, 2003), *available at* http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm.

[33] Remarks of John W. Albert, Senior Associate Chief Accountant, Office of the Chief Accountant, U.S. Securities and Exchange Commission, Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments (Wash. D.C., Dec. 11, 2006) ("Albert Remarks"), *available at* http://www.sec.gov/news/speech/2006/spch121106jwa.htm.

[34] McGrath Remarks, *supra* note 24.

[35] *Id.*

[36] Ucuzoglu Remarks, *supra* note 30.

[37] SEC Press Release No. 2005-119 (Aug. 23, 2005), *available at* http://www.sec.gov/news/press/2005-119.htm.

[38] *See* Accounting and Auditing Enforcement Release No. 2232 (April 18, 2005) ("AAER Rel. No. 2232"), *available at* http://www.sec.gov/litigation/admin/33-8569.pdf.

[39] *See*, *e.g.*, In re The PNC Financial Services Group, Inc., SEC Rel. No. 34-46225 (July 18, 2002); In re Edison Schools, Inc., SEC Rel. No. 34-45925 (May 14, 1998).

[40] *See* AAER Rel. No. 2232, *supra* note 38.

[41] *Id.*