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BRIEFING

'Hot button' disclosure issues for US annual reports

The SEC identifies common financial reporting weaknesses

Executive summary

The US Securities and Exchange Commission (SEC) recently identified a number of common weaknesses in financial disclosure, after examining annual reports filed by *Fortune 500* companies in 2002. We expect that the SEC will continue to scrutinise disclosure in these areas in 2003. In addition, the SEC will begin to examine the annual reports of major non-US companies. As a result, companies that are now preparing their US annual reports on Form 20-F must pay particular attention to the common problem areas identified by the SEC. They should also be prepared to respond to SEC staff comments on their annual reports.

The US Securities and Exchange Commission (SEC) recently identified a number of common weaknesses in financial disclosure, after examining annual reports filed by all of the *Fortune 500* companies in 2002. We expect that the SEC will continue to scrutinise disclosure in these areas in 2003 and will begin to focus on the annual reports of major non-US companies. Non-US companies should be prepared to respond to SEC staff comments on their Form 20-F filings. As a result, companies that are now preparing their US annual reports on Form 20-F must pay particular attention to the following common problem areas that have been identified by the SEC.

Management's discussion and analysis (MD&A)

A litany of period-to-period percentage changes in individual line items and boilerplate explanations is not sufficient. The SEC requires a detailed analysis of material year-to-year changes and trends and a meaningful discussion of key areas such as liquidity, cash flow and capital resources. Companies must disclose forward looking information in some cases when there are known trends or uncertainties that are likely to have a material impact in the future.

Critical accounting policies

The SEC already expects companies to disclose their most important accounting estimates and policies in the MD&A, even though this disclosure is not yet specifically required. Companies should also be prepared to provide a sensitivity analysis to show the quantitative effect of adopting different accounting estimates or using different assumptions.

Non-GAAP financial (pro forma) information

In some cases, non-GAAP (Generally Accepted Accounting Principles) information – the most obvious example being EBITDA – may be confusing or misleading to investors. However, the SEC will allow its use if there is a legitimate business reason for doing so. Companies should be prepared to disclose how non-GAAP financial information is calculated and justify why its use is necessary. New rules enacted under the Sarbanes-Oxley Act of 2002 regulate how non-GAAP information may be used in SEC filings, earnings releases and other announcements.

Revenue recognition

The SEC believes that disclosure of revenue recognition policies continues to be inadequate. Certain industries, including computer equipment and services, energy and retail, are especially likely to attract attention. In general, companies should be prepared to disclose their revenue recognition policies in detail in both the MD&A and notes to the accounts.

Restructuring charges

Companies should disclose the facts and circumstances of any restructuring plan and must be prepared to give a detailed period-by-period analysis of restructuring charges, payments and any reversals or adjustments.

Impairment charges

Companies must ensure that their accounting for impairments in long-lived assets, securities held for investment, intangible assets and goodwill fully complies with GAAP. Companies must be prepared to make detailed MD&A disclosure about impairment, including justification of a management decision that no impairment charge is necessary.

Pension plans

Companies should review the assumptions used to calculate pension expenses and liabilities. In particular, estimates of long-term expected returns for plan assets may have to be revised downwards.

Segment reporting

Incorrect reporting of operating segments and inappropriate aggregation of multiple segments are frequently challenged by the SEC.

Off-balance-sheet arrangements and securitised financial assets

The SEC now demands significantly better disclosure of these matters, including in some cases tabular numerical information regarding off-balance-sheet arrangements. There will be ongoing intense scrutiny and new regulation, including new disclosure rules promulgated under the Sarbanes-Oxley Act and new accounting interpretations.

Environmental and product liability disclosures

Companies should review their disclosure in these areas to ensure that it provides all of the required information.

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