508 Introduction to SEC Reporting

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Paul Mamalian is assistant general counsel of Choice Hotels International, in Silver Spring, Maryland, which franchises hotels under the Comfort Inn, Comfort Suites, Quality, Sleep Inn, Clarion, MainStay Suites, Econo Lodge, and Rodeway Inn brands. He is responsible for corporate and securities, trademark, advertising, and e-commerce matters.

Prior to joining Choice Hotels, Mr. Mamalian was an attorney at Pillsbury Winthrop and Reed Smith.

He currently serves on the board of directors of the National Kidney Foundation of the national capital area.

Mr. Mamalian received his B.A. from The George Washington University and his J.D. from The George Washington University School of Law.

Luise Welby

Luise M. Welby is director, legal division at Freddie Mac in McLean, Virginia, where she serves as chief of staff to the general counsel.

Prior to assuming this position, she was an assistant general counsel-securities, specializing in matters related to disclosure, periodic reporting, and corporate governance. She also has an extensive background in strategic initiatives, technology transactions, and debt financing. Prior to joining Freddie Mac, Ms. Welby worked at the U.S. Securities and Exchange Commission, and in her last position was counsel to Commissioner Steven M.H. Wallman. She began her career as a corporate and securities associate with Hogan and Hartson in Washington, DC.

Ms. Welby is vice chair of ACC's Corporate and Securities Law Committee. She is also a member of the board of directors of The Arlington Community Temporary Shelter, a nonprofit organization serving abused and homeless women and their families in Arlington, Virginia.

Ms. Welby received a B.B.A from the University of Notre Dame and a J.D. from the University of California at Los Angeles School of Law.

Janet B. Wright

Janet B. Wright is director-corporate legal for Dell Inc. in Round Rock, Texas. Her responsibilities include general corporate and securities matters, domestic and international tax matters, domestic and international equity compensation, employee benefits programs, and other corporate legal work. Prior to joining Dell, Ms. Wright spent 10 years in private practice. During that period, she focused on mergers and acquisitions, equity structuring and choice of entity issues, international and domestic tax work, and tax controversy work.

She is a member of the ABA's Section of International Law and Practice and the Tax Section, and she serves as chair of the International Section's international tax committee and vice chair of the International Corporate Counsel Forum. She is the former chair of the International Section's women's interest network.

Ms. Wright graduated from the Southern Methodist University School of Law and was a member of the board of editors of the Journal of Air Law and Commerce.

U.S. Securities and Exchange Commission

SEC Interpretation:
Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures

Securities and Exchange Commission

17 CFR Parts 211, 231, 241 and 271

[Release Nos. 33-6835; 34-26831; IC-16961; FR-36;]

Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures

Agency: SECURITIES AND EXCHANGE COMMISSION

Action: Interpretive Rule

SUMMARY: The Commission today announced the publication of an interpretive release regarding the disclosure required by Item 303 of Regulation S-K, Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). In addition to reporting the results of the first two phases of a continuing review project (the "MD&A Project" or the "Project") undertaken by the staff of the Division of Corporation Finance (the "Division"), the release sets forth the Commission's views regarding several disclosure matters that should be considered by registrants in preparing MD&As. Additionally, in discussing appropriate MD&A disclosure as to participation in high yield, highly leveraged or non-investment grade loans and investments, the release also sets forth the position of the Commission concerning disclosures by investment companies which invest in, or are permitted to invest in, securities issued in highly leveraged transactions, even though investment companies are not subject to MD&A disclosure requirements.

DATE: May 18, 1989.

FOR FURTHER INFORMATION CONTACT: Questions about specific filings should be directed to the staff members responsible for reviewing the documents the registrant files with the Commission. General questions about the release or the MD&A Project should be referred to Howard F. Morin, Assistant Director, at (202) 272-3203, Paul N. Edwards, Special Counsel, at (202) 272-3205, or Emanuel D. Strauss, Attorney-Adviser, Office of Chief Counsel, at (202) 272-2573, each of the Division of Corporation Finance, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Questions about Investment Company Act issues should be referred to Carolyn Lewis, Assistant Director, Division of Investment Management, at (202) 272-2102.

SUPPLEMENTARY INFORMATION: In response to comments received on a concept release issued in 1987 (the "Concept Release"),[1] the Commission undertook the MD&A Project, a special review of the adequacy of MD&A disclosures provided by registrants. Based on the results of the first two phases of the staff's continuing Project, the Commission has concluded that further guidance should be given to registrants to improve overall compliance with the MD&A disclosure requirements.

I. Background

The current framework of MD&A was adopted in 1980,[2] although the origins of the MD&A requirements date to 1968.[3] MD&A requires a discussion of liquidity, capital resources, results of operations, and other information necessary to an understanding of a registrant's financial condition, changes in financial condition and results of operations.[4] While the MD&A requirements adopted in 1980 are far more comprehensive than earlier formulations, they are intentionally general, reflecting the Commission's view that a flexible approach elicits more meaningful disclosure and avoids boilerplate discussions, which a more specific approach could foster. One year after adoption of the current framework, the Commission published a release that included examples of MD&A disclosure to assist registrants.[5]

In 1986, Coopers & Lybrand submitted to the Commission's Office of the Chief Accountant a proposal recommending increased MD&A disclosure of business risks and the performance by the independent auditor of specified review procedures with respect to these disclosures. Shortly thereafter, the managing partners of seven accounting firms[6] issued a white paper entitled "The Future Relevance, Reliability, and Credibility of Financial Information; Recommendations to the AICPA Board of Directors," which also called for increased risk disclosure, but contemplated that such disclosure would be separate from MD&A and would be subjected to audit coverage.

The Commission thereafter issued the Concept Release requesting comments concerning the adequacy of the MD&A requirements and the costs and benefits of the revisions suggested by the proposals.[7] Virtually all the 196 commentators opposed the proposals initiated by members of the accounting profession, and most took the position that there was no need to change the MD&A requirements.[8] A number of commentators, however, suggested that stricter enforcement and review, or additional guidance through an interpretive release, would improve compliance. Accordingly, the Division decided to undertake a special review of MD&A disclosures to assess the adequacy of disclosure practices and to identify any common areas of deficiencies, with a view to providing further guidance on compliance with the requirements of Item 303 of Regulation S-K and determining the need for revisions of the Item. Based on the results of the MD&A review, the Commission concurs with the view expressed by most commentators that no amendments to the MD&A requirements set forth in Regulation S-K are needed at this time.

II. Summary of the Project

The staff commenced work on the MD&A Project in early 1988. A total of 218 companies in 12 industries were selected for review in the first phase of this continuing project.[9] Specific industries were chosen so that the staff, through increased familiarity and additional research, could enhance its expertise regarding the industries. Each registrant was selected for an "issuer review" that focused on the registrant rather than any one report filed under the Securities Exchange Act of 1934 ("Exchange Act").[10] Particular emphasis was placed on disclosures made in response to the MD&A requirements.

Of the 218 registrants reviewed, 206 received letters of comment, many of which related to more than one report. Three different categories of comments were issued: a) requests for amendment; b) requests for supplemental information; and c) requests for compliance in future filings ("futures" comments).[11] Amendments were filed by 72 registrants in response to staff comments.

Work on a second phase of the MD&A Project commenced in October 1988. A total of 141 companies in a second set of 12 industries[12] were selected for review, resulting in 139 comment letters being issued in December, 1988. To date, amendments by 53 registrants have been filed in response to staff comments.

The amendments received in the first two phases principally addressed MD&A, the business description required under Item 101 of Regulation S-K, and the financial statements. More than one-half of the amendments substantively expanded MD&A, most often addressing one or more disclosure issues as to which guidance is provided in this release.

The Division has referred six registrants reviewed during the MD&A Project to the Division of Enforcement due primarily to substantive accounting problems which, in several instances, also affected the adequacy of the registrants' MD&As. The accounting problems encountered include, among other things, possible inadequate maintenance of accounting records and systems of internal controls and possible improper accounting regarding material acquisitions.

The staff has already begun a third phase of the MD&A Project relating to 12 new industries,[13] using the Forms 10-K recently filed for the fiscal year ended November 30, 1988 or later.

III. Evaluation of Disclosure - Interpretive Guidance

A. Introduction

The MD&A requirements are intended to provide, in one section of a filing,[14] material historical and prospective textual disclosure enabling investors and other users to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrant's prospects for the future. As the Concept Release states:

> The Commission has long recognized the need for a narrative explanation of the financial statements, because a numerical presentation and brief accompanying footnotes alone may be insufficient for an investor to judge the quality of earnings and the likelihood that past performance is indicative of future performance. MD&A is intended to give the investor an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company. The Item asks management to discuss the dynamics of the business and to analyze the financials.[15]

As the Commission has stated, "[i]t is the responsibility of management to identify and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the individual company."[16]

The Commission has determined that interpretive guidance is needed regarding the following matters: prospective information required in MD&A; long and short-term liquidity and capital resources analysis; material changes in financial statement line items; required interim period disclosure; MD&A analysis on a segment basis; participation in high yield financings, highly leveraged transactions or non-investment grade loans and investments; the effects of federal financial assistance upon the operations of financial institutions; and preliminary merger negotiations.

B. Prospective Information

Several specific provisions in Item 303 require disclosure of forward-looking information. MD&A requires discussions of "known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way."[17] Further, descriptions of known material trends in the registrant's capital resources and expected changes in the mix and cost of such resources are required.[18] Disclosure of known trends or uncertainties that the registrant reasonably expects will have a material impact on net sales, revenues, or income from continuing operations is also required.[19] Finally, the Instructions to Item 303 state that MD&A "shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition."[20]

The Project results confirm that the distinction between prospective information that is required to be discussed and voluntary forward-looking disclosure is an area requiring additional attention. This critical distinction is explained in the Concept Release:

> Both required disclosure regarding the future impact of presently known trends, events or uncertainties and optional forward-looking information may involve some prediction or projection. The distinction between the two rests with the nature of the prediction required. Required disclosure is based on *currently known trends, events, and uncertainties that are reasonably expected to have material effects*, such as: A reduction in the registrant's product prices; erosion in the registrant's market share; changes in insurance coverage; or the likely non-renewal of a material contract. In contrast, optional forward-looking disclosure involves *anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty*.[21]

The rules establishing a safe harbor for disclosure of "forward-looking statements" define such statements to include statements of "future economic performance contained in" MD&A. These safe harbors apply to required statements concerning the future effect of known trends, demands, commitments, events or uncertainties, as well as to optional forward-looking statements.[22]

A disclosure duty exists where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial condition or results of operation.[23] Registrants preparing their MD&A disclosure should determine and carefully review what trends, demands, commitments, events or uncertainties are known to management. In the following example,[24] the registrant discloses the reasonably likely material effects on operating results of a known trend in the form of an expected further decline in unit sales of mature products.

> While market conditions in general remained relatively unchanged in 1987, unit volumes declined 10% as the Company's older products, representing 40% of overall revenues, continue to approach the end of their life cycle. Unit volumes of the older products are expected to continue to decrease at an accelerated pace in the future and materially adversely affect revenues and

operating profits.

In preparing the MD&A disclosure, registrants should focus on each of the specific categories of known data. For example, Item 303(a)(2)(i) requires a description of the registrant's material "commitments" for capital expenditures as of the end of the latest fiscal period. However, even where no legal commitments, contractual or otherwise, have been made, disclosure is required if material planned capital expenditures result from a known demand, as where the expenditures are necessary to a continuation of the registrant's current growth trend. Similarly, if the same registrant determines not to incur such expenditures, a known uncertainty would exist regarding continuation of the current growth trend. If the adverse effect on the registrant from discontinuation of the growth trend is reasonably likely to be material, disclosure is required. Disclosure of planned material expenditures is also required, for example, when such expenditures are necessary to support
a new, publicly announced product or line of business.[25]

In the following example, the registrant discusses planned capital expenditures, and related financing sources, necessary to maintain sales growth.

> The Company plans to open 20 to 25 new stores in fiscal 1988. As a result, the Company expects the trend of higher sales in fiscal 1988 to continue at approximately the same rate as in recent years. Management estimates that approximately $50 to $60 million will be required to finance the Company's cost of opening such stores. In addition, the Company's expansion program will require increases in inventory of about $1 million per store, which are anticipated to be financed principally by trade credit. Funds required to finance the Company's store expansion program are expected to come primarily from new credit facilities with the remainder provided by funds generated from operations and increased lease financings. The Company recently entered into a new borrowing agreement with its primary bank, which provides for additional borrowings of up to $50 million for future expansion. The Company intends to seek additional credit facilities during fiscal 1988.

Often a matter which had a material impact on past operating results also involves prospective effects which should be discussed.[26] In identifying the reason for a material change in income from continuing operations and quantifying its effects, the registrant in the following example also describes the reasonably likely effect of a known event: completion of an important contract.

> The Company produced operating income of $22 million during 1987 as compared to $15 million during 1986, a 47 percent increase. Substantially all of the 47 percent increase can be attributed to the Company's completion of a major contract at a cost less than anticipated. It is expected that operating income during the current year will be significantly less, as only a portion of the profit generated by the completed contract is expected to be replaced by new contracts as a result of a slowdown within the Company's principal industry.

Events that have already occurred or are anticipated often give rise to known uncertainties. For example, a registrant may know that a material government contract is about to expire. The registrant may be uncertain as to whether the contract will be renewed, but nevertheless would be able to assess facts relating to whether it will be renewed. More particularly, the registrant may know that a competitor has found a way to provide the same service or product at a price less than that charged by the registrant, or may have been advised by the government that the contract may not be renewed. The registrant also would have factual information relevant to the financial impact of non-renewal upon the registrant. In situations such as these, a registrant would have identified a known uncertainty reasonably likely to have material future effects on its financial condition or results of operations, and disclosure would be required.

In the following example, the registrant discloses the reasonably likely material effect of a known uncertainty regarding implementation of recently adopted legislation.

> The Company had no firm cash commitments as of December 31, 1987 for capital expenditures. However, in 1987, legislation was enacted which may require that certain vehicles used in the Company's business be equipped with specified safety equipment by the end of 1991. Pursuant to this legislation, regulations have been proposed which, if promulgated, would require the expenditure by the Company of approximately $30 million over a three-year period.

Where a trend, demand, commitment, event or uncertainty is known, management must make two assessments:

> (1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
>
> (2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.[27]

Each final determination resulting from the assessments made by management must be objectively reasonable, viewed as of the time the determination is made.[28]

Application of these principles may be illustrated using a common disclosure issue which was considered in the review of a number of Project registrants: designation as a potentially responsible party ("PRP") by the Environmental Protection Agency (the "EPA") under The Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("Superfund").[29]

> ***Facts***: A registrant has been correctly designated a PRP by the EPA with respect to cleanup of hazardous waste at three sites. No statutory defenses are available. The registrant is in the process of preliminary investigations of the sites to determine the nature of its potential liability and the amount of remedial costs necessary to clean up the sites. Other PRPs also have been designated, but the ability to obtain contribution is unclear, as is the extent of insurance coverage, if any. Management is unable to determine that a material effect on future financial condition or results of operations is not reasonably likely to occur.

Based upon the facts of this hypothetical case, MD&A disclosure of the effects of the PRP status, quantified to the extent reasonably practicable,

would be required.[30] For MD&A purposes, aggregate potential cleanup costs must be considered in light of the joint and several liability to which a PRP is subject. Facts regarding whether insurance coverage may be contested, and whether and to what extent potential sources of contribution or indemnification constitute reliable sources of recovery may be factored into the determination of whether a material future effect is not reasonably likely to occur.

C. Liquidity - Capital Resources

Instruction 2 to Item 303(a) calls for an evaluation of "amounts and certainty of cash flows." "Except where it is otherwise clear from the discussion," Item 303(a)(1) and Instructions 2 and 5 to Item 303(a) together also mandate indication of which balance sheet conditions or income or cash flow items should be considered in assessing liquidity, and a discussion of prospective information regarding the registrant's short and long-term sources of, and needs for, capital. Disclosure of material commitments for capital expenditures as of the end of the latest fiscal period is required by Item 303(a)(2). Trend analysis and a description of "any expected material changes in the mix and relative cost" of the registrant's capital resources must also be provided.[31]

Generally, short-term liquidity and short-term capital resources cover cash needs up to 12 months into the future. These cash needs and the sources of funds to meet such needs relate to the day-to-day operating expenses of the registrant and material commitments coming due during that 12-month period.

The discussion of long-term liquidity and long-term capital resources must address material capital expenditures, significant balloon payments or other payments due on long-term obligations, and other demands or commitments, including any off-balance sheet items, to be incurred beyond the next 12 months, as well as the proposed sources of funding required to satisfy such obligations.[32]

Where a material deficiency in short or long-term liquidity has been identified, the registrant should disclose the deficiency, as well as disclosing either its proposed remedy, that it has not decided on a remedy, or that it is currently unable to address the deficiency.[33] In the following example, a financially troubled registrant discusses the material effects of its cash flow problems on its business, and its efforts to remedy those problems.

> The Company has violated certain requirements of its debt agreements relating to failure to maintain certain minimum ratios and levels of working capital and stockholders' equity. The Company's lenders have not declared the Company in default and have allowed the Company to remain in violation of these agreements. Were a default to be declared, the Company would not be able to continue to operate. A capital infusion of $4,000,000 is necessary to cure these defaults. The Company has engaged an investment banker and is considering various alternatives, including the sale of certain assets or the sale of common shares, to raise these funds.
>
> The Company frequently has not been able to make timely payments to its trade and other creditors. As of year-end and as of February 29, 1988, the Company had past due payables in the amount of $525,000 and $705,000, respectively. Deferred payment terms have been negotiated with most of these vendors. However, certain vendors have suspended parts deliveries to the Company. As a result, the Company was not always able to make all shipments on time, although no orders have been cancelled to date. Were significant volumes of orders to be cancelled, the Company's ability to continue to operate would be jeopardized. The Company is currently seeking sources of working capital financing sufficient to fund delinquent balances and meet ongoing trade obligations.

Short and long-term liquidity and capital resources analysis should become more comparable from registrant to registrant as a result of the Financial Accounting Standards Board's recent issuance of SFAS 95,[34] which requires the statement of changes in financial position to be replaced by a statement of cash flows as part of a full set of financial statements. This new statement reports net cash provided or used by each of operating, investing and financing activities, as defined, and the net effect of those flows on cash and cash equivalents.

Registrants are expected to use the statement of cash flows, and other appropriate indicators, in analyzing their liquidity, and to present a balanced discussion dealing with cash flows from investing and financing activities as well as from operations. This discussion should address those matters that have materially affected the most recent period presented but are not expected to have short or long-term implications, and those matters that have not materially affected the most recent period presented but are expected materially to affect future periods.[35] Examples of such matters include: (a) discretionary operating expenses such as expenses relating to advertising, research and development or maintenance of equipment; (b) debt refinancings or redemptions; or (c) levels of financing provided by suppliers or to customers. Liquidity analysis premised upon the new statement of cash flows and prepared in accordance with this guidance should enhance the utility to investors of MD&A disclosure by improving comparability from registrant to registrant and providing information more directly relevant to liquidity than that previously premised upon the statement of changes in financial position.

D. Material Changes

Some Project registrants did not provide adequate disclosure of the reasons for material year-to-year changes in line items, or discussion and quantification of the contribution of two or more factors to such material changes. Instruction 4 to Item 303(a) requires a discussion of the causes of material changes from year-to-year in financial statement line items "to the extent necessary to an understanding of the registrant's businesses as a whole." An analysis of changes in line items is required where material and where the changes diverge from changes in related line items of the financial statements, where identification and quantification of the extent of contribution of each of two or more factors is necessary to an understanding of a material change, or where there are material increases or decreases in net sales or revenue.[36]

Discussion of the impact of discontinued operations and of extraordinary gains and losses is also required where these items have had or are reasonably likely to have a material effect on reported or future financial condition or results of operations. Other non-recurring items should be discussed as "unusual or infrequent" events or transactions "that materially affected the amount of reported income from continuing operations."[37]

As Instruction 4 to Item 303(a) states, repetition and line-by-line analysis is

not required or generally appropriate when the causes for a change in one line item also relate to other line items. The same Instruction also states that the discussion need not recite amounts of changes readily computable from the financial statements and "shall not merely repeat numerical data contained in" such statements. However, quantification should otherwise be as precise, including use of dollar amounts or percentages, as reasonably practicable.

In the following example, the registrant analyzes the reasons for a material change in revenues and in so doing describes the effects of offsetting developments.

> Revenue from sales of single-family homes for 1987 increased 6% from 1986. The increase resulted from a 14% increase in the average sales price per home, partially offset by a 6% decrease in the number of homes delivered. Revenues from sales of single-family homes for 1986 increased 2% from 1985. The average sales price per home in 1986 increased 6%, which was offset by a 4% decrease in the number of homes delivered.
>
> The increase in the average sales prices in 1987 and 1986 is primarily the result of the Company's increased emphasis on higher priced single-family homes. The decrease in homes delivered in 1987 and 1986 was attributable to a decline in sales in Texas. The significant decline in oil prices and its resulting effect on energy-related business has further impacted the already depressed Texas area housing market and is expected to do so for the foreseeable future. The Company curtailed housing operations during 1987 in certain areas in Texas in response to this change in the housing market. Although the number of homes sold is expected to continue to decline during the current year as a result of this action, this decline is expected to be offset by increases in average sales prices.

E. Interim Period Reporting

The second sentence of Item 303(b) states that MD&A relating to interim period financial statements "shall include a discussion of material changes in those items specifically listed in paragraph (a) of this Item, except that the impact of inflation and changing prices on operations for interim periods need not be addressed."[38] As this sentence indicates, material changes to each and every specific disclosure requirement contained in paragraph (a), with the noted exception, should be discussed. This would include, for example, internal and external sources of liquidity, expected material changes in the mix and relative cost of such resources, and unusual or infrequent events or transactions that materially affected the amount of reported income from continuing operations.[39]

In light of the obligation to update MD&A disclosure periodically, the impact of known trends, demands, commitments, events or uncertainties arising during the interim period which are reasonably likely to have material effects on financial condition or results of operations constitutes required disclosure in MD&A.[40] For example, a calendar year end registrant describes, in its June 30 Form 10-Q, a recent event which is reasonably likely to have a material future effect on its financial condition or results of operations.

> The Company was advised in late June that Company A, its principal customer, which accounted for 28% and 30% of revenues for the last six months and prior fiscal year, respectively, intends to terminate all purchases effective during the third quarter, due to in-house capabilities recently developed by this customer. The Company is materially dependent on its business with this customer and anticipates upon such termination a material adverse effect on revenues and income. Efforts are being made to replace revenues attributable to such customer by developing new customers. The Company expects it will take at least 6 months to generate such replacement revenues.

F. Other Observations

1. Segment Analysis

In many cases, MD&As of Project registrants with more than one segment were prepared on a segment as well as a consolidated basis. In formulating a judgment as to whether a discussion of segment information is necessary to an understanding of the business, a multi-segment registrant preparing a full fiscal year MD&A should analyze revenues, profitability, and the cash needs of its significant industry segments. To the extent any segment contributes in a materially disproportionate way to those items, or where discussion on a consolidated basis would present an incomplete and misleading picture of the enterprise, segment discussion should be included. This may occur, for example, when there are legal or other restrictions upon the free flow of funds from one segment, subsidiary or division of the registrant to others; when known trends, demands, commitments, events or uncertainties within a segment are reasonably likely to have a material effect on the business as a whole; when the ability to dispose of identified assets of a segment may be relevant to the financial flexibility of the registrant; and in other circumstances in which the registrant concludes that segment analysis is appropriate to an understanding of its business.[41]

The following example illustrates segment disclosure for a manufacturer with two segments. The two segments contributed to operating income amounts that were disproportionate to their respective revenues. The registrant discusses sales and operating income trends, factors explaining such trends, and where applicable, known events that will impact future results of operations of the segment.

Net Sales by Industry Segment						
	1987		1986		1985	
Industry segments	($ million)	Percent of Total	($ million)	Percent of Total	($ million	Percent of Total
Segment I	585	55	479	53	420	48
Segment II	472	45	433	47	457	52
Total Sales	1057	100	912	100	877	100

1987 vs. 1986

Segment I sales increased 22% in 1987 over the 1986 period. The increase included the effect of the acquisition of Corporation T. Excluding this acquisition, sales would have increased by 16% over 1986. Product Line A sales increased by 18% due to a 24% increase in selling prices, partially offset by lower shipments. Product Line B sales increased by 35% due to a 17% increase in selling prices and a 15% increase in shipment volume.

Segment II sales increased 9% due to a 12% increase in selling prices partly offset by a 3% reduction in shipment volumes.

1986 vs. 1985

Segment I sales increased 14% in 1986. Product Line A sales increased 22%, in spite of a slight reduction in shipments, because of a 23% increase in selling prices.

Product Line B sales declined 5% due mainly to a 7% decrease in selling prices, partially offset by higher shipments.

The 5% decline in Segment II sales reflected a 3% reduction in selling prices and a 2% decline in shipments.

The substantial increases in selling prices of Product Line A during 1987 and 1986 occurred primarily because of heightened worldwide demand which exceeded the industry's production capacity. The Company expects these conditions to continue for the next several years. The Company anticipates that shipment volumes of Product Line A will increase as its new production facility reaches commercial production levels in 1988.

Segment II shipment volumes have declined during the past two years primarily because of the discontinuation of certain products which were marginally profitable and did not have significant growth potential.

Operating Profit by Industry Segment

Industry segments	1987		1986		1985	
	($ million)	Percent of Total	($ million)	Percent of Total	($ million	Percent of Total
Segment I	126	75	108	68	67	55
Segment II	42	25	51	32	54	45
Operating Profit	168	100	159	100	121	100

1987 vs. 1986

Segment I operating profit was $18 million (17%) higher in 1987 than in 1986. This increase includes the effects of higher sales prices and slightly improved margins on Product Line A, higher shipments of Product Line B and the acquisition of Corporation T. Excluding this acquisition operating profit would have been 11% higher than in 1986. Partially offsetting these increases are costs and expenses of $11 million related to new plant start-up, slightly reduced margins on Product Line B sales and a $9 million increase in research and development expenses.

Segment II operating profit declined $9 million (18%) due mainly to substantially higher costs in 1987 resulting from a 23% increase in average raw material costs which could not be fully recovered through sales price increases. The Company expects that Segment II margins will continue to decline, although at a lesser rate than in 1987 as competitive factors limit the Company's ability to recover cost increases.

1986 vs. 1985

Segment I operating profit was $41 million (61%) higher in 1986 than in 1985. After excluding the effect of the $23 million non-recurring charge for the early retirement program in 1985, Segment I operating profit in 1986 was $18 million (27%) higher than in 1985. This increase reflected higher prices and a corresponding 21% increase in margins on Product Line A, and a 17% increase in margins on Product Line B due primarily to cost reductions resulting from the early retirement program.

Segment II operating profit declined about $3 million (6%) due mainly to lower selling prices and slightly reduced margins in 1986.

2. Participation in High Yield Financings, Highly Leveraged Transactions or Non-Investment Grade Loans and Investments

A registrant, whether a financial institution (such as a bank, thrift, insurance company or finance company), broker-dealer or one its affiliates, or any other public company, may participate in several ways, directly or indirectly, in high yield financings, or highly leveraged transactions or make non-investment grade loans or investments relating to corporate restructurings such as leveraged buyouts, recapitalizations including significant stock buybacks and cash dividends, and acquisitions or mergers.[42] A registrant may participate in the financing of such a transaction either as originator, syndicator, lender, purchaser of secured senior debt, or as an investor in other debt instruments (often unsecured or subordinated), redeemable preferred stock or other equity securities. Participation in high yield or highly leveraged transactions, as well as investment in non-investment grade securities, generally involves greater returns, in the form of higher fees and higher average yields or potential market gains. Participation in such transactions may involve greater risks, often related to credit worthiness, solvency, relative liquidity of the secondary trading market, potential market losses, and vulnerability to rising interest rates and economic downturns.[43]

Similar risk-reward exposure appears to exist with the growing practice by certain registrants of originating low down-payment mortgages without obtaining mortgage insurance. Other registrants have substantial participations in venture capital financings.

In view of these potentially greater returns and potentially greater risks, disclosure of the nature and extent of a registrant's involvement with high yield or highly leveraged transactions and non-investment grade loans and investments may be required under one or more of several MD&A items, and registrants should consider carefully the extent of disclosure required.[44] MD&A analysis is required if such participation has had or is reasonably likely to have a material effect on financial condition or results of operations.

In determining the adequacy of disclosure concerning participation in high yield, highly leveraged and non-investment grade loans and investments, registrants should consider the need to disclose:

1. relevant lending and investing policies, including credit and risk management policies;
2. the amounts of holdings, stated separately by type if individually material, including guarantees and repurchase or other commitments to lend or acquire such loans and investments, and the potential risks inherent in such holdings;
3. information regarding the level of activity during the period, e.g., originations and retentions;
4. amounts of holdings, if any, giving rise to significantly greater risks (that may have material effects on financial condition or results of operations) than are present in other similar transactions and instruments; for example, where the issuer is bankrupt or has issued securities on which interest payments are in default, or where there are significant concentrations (e.g., in an individual borrower, industry or geographic area), particularly where those concentrations are in securities with relatively low trading market liquidity (such as those that depend upon a single market maker for their liquidity); and
5. analysis of the actual and reasonably likely material effects of the above matters on income and operations, e.g., the amounts of fees recognized and deferred, yields, amounts of realized and unrealized market gains or losses, and credit losses.

Such disclosure may appear in the business discussion, or other appropriate location, but the effects resulting from participation should be analyzed in MD&A.

Similar concerns are raised with regard to investment companies that invest, or are permitted to invest, all or a portion of their portfolios in high-yield or non-investment grade securities. An investment company that seeks high income by investing in other than high-grade bonds (or is permitted to do so, even if it does not currently include such securities in its portfolio) should disclose in its prospectus the risks involved in such investments.[45] These risks include, but are not limited to, the risks described above, such as market price volatility based upon interest rate sensitivity, creditworthiness and relative liquidity of the secondary trading market, as well as the effects such risks may have on the net asset value of the fund. In addition, the board of directors of a fund that invests in such securities should carefully consider factors affecting the secondary market for such securities in determining whether or not any particular security is liquid or illiquid, and whether market quotations are "readily available" for purposes of valuing portfolio securities.[46]

The nature of disclosure required by non-investment companies will vary depending on the type of participation. In the following example the registrant is a bank holding company that participates in highly leveraged transactions as a lender and not as an investor.

> The Company is active in originating and syndicating loans in highly leveraged corporate transactions. The Company generally includes in this category domestic and international loans and commitments made by the Banks in recapitalizations, acquisitions, and leveraged buyouts which result in the borrower's debt to total assets ratio exceeding 75%. As of December 31, 1988, the Company had loans outstanding in approximately 61 highly leveraged transactions in an aggregate principal amount of approximately $900 million, was committed under definitive loan agreements relating to approximately 23 highly leveraged transactions to lend an additional amount of approximately $650 million, and had other highly leveraged transactions at various stages of discussion or preliminary commitment. The Company's equity investments in highly leveraged transactions are not material.
>
> In recent years the Company has not made a loan in excess of $175 million in any individual highly leveraged transaction, and the Company has typically retained, after syndication and sales of loan participations, a principal amount not exceeding approximately $35 million in any such transaction. At December 31, 1988, only two loans had outstanding balances exceeding $35 million ($51 million and $47 million, respectively) and no industry represented more than 15% of the Company's total highly leveraged loan portfolio. Should an economic downturn or sustained period of rising interest rates occur, highly leveraged transaction borrowers may experience financial stress. As a result, risks associated with these transactions may be higher than for more traditional financing.
>
> The Company estimates that its fees for lending and corporate finance activities relating to highly leveraged transactions were approximately $64 million during 1988, of which approximately $48 million was recognized as income and $16 million was deferred, compared with $40 million during 1987 of which approximately $32 million was recognized as income and $8 million was deferred. The deferred portion of such fees will be recognized over the terms of the related loans in accordance with Statement of Financial Accounting Standards Number 91.
>
> In recent years, the Company has had no significant charge-offs of loans made in highly leveraged transactions. At December 31, 1988, approximately $25 million (3%) of such outstanding loans were on nonaccrual status, which was not materially greater than that for the Company's other lending activities.
>
> A reduction in the Company's activities relating to highly leveraged transactions could have some negative impact on the Company's results of operations. The size of such impact would depend on the magnitude of the reduction and on the profitability of the activities to which the Company might redirect its resources. Although any estimate of the impact of a total discontinuation of all new highly leveraged transactions depends on various factors that cannot now be determined, the Company believes that such a discontinuation would reduce its gross revenues approximately 6% and net income by approximately 12%.

In the following example, the registrant is an investor in non-investment grade debt securities.

> At December 31, 1988, the Company held in its portfolio, net of reserves, $81 million of high yield, unrated or less than investment grade corporate debt securities with an aggregate market value of $75 million. Investments in unrated or less than investment grade corporate debt securities have different risks than other investments in corporate debt securities rated investment grade and held by the Company. Risk of loss upon default by the borrower is significantly greater with respect to

> such corporate debt securities than with other corporate debt securities because these securities are generally unsecured and are often subordinated to other creditors of the issuer, and because these issuers usually have high levels of indebtedness and are more sensitive to adverse economic conditions, such as recession or increasing interest rates, than are investment grade issuers. In addition, investments by the Company in corporate debt securities of any given issuer are generally larger than its investments in most other securities, thus resulting in a greater impact in the event of default. There is only a thinly traded market for such securities and recent market quotations are not available for some of these securities. Market quotes are generally available only from a limited number of dealers and may not represent firm bids of such dealers or prices for actual sales. As of December 31, 1988, the Company's five largest investments in corporate debt securities aggregated $35 million, none of which individually exceeded $10 million, and had an approximate market value of $31 million.

3. Effects of Federal Financial Assistance Upon Operations

Many financial institutions, such as thrifts and banks, are receiving financial assistance in connection with federally assisted acquisitions or restructurings. Such assistance may take various forms and is intended to make the surviving financial institution a viable entity. Examples of such methods of assistance include: a) yield maintenance assistance (which guarantees additional interest on specified interest bearing assets, a level of return on specified non-interest-bearing assets, reimbursement if covered assets are ultimately collected or sold for amounts that are less than a specified amount, or any combination thereof); b) indemnification against certain loss contingencies; c) the purchase of equity securities issued by the institution for cash or a note receivable from the federal agency; and d) arrangements designed to insulate the surviving entity from the economic effects of problem assets acquired from the predecessor financial institution (such as a "put agreement" whereby the surviving institution may "put" troubled loans directly or indirectly to the federal agency at higher than their fair value).

If these or any other types of federal financial assistance have materially affected, or are reasonably likely to have a material future effect upon, financial condition or results of operations, the MD&A should provide disclosure of the nature, amounts, and effects of such assistance.[47]

In the following example, a financial institution discloses the material effects of a federally assisted corporate reorganization. Such disclosure was in addition to various disclosures of the existence and effect of such federal assistance in the description of business portions of the filing (pursuant to Industry Guide 3) and in the registrant's financial statements.

> During 1988, earnings for the Company included $60 million of assistance income, including (a) $10 million in indemnity from the Federal Agency in respect of litigation costs associated with the Company's predecessor and (b) $50 million related to the 1988 puts of troubled loans to the Federal Agency under the Company's Put Agreement. The assistance income arises from provisions in the Reorganization agreements that are intended to relieve the Company from the adverse economic effects of litigation and problem assets held by its predecessor. These provisions are intended to place the Company in substantially the same position as if such litigation and problem assets had been assumed by the Federal Agency at the time of the Reorganization. Based on existing economic circumstances, management believes that the expiration of the Put Agreement in June 1989 may adversely affect future operations including an increased level of nonperforming loans and loan loss provisions which cannot be recovered pursuant to the Put Agreement.

4. Preliminary Merger Negotiations

While Item 303 could be read to impose a duty to disclose otherwise nondisclosed preliminary merger negotiations, as known events or uncertainties reasonably likely to have material effects on future financial condition or results of operations, the Commission did not intend to apply, and has not applied, Item 303 in this manner.[48] As reflected in the various disclosure requirements under the Securities Act and Exchange Act that specifically address merger transactions, the Commission historically has balanced the informational need of investors against the risk that premature disclosure[49] of negotiations may jeopardize completion of the transaction.[50] In general, the Commission's recognition that registrants have an interest in preserving the confidentiality of such negotiations is clearest in the context of a registrant's continuous reporting obligations under the Exchange Act, where disclosure on Form 8-K of acquisitions or dispositions of assets not in the ordinary course of
business is triggered by completion of the transaction.[51]

In contrast, where a registrant registers securities for sale under the Securities Act, the Commission requires disclosure of material probable acquisitions and dispositions of businesses, including the financial statements of the business to be acquired or sold.[52] Where the proceeds from the sale of the securities being registered are to be used to finance an acquisition of a business, the registration statement must disclose the intended use of proceeds. Again, accommodating the need for confidentiality of negotiations, registrants are specifically permitted not to disclose in registration statements the identity of the parties and the nature of the business sought if the acquisition is not yet probable and the board of directors determines that the acquisition would be jeopardized.[53]

The Commission's interpretation of Item 303, as applied to preliminary merger negotiations, incorporates the same policy determinations. Accordingly, where disclosure is not otherwise required, and has not otherwise been made, the MD&A need not contain a discussion of the impact of such negotiations where, in the registrant's view, inclusion of such information would jeopardize completion of the transaction. Where disclosure is otherwise required or has otherwise been made by or on behalf of the registrant, the interests in avoiding premature disclosure no longer exist. In such case, the negotiations would be subject to the same disclosure standards under Item 303 as any other known trend, demand, commitment, event or uncertainty. These policy determinations also would extend to preliminary negotiations for the acquisition or disposition of assets not in the ordinary course of business.

IV. Conclusion

In preparing MD&A disclosure, registrants should be guided by the general purpose of the MD&A requirements: to give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's financial condition and results of operations, with particular emphasis on the registrant's prospects for the future. The MD&A requirements are intentionally flexible and general.

Because no two registrants are identical, good MD&A disclosure for one registrant is not necessarily good MD&A disclosure for another. The same is true for MD&A disclosure of the same registrant in different years. The flexibility of MD&A creates a framework for providing the marketplace with appropriate information concerning the registrant's financial condition, changes in financial condition and results of operations.

The "Codification of Financial Reporting Policies" announced in Financial Reporting Release 1 (April 15, 1982) [47 FR 21028] is updated:

1. By amending the preamble to section 501 to delete its final three sentences and to substitute the following new language:

> In 1988, a project was undertaken to evaluate current compliance with MD&A requirements. This project followed the issuance of a concept release in 1987 requesting public comment on, among other things, the adequacy of the existing MD&A requirements. In 1989, the Commission published Financial Reporting Release No. 36, which summarized the results of the project, included examples of disclosure and set forth the Commission's views regarding several disclosure matters under MD&A. The following excerpts from that release are presented to assist registrants in preparing MD&As. Registrants may wish to refer to the release for a discussion of the results of the project.

2. By deleting sections 501.01 through 501.03, the first four paragraphs and first two sentences of the fifth paragraph of section 501.04.a, all of section 501.04.b and sections 501.05.b through 501.05.f, and by redesignating amended section 501.04.a as 501.03.b, section 501.05.a as 501.08, and sections 501.06 through 501.08 as sections 501.09 through 501.11.

3. By adding the following new Financial Reporting Codification sections consisting of sections from the release as indicated:

a) Section 501.01. Evaluation of Disclosure - Interpretive Guidance, consisting of section III.A. of the release;

b) Section 501.02. Prospective Information, consisting of section III.B. of the release;

c) Section 501.03.a. Liquidity - Capital Resources, consisting of section III.C. of the release;

d) Section 501.04. Material Changes, consisting of section III.D. of the release;

e) Section 501.05. Interim Period Reporting, consisting of section III.E. of the release;

f) Section 501.06. Other Observations (including subsections 501.06.a. Segment Analysis, 501.06.b. Participation in High Yield Financings, Highly Leveraged Transactions or Non-Investment Grade Loans and Investments, 501.06.c. Effects of Federal Financial Assistance Upon Operations, and 501.06.d. Preliminary Merger Negotiations), consisting of section III.F. of the release;

g) Section 501.07. Conclusion, consisting of section IV of the release.

4. By revising the footnotes from the release which are included in the Codification and which contain the citation form "*supra*," except footnote 35 of the release, to include the complete citation form rather than the "*supra*" form.

5. By renumbering the footnotes from the release which are included in the Codification, to run consecutively from number one through number forty.

6. By revising footnote 35 of the release (footnote 22 as renumbered), to cite *supra* to notes 4-17 rather than to notes 17-30.

The Codification is a separate publication of the Commission. It will not be published in the Federal Register/Code of Federal Regulations Systems.

List of Subjects in Parts 211, 231, 241 and 271

Reporting and Record Keeping Requirements, Securities.

Parts 211, 231, 241 and 271 of Title 17, Chapter II of the Code of Federal Regulations are amended by adding this Release No. 33-6835, 34-26831, IC-16961 and FR-36 (May 18, 1989) to the lists of interpretive releases.

By the Commission.

Jonathan G. Katz
Secretary

Dated: May 18, 1989

Footnotes

1 Securities Act Release No. 6711 (April 24, 1987) [52 FR 13715].

2 Securities Act Release No. 6231 (September 2, 1980) [45 FR 63630].

3 Securities Act Release No. 4936 (December 9, 1968) [33 FR 18617]; Securities Act Release No. 5520 (August 14, 1974) [39 FR 31894]. *See also* Securities Act Release No. 6711, *supra* n. 1, for a more detailed summary of the origins of the MD&A requirements.

4 17 CFR 229.303(a).

5 Securities Act Release No. 6349 (September 28, 1981), 23 SEC Docket 962 [not published in the Federal Register]; *see also* Securities Act Release No. 6791 (August 1, 1988) [53 FR 29226].

6 Arthur Andersen & Co.; Arthur Young; Coopers & Lybrand; Deloitte Haskins & Sells; Ernst & Whinney; Peat, Marwick, Mitchell & Co.; and Touche Ross & Co.

7 Securities Act Release No. 6711, *supra* n. 1. In the Concept Release, the Commission indicated that much of the business risk disclosure recommended in the Coopers & Lybrand proposal is required by current rules, although not necessarily by MD&A.

8 The comments are available for inspection and copying in the Commission's Public Reference Room at 450 5th Street, N.W., Washington, D.C. [File No. S7-14-87].

9 The industries were: Miscellaneous Chemical Products; Retail-Grocery Stores; Airlines; Drugs; Real Estate Developers; Nursing Care Facilities/Hospitals; Radio and Television Broadcasting/Cable Television; Textile Mill Products/Knitting Mills; Computer Hardware; Building Contractors and Construction; Toys and Recreational Equipment; and Multi-segment Companies.

10 The most recent Form 10-K and subsequent reports filed under the Exchange Act were given full reviews and the prior 10-K and intervening reports, as well as proxy and registration statements filed during the period, were examined for background information.

11 Registrants received combinations of the above categories of comment. Many of the comment letters requested supplemental support for various presentations, and, in several instances, requests for amendments were revised to futures comments during the review process. Conversely, several amendments were requested after staff consideration of supplemental responses provided by registrants. Compliance with futures comments is verified by staff review of subsequent filings.

12 The industries were: Banks; Savings and Loans; Meat Products; Dairy Products; Miscellaneous Plastic Products; Furniture; Radio and Television Communication Equipment and Apparatus; Research and Measurement Instruments; Industrial Machinery; Computer Software; Eating Places; and Motion Picture-Television Production.

13 The industries are: Retail-Department Stores; Retail-Apparel Stores; Semiconductor and Related Devices; Crude Petroleum and Natural Gas; Railroads; Steel Works; Paper and Allied Products; Natural Gas Transmission; Lumber and Wood Products; Property-Casualty Insurance; Aircraft-Aircraft Engines; and Newspapers-Publishing and Printing.

14 The MD&A should contain a discussion of all the material impacts upon the registrant's financial condition or results of operations, including those arising from disclosure provided elsewhere in the filing.

15 Securities Act Release No. 6711, *supra* n. 1, at 13717.

16 Securities Act Release No. 6349, *supra* n. 5, at 964.

17 17 CFR 229.303(a)(1).

18 17 CFR 229.303(a)(2)(ii).

19 17 CFR 229.303(a)(3)(ii).

20 17 CFR 229.303(a), Instruction 3. The data known to management which may trigger required forward-looking disclosure is hereinafter referred to as "known trends, demands, commitments, events or uncertainties."

21 Securities Act Release No. 6711, *supra* n. 1, at 13717 (emphasis added).

22 Rule 175(c) under the Securities Act of 1933 ("Securities Act"), 17 CFR 230.175(c), and Rule 3b-6(c) under the Exchange Act, 17 CFR 240.3b-6.

23 *Cf. In re American Savings and Loan Association of Florida* , Exchange Act Release No. 25788 (June 8, 1988), 41 SEC Docket 78. In this administrative proceeding jointly conducted by the Commission and the Federal Home Loan Bank Board (the "FHLBB"), it was determined that the MD&As in a Form 10-K and two Forms 10-Q were inadequate under the FHLBB's disclosure requirements, which are substantially similar to the Commission's, for failing to disclose, among other matters, required forward-looking information regarding the potential exposure and risks associated with repurchase transactions between American Savings and Loan and E.S.M. Government Securities. *Cf. also In re Burroughs Corporation*, Exchange Act Release No. 21872 (March 20, 1985), 32 SEC Docket (CCH) 935 (failure
to discuss the impact of inventory obsolescence); *In re Marsh & McClennan Companies, Inc.*, Exchange Act Release No. 24023 (January 22, 1987), 37 SEC Docket (CCH) 634 (failure adequately to disclose, in a Form 10-K, the effects of a principal subsidiary's investing and financing activities).

24 The examples used herein, while modeled in large part upon Project registrants' original or revised MD&As, have been changed so that the registrants are not identified and particular points are emphasized. Of course, each example has been removed from its context as part of a larger document. The examples are provided for purposes of illustration only.

25 *See* Item 101(c)(1)(ii) of Regulation S-K

26 *See*, *e.g.*, *In re Charter Company*, Exchange Act Release No. 21647 (January 10, 1985), 32 SEC Docket (CCH) 289, in which the MD&A in the registrant's Form 10-K failed to disclose the favorable effect on earnings of the accounting method used, and the anticipated substantial reduction in future profits that would result from use of such method. *Cf. SEC v. Baldwin-United Corporation*, Litigation Release

No. 10878 (September 26, 1985) and *In re Robert S. Harrison*, Exchange Act Release No. 22466 (September 26, 1985), 34 SEC Docket (CCH) 141 (both involving a different means of accounting for the same insurance product as in Charter, and Baldwin-United Corporation's failure to disclose, in the MD&A of its Form 10-K, its failure to meet the earnings assumptions of the accounting model used, and internal estimates of insufficient taxable income to use tax benefits inherent in the earnings assumptions).

27 MD&A mandates disclosure of specified forward-looking information, and specifies its own standard for disclosure - i.e., reasonably likely to have a material effect. This specific standard governs the circumstances in which Item 303 requires disclosure. The probability/magnitude test for materiality approved by the Supreme Court in *Basic, Inc., v. Levinson*, 108 S.Ct. 978 (1988), is inapposite to Item 303 disclosure.

28 Where a material change in a registrant's financial condition (such as a material increase or decrease in cash flows) or results of operations appears in a reporting period and the likelihood of such change was not discussed in prior reports, the Commission staff as part of its review of the current filing will inquire as to the circumstances existing at the time of the earlier filings to determine whether the registrant failed to discuss a known trend, demand, commitment, event or uncertainty as required by Item 303.

29 42 U.S.C. Sections 9601, et seq. (1983 & Supp. 1988).

30 Designation as a PRP does not in and of itself trigger disclosure under Item 103 of Regulation S-K and Instruction 5 thereto, 17 CFR 229.103, regarding "Legal Proceedings," because PRP status alone does not provide knowledge that a governmental agency is contemplating a proceeding. Nonetheless, a registrant's particular circumstances, when coupled with PRP status, may provide that knowledge. While there are many ways a PRP can become subject to potential monetary sanctions, including triggering the stipulated penalty clause in a remedial agreement, the costs anticipated to be incurred under Superfund, pursuant to a remedial agreement entered into in the normal course of negotiation with the EPA, generally are not "sanctions" within either Instruction 5(B) or (C) to Item 103. Such remedial costs normally would constitute charges to income, or in some cases capital expenditures. The availability of insurance, indemnification or contribution may be relevant under Instruction 5(A) or (B) in determining whether the criteria for disclosure have been met. *Thomas A. Cole, Esq.*, (January 17, 1989).

31 Most registrants combine discussions of capital resources and liquidity as permitted by Item 303(a).

When viewed to encompass capital resources, the Commission's concept of liquidity is comparable to the Financial Accounting Standards Board's ("FASB") concept of financial flexibility or the ability of an enterprise to adjust its future cash flows to meet needs and opportunities, both expected and unexpected. Financial flexibility is broader than the FASB's concept of liquidity (defined as short-term nearness of assets and liabilities to cash) because it includes potential internal and external sources of cash not directly associated with items shown on the balance sheet.

Securities Act Release No. 6349, *supra* n. 5, at 972; *see also* Statement of
Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* ¶24a.

32 *See*, *e.g.*, *In re Hiex Develooment USA, Inc.*, Exchange Act Release No. 26722 (April 13, 1989), 43 SEC Docket (CCH) 1041 (involving in part the registrant's failure to discuss in the MD&A of a Form 10, a material contractual commitment to purchase equipment from an affiliate over a ten year period).

33 *See*, *e.g.*, *SEC v. The Charter Company*, Exchange Act Release No. 23350 (June 20, 1986), 35 SEC Docket (CCH) 1232, and *In re Ray M. Van Landingham and Wallace A. Patzke, Jr.*, Exchange Act Release No. 23349 (June 20, 1986), 35 SEC Docket (CCH) 1227, both involving Charter Company's liquidity disclosure concerning losses of trade credit, demands by its banks for a series of materially restrictive loan covenants and discussions with Charter's banks regarding asset sales, dividend restrictions and operational changes.

In a filing which includes an independent accountant's report that is modified as a result of uncertainty about a registrant's continued existence, Section 607.02 of the Codification of Financial Reporting Policies requires "appropriate and prominent disclosure of the registrant's financial difficulties and viable plans to overcome such difficulties."

34 Statement of Financial Accounting Standards No. 95, Statement of Cash Flows. While the new statement is required for annual financial statements for fiscal years ending after July 15, 1988, financial statements for prior

years are not required to be restated, and interim financial statements in the initial year of application are not required to use the new statement. Such interim period statements must be restated when presented as comparative prior periods with future interim financial statements.

35 *See* 17 CFR 229.303(a), Instruction 3; *supra* n. 17-30 and accompanying text.

36 *See SEC v. The E.F. Hutton Group, Inc.*, Exchange Act Release No. 22579 (October 29, 1985), 34 SEC Docket (CCH) 538, involving Hutton's failure to disclose that its bank overdrafting practices were the cause for material changes in interest income from year-to-year, and the risks and uncertainties associated with such practices.

Although Item 303(a)(3)(iii) speaks only to material increases, not decreases, in net sales or revenues, the Commission interprets Item 303(a)(3)(i) and Instruction 4 as seeking similar disclosure for material decreases in net sales or revenues.

37 17 CFR 229.303(a)(3)(i); *see SEC v. Allegheny International, Inc.*, Litigation Release No. 11533 (September 9, 1987), 39 SEC Docket (CCH) 196 (failure to disclose a sale of realty that constituted an unusual and infrequent event which had a material impact on pre-tax income); see generally Accounting Principles Board Opinion No. 30.

38 17 CFR 229.303(b).

39 *See*, *e.g.*, *In re American Express Company*, Exchange Act Release No. 23332 (June 17, 1986), 35 SEC Docket (CCH) 1163 (failure to discuss the impact, in several Forms 10-Q and a Form 10-K, of two reinsurance transactions by an insurance subsidiary which were treated by the registrant as materially increasing net income, but which lacked economic substance); *In re Michael R. Maury*, Exchange Act Release No. 23067 (March 26, 1986), 35 SEC Docket (CCH) 435 (the MD&A in a Form 10-Q was found deficient for its failure to disclose the effects on net income of the reversal of previously established reserves).

40 *See SEC v. Ronson Corporation*, Litigation Release No. 10093 (August 15, 1983), 28 SEC Docket (CCH) 841, where the MD&As in a Form 10-K and two Forms 10-Q were found to be inadequate in their failure to state that Ronson's largest customer had shut down its operations which required purchases from Ronson, that it was unlikely that this customer would resume purchases in the short term and that, due to technological changes being made at this customer's facilities, once purchases were resumed, an indefinite reduction in necessary purchases of 30-50% was likely.

41 Registrants affected by Statement of Financial Accounting Standards No. 94, *Consolidation of All Majority-Owned Subsidiaries*, which requires, among other things, consolidation of non-homogeneous subsidiaries, should recognize that segment analysis generally will be appropriate, inasmuch as the prior justification for not consolidating these operations was that they had different characteristics from those of the parent and its other affiliates. *See id.* at ¶55 (recognizing that although the aggregation of assets, liabilities and operations from non-homogeneous activities may obscure important information about these activities, the disclosures required by Statement of Financial Accounting Standards No. 14, *Financial Reporting for Segments of a Business Enterprise*, can provide meaningful information about the different operations within a business enterprise).

42 On February 16, 1989 the Federal Reserve Board issued bank examination guidelines regarding highly leveraged transactions. Letter from William Taylor, Director, Division of Banking Supervision and Regulation, to the Officer in Charge of Supervision at each Federal Reserve Bank (February 16, 1989). The guidelines are intended to assist bank examiners in identifying exposures that may warrant closer scrutiny and are not intended to imply criticism of any particular transaction, nor to suggest what is deemed to be an appropriate degree of leverage in any particular industry. In these guidelines, criteria to define a highly leveraged financing include identification of borrowers whose debt to total assets ratio exceeds 75%. Registrants may refer to this guidance or to other recognized criteria that may be developed in defining highly leveraged transactions. In any event, registrants should indicate how highly leveraged transactions are defined for disclosure purposes. In this regard, the Commission recognizes that leverage characteristics may vary from industry to industry, and that debt ratios that are appropriate for some industries may be unusually high or low in other industries. Similarly, the Commission does not intend to imply criticism of any particular transaction or to suggest an appropriate degree of leverage in any particular industry or for any particular firm.

43 *See*, *e.g.*, P. Asquith, D. Mullins, Jr., and E. Wolff, Original Issue High Yield Bonds: Aging Analyses of Defaults, Exchanges, and Calls (March, 1989).

44 Other related disclosure includes Schedule 1 of Rule 12-02

of Regulation S-X, 17 CFR 210.12-02, which requires separate disclosure for each particular issue of corporate securities carried on the balance sheet at greater than 2% of total assets, and allows reasonable groupings, e.g., by similar investment risk, of all other securities. Also, for securities with significantly greater investment risk factors than are typical for that class of issuer, such as securities where interest is in default or the issuer is in bankruptcy, separate listing or grouping is required to be accompanied by a brief description of the relevant risk factors. Guide 3, Item III(c)(4) requires bank holding companies to disclose concentrations of loans exceeding 10% of total loans, and defines "concentration" to exist where a number of borrowers are engaged in similar activities that would cause them to be similarly impacted by economic or other conditions. Item II of Guide 3 instructs that consideration should be given to disclosure of the risk characteristics of securities held as investments. Savings and loan holding companies should provide similar disclosures pursuant to Staff Accounting Bulletin Topic 11:K. Insurance companies are also subject to similar requirements under Article 7 of Regulation S-X, Rule 7-03(a)(1), Notes 5-6, 17 CFR 210.7-03(a)(1).

45 *See* Guide 20 to Form N-1A.

46 *See* Guide 28 to Form N-1A.

47 For a related discussion of the accounting treatment and financial statement disclosure of federal assistance associated with regulatory-assisted acquisitions of banking and thrift institutions, *see EITF Abstracts*, Issue No. 88-19.

48 *See*, *e.g.*, Brief for the Securities and Exchange Commission as Amicus Curiae at 7 and note 3, *Basic, Inc. v. Levinson*, *supra* n. 27; *In the Matter of Carnation Company*, Exchange Act Release No. 22214 (July 8, 1985), 33 SEC Docket (CCH) 874.

49 *See Basic, Inc. v. Levinson*, *supra* n. 27, at 985 ("Arguments based on the premise that some disclosure would be 'premature' in a sense are more properly considered under the rubric of an issuer's duty to disclose. The 'secrecy' rationale is simply inapposite to the definition of materiality.").

50 *See*, *e.g.*, Securities Exchange Act Release No. 16384 (November 29, 1979) [44 FR 70326, 70336] (considering these conflicting interests in adopting Item 7 of Schedule 14D-9, 17 CFR 240.101, which requires that the subject company of a public tender offer provide two levels of disclosure: (a) a statement as to whether or not "any negotiation [which would result in certain transactions or fundamental changes] is being undertaken or is underway . . . in response to the tender offer," which disclosure need not include "the possible terms of the transaction or the parties thereto" if in the registrant's view such disclosure would jeopardize the negotiations; and (b) a description of "any transaction, board resolution, agreement in principle, or a signed contract" relating to such transactions or changes).

51 Item 2 of Form 8-K, 17 CFR 249.308. *See also* Item 8 of Form 10-K, 17 CFR 249.310 (excluding pro forma financial information otherwise called for by Article 11 of Regulation S-X from the financial information required); Item 1 of Form 10-Q, 17 CFR 249.308a, and Rule 10-01 of Regulation S-X, 17 CFR 210.10-01.

With respect to the disposal of a segment of a business, however, Accounting Principles Board Opinion 30 requires that results of operations of the segment be reclassified as discontinued operations, and any estimated loss on disposal be recorded, as of the date management commits itself to a formal plan to dispose of the segment (i.e., the "measurement date"). Filings, including periodic reports under the Exchange Act that contain annual or interim financial statements are required to reflect the prescribed accounting treatment as of the measurement date.

52 Article 11 of Regulation S-X, 17 CFR 210.11-01 et seq. (generally requiring the provision of pro forma financial information where a significant acquisition or disposition "has occurred or is probable"). Entry into the continuous reporting system by registration under the Exchange Act also requires the provision of such pro forma financial information. Item 13 of Form 10, 17 CFR 249.210. *See also* Item 14 of Schedule 14A, 17 CFR 240.14a-101 (requiring Article 11 pro forma financial information and extensive other information about certain extraordinary transactions if shareholder action is to be taken with respect to such a transaction).

53 Item 504 of Regulation S-K, 17 CFR 229.504, Instruction 6.

http://www.sec.gov/rules/interp/33-6835.htm

U.S. Securities and Exchange Commission

Interpretation:
Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations

Securities and Exchange Commission

17 CFR Parts 211, 231 and 241

[Release Nos. 33-8350; 34-48960; FR-72]

Agency: Securities and Exchange Commission.

Action: Interpretation.

Summary: The Commission is publishing interpretive guidance regarding the disclosure commonly known as Management's Discussion and Analysis of Financial Condition and Results of Operations, or MD&A, which is required by Item 303 of Regulation S-K, Items 303(b) and (c) of Regulation S-B, Item 5 of Form 20-F and Paragraph 11 of General Instruction B of Form 40-F. This guidance is intended to elicit more meaningful disclosure in MD&A in a number of areas, including the overall presentation and focus of MD&A, with general emphasis on the discussion and analysis of known trends, demands, commitments, events and uncertainties, and specific guidance on disclosures about liquidity, capital resources and critical accounting estimates.

Effective Date: December 29, 2003

For Further Information Contact: Questions about specific filings should be directed to staff members responsible for reviewing the documents the registrant files with the Commission. General questions about this release should be referred to Todd Hardiman, Karl Hiller, Nina Mojiri-Azad, Mara Ransom, or Sondra Stokes, Division of Corporation Finance, at (202) 824-5300, Securities and Exchange Commission, 450 5th Street N.W., Washington, D.C. 20549-0401.

Supplementary Information:

I. Overview

A. Purpose

This release interprets requirements for Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A").[1] It provides guidance to assist companies:

- in preparing MD&A disclosure that is easier to follow and understand; and
- in providing information that more completely satisfies our previously enunciated principal objectives of MD&A.

We believe that management's most important responsibilities include communicating with investors in a clear and straightforward manner. MD&A is a critical component of that communication. The Commission has long sought through its rules, enforcement actions and interpretive processes to elicit MD&A that not only meets technical disclosure requirements but generally is informative and transparent. We believe and expect that when companies follow the guidance in this release, the overall quality of their MD&A will improve. The Division of Corporation Finance will continue to review MD&A submitted after this guidance is released and take action as appropriate. In addition, we have instructed the Division to keep us apprised of whether this guidance has produced improved disclosure, and to suggest additional Commission action related to MD&A as appropriate.

B. Approach to MD&A

The purpose of MD&A is not complicated. It is to provide readers information "necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations."[2] The MD&A requirements are intended to satisfy three principal objectives:

- to provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management;
- to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
- to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.[3]

MD&A should be a discussion and analysis of a company's business as seen through the eyes of those who manage that business. Management has a unique perspective on its business that only it can present. As such, MD&A should not be a recitation of financial statements in narrative form or an otherwise uninformative series of technical responses to MD&A requirements, neither of which provides this important management perspective. Through this release we encourage each company and its management to take a fresh look at MD&A with a view to enhancing its quality. We also encourage early top-level involvement by a company's management in identifying the key disclosure themes and items that should be included in a company's MD&A.

Based on our experience with many companies' current disclosures in MD&A, we believe there are a number of general ways for companies to enhance their MD&A consistent with its purpose. The recent review experiences of the staff of the Division of Corporation Finance, including its Fortune 500 review,[4] have led us to conclude that additional guidance would be especially useful in the following areas:

- the overall presentation of MD&A;
- the focus and content of MD&A (including materiality, analysis, key performance measures and known material trends and uncertainties);
- disclosure regarding liquidity and capital resources; and

- disclosure regarding critical accounting estimates.

Therefore, in this release, we emphasize the following points regarding overall presentation:

- within the universe of material information, companies should present their disclosure so that the most important information is most prominent;
- companies should avoid unnecessary duplicative disclosure that can tend to overwhelm readers and act as an obstacle to identifying and understanding material matters; and
- many companies would benefit from starting their MD&A with a section that provides an executive-level overview that provides context for the remainder of the discussion.

We also emphasize the following points regarding focus and content:

- in deciding on the content of MD&A, companies should focus on material information and eliminate immaterial information that does not promote understanding of companies' 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);[5]
- companies should identify and discuss key performance indicators, including non-financial performance indicators, that their management uses to manage the business and that would be material to investors;
- companies must identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance;[6] and
- companies should provide not only disclosure of information responsive to MD&A's requirements, but also an analysis that is responsive to those requirements that explains management's view of the implications and significance of that information and that satisfies the objectives of MD&A.

C. Impact of Increased Amounts of Information Available to Companies

Companies have access to and use substantially more detailed and timely information about their financial condition and operating performance than they did when our MD&A requirements initially were introduced or when we last provided general interpretive guidance.[7] Some of this information is itself non-financial in nature, but bears on companies' financial condition and operating performance. The increased availability of information is relevant to companies in preparing MD&A for the following reasons:

- First, companies must evaluate an increased amount of information to determine which information they must disclose. In doing so, companies should avoid the unnecessary information overload for investors that can result from disclosure of information that is not required, is immaterial, and does not promote understanding.
- Second, in identifying, discussing and analyzing known material trends and uncertainties, companies are expected to consider all relevant information, even if that information is not required to be disclosed.

D. Liquidity and Capital Resources

We devote a separate section of this release to disclosure in MD&A regarding liquidity and capital resources. In that section, we emphasize the need for attention to disclosure of cash requirements and sources of cash. We believe that:

- companies should consider enhanced analysis and explanation of the sources and uses of cash and material changes in particular items underlying the major captions reported in their financial statements, rather than recitation of the items in the cash flow statements;
- companies using the indirect method[8] in preparing their cash flow statements should pay particular attention to disclosure and analysis of matters that are not readily apparent from their cash flow statements; and
- companies also should consider whether their MD&A should include enhanced disclosure regarding debt instruments, guarantees and related covenants.

E. Critical Accounting Estimates

Finally, we have included a separate section in this release regarding accounting estimates and assumptions that may be material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on financial condition or operating performance. Companies should consider enhanced discussion and analysis of these critical accounting estimates and assumptions that:

- supplements, but does not duplicate, the description of accounting policies in the notes to the financial statements; and
- provides greater insight into the quality and variability of information regarding financial condition and operating performance.

F. Effect on Prior Commission Statements

This release does not modify existing legal requirements or create new legal requirements. Rather, we intend this release to assist companies in preparing MD&A by providing interpretive guidance and, in some cases, providing additional guidance in areas that the Commission has addressed previously. We do not believe that the guidance in this release conflicts with prior Commission guidance, nor is it our intention to alter any prior Commission guidance.

II. Background

The following is a chronology of certain prior Commission action regarding MD&A:

1980 — We adopted the present form of the disclosure requirements for MD&A.[9]

1981 — We published the staff's interpretive guidance for MD&A after its

review of disclosures that were prepared in accordance with the then-recently adopted disclosure requirements.[10]

1987 — We sought public comment on the adequacy of MD&A and on proposed revisions submitted by members of the professional accounting community.[11]

1989 — We published an interpretive release that addressed a number of disclosure matters that should be considered by companies in preparing MD&A.[12] The 1989 Release provided guidance in various areas, including required prospective information, analysis of long and short-term liquidity and capital resources, material changes in financial statement line items, required interim period disclosure, segment analysis, participation in high-yield financings, highly leveraged transactions or non-investment grade loans and investments, the effects of federal financial assistance upon the operations of financial institutions and the disclosure of preliminary merger negotiations.

December 2001 — As part of its process of reviewing financial and non-financial disclosures made by public companies, the Division of Corporation Finance announced that it would preliminarily review the annual reports filed in 2002 by the Fortune 500 companies, and undertake further review as appropriate, consistent with its selective review program. The focus of the project was to identify "disclosure that appeared to be critical to an understanding of each company's financial position and results, but which, at least on its face, seemed to conflict significantly with generally accepted accounting principles [GAAP] or SEC rules, or to be materially deficient in explanation or clarity."[13] As a result of this review, comment letters, many of which commented on companies' MD&A, were sent to more than 350 of the Fortune 500 companies. Earlier this year, the Division published a summary of the most frequent general areas of comment resulting from this review.[14]

December 2001 — The Commission issued cautionary advice to companies regarding the need for greater investor awareness of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation. This cautionary advice encouraged public companies to include in their MD&A full explanations of their "critical accounting policies," the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions.[15]

January 2002 — After receiving a petition requesting additional MD&A interpretive guidance,[16] we issued a statement "to suggest steps that issuers should consider in meeting their current disclosure obligations with respect to the topics described."[17] The statement provided explicit interpretive guidance on certain MD&A topics considered material to an understanding of companies' operations. The topics addressed by the release were liquidity and capital resources (including off-balance sheet arrangements), trading activities involving non-exchange traded contracts accounted for at fair value, and relationships and transactions with persons or entities that derive benefits from their non-independent relationships with the company or the company's related parties.[18]

May 2002 — We proposed additional MD&A disclosure requirements, which remain under consideration, regarding the application of companies' critical accounting estimates.[19]

January 2003 — We adopted additional disclosure requirements regarding off-balance sheet arrangements and aggregate contractual obligations.[20] The new rules require the disclosure of off-balance sheet arrangements in a designated section of MD&A and an overview of certain known contractual obligations in a tabular format.[21]

We also have brought numerous enforcement actions based on alleged violations of MD&A requirements and will continue to bring such actions under appropriate circumstances.[22]

Based on recent experiences, we have determined that additional interpretive guidance regarding the requirements of MD&A will be useful to companies in enhancing overall disclosure under MD&A requirements.

III. Overall Approach to MD&A

A. The Presentation of MD&A

Since the introduction of our MD&A requirements, many companies have become larger, more global and more complex. At the same time, the combination of our rules and investors' demands have led to an increase in the number of subjects and matters addressed in MD&A. For these and other reasons, many companies' MD&A have become necessarily lengthy and complex. Unfortunately, the presentation of the MD&A of too many companies also may have become unnecessarily lengthy, difficult to understand and confusing.

MD&A, like other disclosure, should be presented in clear and understandable language. We understand that complex companies and situations require disclosure of complex matters and we are not in any way seeking over-simplification or "dumbing down" of MD&A. However, we believe that companies can improve the clarity and understandability of their MD&A by using language that is clearer and less convoluted. We believe that efforts by companies to provide clearer and better organized presentations of MD&A can result in more understandable disclosure that does not sacrifice the appropriate level of complexity or nuance. In order to engender better understanding, companies should prepare MD&A with a strong focus on the most important information, provided in a manner intended to address the objectives of MD&A. In particular:

- Companies should consider whether a tabular presentation of relevant financial or other information may help a reader's understanding of MD&A. For example, a company's MD&A might be clearer and more concise if it provides a tabular comparison of its results in different periods, which could include line items and percentage changes as well as other information determined by a company to be useful, followed by a narrative discussion and analysis of known changes, events, trends, uncertainties and other matters. A reader's understanding of a company's fair value calculations or discounted cash flow figures also could, in some situations, be enhanced by providing a tabular summary of the company's various material interest and discount rate assumptions in one location.

- Companies should consider whether the headings they use assist readers in following the flow of, or otherwise assist in understanding,

MD&A, and whether additional headings would be helpful in this regard.

- Many companies' MD&A could benefit from adding an introductory section or overview that would facilitate a reader's understanding. As with all disclosure, what companies would appropriately include in an introduction or overview will depend on the circumstances of the particular company. As a general matter, an introduction or overview should include the most important matters on which a company's executives focus in evaluating financial condition and operating performance and provide the context for the discussion and analysis of the financial statements. Therefore, an introduction or overview should not be a duplicative layer of disclosure that merely repeats the more detailed discussion and analysis that follows.

- While all required information must of course be disclosed, companies should consider using a "layered" approach. Such an approach would present information in a manner that emphasizes, within the universe of material information that is disclosed, the information and analysis that is most important. This presentation would assist readers in identifying more readily the most important information. Using an overview or introduction is one example of a layered approach. Another is to begin a section containing detailed analysis, such as an analysis of period-to-period information, with a statement of the principal factors, trends or other matters that are the principal subjects covered in more detail in the section.

We would expect a good introduction or overview to provide a balanced, executive-level discussion that identifies the most important themes or other significant matters with which management is concerned primarily in evaluating the company's financial condition and operating results. A good introduction or overview would:

- include economic or industry-wide factors relevant to the company;

- serve to inform the reader about how the company earns revenues and income and generates cash;

- to the extent necessary or useful to convey this information, discuss the company's lines of business, location or locations of operations, and principal products and services (but an introduction should not merely duplicate disclosure in the Description of Business section); and

- provide insight into material opportunities, challenges and risks, such as those presented by known material trends and uncertainties, on which the company's executives are most focused for both the short and long term, as well as the actions they are taking to address these opportunities, challenges and risks.

Because these matters do not generally remain static from period to period, we would expect the introduction to change over time to remain current. As is true with all sections of MD&A, boilerplate disclaimers and other generic language generally are not helpful in providing useful information or achieving balance, and would detract from the purpose of the introduction or overview.

An introduction or overview, by its very nature, cannot disclose everything and should not be considered by itself in determining whether a company has made full disclosure. Further, 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.[23]

Throughout MD&A, including in an introduction or overview, discussion and analysis of financial condition and operating performance includes both past and prospective matters. In addressing prospective financial condition and operating performance, there are circumstances, particularly regarding known material trends and uncertainties, where forward-looking information is required to be disclosed. We also encourage companies to discuss prospective matters and include forward-looking information in circumstances where that information may not be required, but will provide useful material information for investors that promotes understanding.

B. The Content and Focus of MD&A

In addition to enhancing MD&A through the use of clearer language and presentation, many companies could improve their MD&A by focusing on the most important information disclosed in MD&A. Disclosure should emphasize material information that is required or promotes understanding and de-emphasize (or, if appropriate, delete) immaterial information that is not required and does not promote understanding.

Our MD&A requirements call for companies to provide investors and other users with material information that is necessary to an understanding of the company's financial condition and operating performance, as well as its prospects for the future.[24] While the desired focus of MD&A for a particular company will depend on the facts and circumstances of the company, some guidance about the content and focus of MD&A is generally applicable.

1. Focus on Key Indicators of Financial Condition and Operating Performance

As discussed, one of the principal objectives of MD&A is to give readers a view of the company through the eyes of management by providing both a short and long-term analysis of the business.[25] To do this, companies should "identify and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the individual company."[26]

Financial measures generally are the starting point in ascertaining these key variables and other factors. However, financial measures often tell only part of how a company manages its business. Therefore, when preparing MD&A, companies should consider whether disclosure of all key variables and other factors that management uses to manage the business would be material to investors, and therefore required.[27] These key variables and other factors may be non-financial, and companies should consider whether that non-financial information should be disclosed.

Many companies currently disclose non-financial business and operational data.[28] Academics, authors, and consultants also have researched the types of information, outside of financial statement measures, that would be helpful to investors and other users.[29] Such information may relate to

external or macro-economic matters as well as those specific to a company or industry. For example, interest rates or economic growth rates and their anticipated trends can be important variables for many companies. Industry-specific measures can also be important for analysis, although common standards for the measures also are important. Some industries commonly use non-financial data, such as industry metrics and value drivers.[30] Where a company discloses such information, and there is no commonly accepted method of calculating a particular non-financial metric, it should provide an explanation of its calculation to promote comparability across companies within the industry. Finally, companies may use non-financial performance measures that are company-specific.

In addition, if companies disclose material information (historical or forward-looking) other than in their filed documents (such as in earnings releases or publicly accessible analysts' calls or companion website postings) they also should evaluate that material information to determine whether it is required to be included in MD&A, either because it falls within a specific disclosure requirement or because its omission would render misleading the filed document in which the MD&A appears. We are not seeking to sweep into MD&A all the information that a company communicates. Rather, companies should consider their communications and determine what information is material and is required in, or would promote understanding of, MD&A.

Since we adopted the MD&A requirements, and even since the last comprehensive guidance on MD&A we released in 1989, there have been significant advancements in the ability to develop and access information quickly and effectively. Changes in business enterprise systems, communications and other aspects of information technology have significantly increased the amount of information available to management, as well as the speed with which they receive and are able to use information.[31] There is therefore a larger and more up-to-date universe of information, financial and non-financial alike, that companies have and should evaluate in determining whether disclosure is required. This situation presents companies with the challenge of identifying information that is required to be disclosed or that promotes understanding, while avoiding unnecessary information overload for readers by not disclosing a greater body of information, just because it is available, where disclosure is not required and does not promote understanding. Further, with advances in technology contributing to increasing amounts and currency of information, the factors relied upon by companies to operate and analyze the business may change. As this occurs, the discussion in MD&A should change over time to maintain an appropriate focus on material factors.

The focus on key performance indicators can be enhanced not only through the language and content of the discussion, but also through a format that will enhance the understanding of the discussion and analysis. The order of the information need not follow the order presented in Item 303 of Regulation S-K if another order of presentation would better facilitate readers' understanding. MD&A should provide a frame of reference that allows readers to understand the effects of material changes and events and known material trends and uncertainties arising during the periods being discussed, as well as their relative importance. To satisfy the objectives of MD&A, companies also should provide a balanced view of the underlying dynamics of the business, including not only a description of a company's successes, but also of instances when it failed to realize goals, if material. Good MD&A will focus readers' attention on these key matters.

2. Focus on Materiality

Companies must provide specified material information in their MD&A,[32] and they also must provide other material information that is necessary to make the required statements, in light of the circumstances in which they are made, not misleading.[33] MD&A must specifically focus on known material events and uncertainties that would cause reported financial information not to be necessarily indicative of future operating performance or of future financial condition.[34] Companies must determine, based on their own particular facts and circumstances, whether disclosure of a particular matter is required in MD&A. However, the effectiveness of MD&A decreases with the accumulation of unnecessary detail or duplicative or uninformative disclosure that obscures material information.[35] Companies should view this guidance as an opportunity to evaluate whether there is information in their MD&A that is no longer material or useful, and therefore should be deleted, for example where there has been a change in their business or the information has become stale.

As the complexity of business structures and financial transactions increase, and as the activities undertaken by companies become more diverse, it is increasingly important for companies to focus their MD&A on material information. In preparing MD&A, companies should evaluate issues presented in previous periods and consider reducing or omitting discussion of those that may no longer be material or helpful, or revise discussions where a revision would make the continuing relevance of an issue more apparent.

Companies also should focus on an analysis of the consolidated financial condition and operating performance, with segment data provided where material to an understanding of consolidated information. Segment discussion and analysis should be designed to avoid unnecessary duplication and immaterial detail that is not required and does not promote understanding of a company's overall financial condition and operating performance.

Both Instruction 4 to Item 303 of Regulation S-K and the 1989 Release address the requirement of discussion and analysis of changes in line items. A review of current MD&A provided by some companies, however, reveals that this is a portion of MD&A that can include an excessive amount of duplicative disclosure, as well as disclosure of immaterial items that do not promote understanding. The 1989 Release explicitly provides for the grouping of line items for purposes of discussion and analysis in a manner that avoids duplicative disclosure. In addition, Instruction 4 and the guidance in the 1989 Release do not require a discussion of every line item and its changes without regard to materiality. Discussion of a line item and its changes should be avoided where the information that would be disclosed is not material and would not promote understanding of MD&A.

Companies also must assess the materiality of items in preparing disclosure in their quarterly reports. There may be different quantitative and qualitative factors to consider when deciding whether to include certain information in a specific quarterly or annual report. The 1989 Release addresses some aspects of MD&A disclosure in the context of quarterly filings. That release clarifies that material changes to items disclosed in MD&A in annual reports should be discussed in the quarter in which they occur.[36] There also may be circumstances where an item may not be

material in the context of a discussion of annual results of operations but is material in the context of interim results.

Disclosure in MD&A in quarterly reports is complementary to that made in the most recent annual report and in any intervening quarterly reports. Therefore, there may be cases, particularly where adequate disclosure is included in the MD&A in those earlier reports, where further disclosure in a quarterly report is not necessary. If, however, disclosure in those earlier reports does not adequately foreshadow subsequent events, or if new information that impacts known trends and uncertainties becomes apparent in a quarterly period, additional disclosure should be considered and may be required.

3. Focus on Material Trends and Uncertainties

One of the most important elements necessary to an understanding of a company's performance, and the extent to which reported financial information is indicative of future results, is the discussion and analysis of known trends, demands, commitments, events and uncertainties. Disclosure decisions concerning trends, demands, commitments, events, and uncertainties generally should involve the:

- consideration of financial, operational and other information known to the company;
- identification, based on this information, of known trends and uncertainties; and
- assessment of whether these trends and uncertainties will have, or are reasonably likely to have, a material impact on the company's liquidity, capital resources or results of operations.

As we have explained in prior guidance, disclosure of a trend, demand, commitment, event or uncertainty is required unless a company is able to conclude either that it is not reasonably likely that the trend, uncertainty or other event will occur or come to fruition, or that a material effect on the company's liquidity, capital resources or results of operations is not reasonably likely to occur.[37] (In this release we sometimes use the term "known material trends and uncertainties" to describe trends, demands, commitments, events or uncertainties as to which disclosure is required.)

In identifying known material trends and uncertainties, companies should consider the substantial amount of financial and non-financial information available to them, and whether or not the available information itself is required to be disclosed. This information, over time, may reveal a trend or general pattern in activity, a departure or isolated variance from an established trend, an uncertainty, or a reasonable likelihood of the occurrence of such an event that should be disclosed.

One of the principal objectives of MD&A is to provide information about the quality and potential variability of a company's earnings and cash flow, so that readers can ascertain the likelihood that past performance is indicative of future performance. Ascertaining this indicative value depends to a significant degree on the quality of disclosure about the facts and circumstances surrounding known material trends and uncertainties in MD&A. Quantification of the material effects of known material trends and uncertainties can promote understanding. Quantitative disclosure should be considered and may be required to the extent material if quantitative information is reasonably available.

As discussed in the 1989 Release, the disclosures required to address known material trends and uncertainties in the discussion and analysis should not be confused with optional forward-looking information. Not all forward-looking information falls within the realm of optional disclosure. In particular, material forward-looking information regarding known material trends and uncertainties is required to be disclosed as part of the required discussion of those matters and the analysis of their effects.[38] In addition, forward-looking information is required in connection with the disclosure in MD&A regarding off-balance sheet arrangements.[39]

4. Focus on Analysis

MD&A requires not only a "discussion" but also an "analysis" of known material trends, events, demands, commitments and uncertainties. MD&A should not be merely a restatement of financial statement information in a narrative form. When a description of known material trends, events, demands, commitments and uncertainties is set forth, companies should consider including, and may be required to include, an analysis explaining the underlying reasons or implications, interrelationships between constituent elements, or the relative significance of those matters.

Identifying the intermediate effects of trends, events, demands, commitments and uncertainties alone, without describing the reasons underlying these effects, may not provide sufficient insight for a reader to see the business through the eyes of management. A thorough analysis often will involve discussing both the intermediate effects of those matters and the reasons underlying those intermediate effects. For example, if a company's financial statements reflect materially lower revenues resulting from a decline in the volume of products sold when compared to a prior period, MD&A should not only identify the decline in sales volume, but also should analyze the reasons underlying the decline in sales when the reasons are also material and determinable. The analysis should reveal underlying material causes of the matters described, including for example, if applicable, difficulties in the manufacturing process, a decline in the quality of a product, loss in competitive position and market share, or a combination of conditions.

Similarly, where a company's financial statements reflect material restructuring or impairment charges, or a decline in the profitability of a plant or other business activity, MD&A should also, where material, analyze the reasons underlying these matters, such as an inability to realize previously projected economies of scale, a failure to renew or secure key customer contracts, or a failure to keep downtime at acceptable levels due to aging equipment. Whether favorable or unfavorable conditions constitute or give rise to the material trends, demands, commitments, events or uncertainties being discussed, the analysis should consist of material substantive information and present a balanced view of the underlying dynamics of the business.

If there is a reasonable likelihood that reported financial information is not indicative of a company's future financial condition or future operating performance due, for example, to the levels of subjectivity and judgment necessary to account for highly uncertain matters and the susceptibility of such matters to change, appropriate disclosure in MD&A should be

considered and may be required. For example, if a change in an estimate has a material favorable impact on earnings, the change and the underlying reasons should be disclosed so that readers do not incorrectly attribute the effect to operational improvements. In addition, if events and transactions reported in the financial statements reflect material unusual or non-recurring items, aberrations, or other significant fluctuations, companies should consider the extent of variability in earnings and cash flow, and provide disclosure where necessary for investors to ascertain the likelihood that past performance is indicative of future performance. Companies also should consider whether the economic characteristics of any of their business arrangements, or the methods used to account for them, materially impact their results of operations or liquidity in a structured or unusual fashion, where disclosure would be necessary to understand the amounts depicted in their financial statements.

IV. Liquidity and Capital Resources

Our rules require companies to provide disclosure in the related categories of liquidity and capital resources.[40] This information is critical to an assessment of a company's prospects for the future and even the likelihood of its survival.[41] A company is required to include in MD&A the following information, to the extent material:

- historical information regarding sources of cash and capital expenditures;
- an evaluation of the amounts and certainty of cash flows;
- the existence and timing of commitments for capital expenditures and other known and reasonably likely cash requirements;
- discussion and analysis of known trends and uncertainties;
- a description of expected changes in the mix and relative cost of capital resources;
- indications of which balance sheet or income or cash flow items should be considered in assessing liquidity; and
- a discussion of prospective information regarding companies' sources of and needs for capital, except where otherwise clear from the discussion.[42]

Discussion and analysis of this information should be considered and may be required to provide a clear picture of the company's ability to generate cash and to meet existing and known or reasonably likely future cash requirements.

In determining required or appropriate disclosure, companies should evaluate separately their ability to meet upcoming cash requirements over both the short and long term.[43] Merely stating that a company has adequate resources to meet its short-term and/or long-term cash requirements is insufficient 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 related to cash flow, capital resources, capital requirements, or liquidity.

A. Cash Requirements

In order to identify known material cash requirements, companies should consider whether the following information would have a material impact on liquidity (discussion of immaterial matters, and especially generic disclosure or boilerplate, should be avoided):

- funds necessary to maintain current operations, complete projects underway and achieve stated objectives or plans;
- commitments for capital or other expenditures;[44] and
- the reasonably likely exposure to future cash requirements associated with known trends or uncertainties, and an indication of the time periods in which resolution of the uncertainties is anticipated.

One starting point for a company's discussion and analysis of cash requirements is the tabular disclosure of contractual obligations,[45] supplemented with additional information that is material to an understanding of the company's cash requirements.[46]

For example, if a company has incurred debt in material amounts, it should explain the reasons for incurring that debt and the use of the proceeds, and analyze how the incurrence of that debt fits into the overall business plan, in each case to the extent material.[47] Where debt has been incurred for general working capital purposes, the anticipated amount and timing of working capital needs should be discussed, to the extent material.[48]

Companies should address, where material, the difficulties involved in assessing the effect of the amount and timing of uncertain events, such as loss contingencies, on cash requirements and liquidity. Any such discussion should be specific to the circumstances and informative, and companies should avoid generic or boilerplate disclosure. In addition, because of these difficulties and uncertainties, companies should consider whether they need to make or change disclosure in connection with quarterly as well as annual reports.

B. Sources and Uses of Cash

As with the discussion and analysis of the results of operations, a company's discussion and analysis of cash flows should not be a mere recitation of changes and other information evident to readers from the financial statements. Rather, MD&A should focus on the primary drivers of and other material factors necessary to an understanding of the company's cash flows and the indicative value of historical cash flows.

In addition to explaining how the cash requirements identified in MD&A fit into a company's overall business plan, the company should focus on the resources available to satisfy those cash requirements. Where there has been material variability in historical cash flows, MD&A should focus on the underlying reasons for the changes, as well as on their reasonably likely impact on future cash flows and cash management decisions. Even where reported amounts of cash provided and used by operations, investing activities or financing have been consistent, if the underlying sources of those cash flows have materially varied, analysis of that variability should be provided. The discussion and analysis of liquidity should focus on material changes in operating, investing and financing cash flows, as

depicted in the statement of cash flows, and the reasons underlying those changes.

1. Operations

The discussion and analysis of operating cash flows should not be limited by the manner of presentation in the statement of cash flows.[49] Alternate accounting methods of deriving and presenting cash flows exist, and while they generally yield the same numeric result in the major captions, they involve the disclosure of different types of information. When preparing the discussion and analysis of operating cash flows, companies should address material changes in the underlying drivers (*e.g.* cash receipts from the sale of goods and services and cash payments to acquire materials for manufacture or goods for resale), rather than merely describe items identified on the face of the statement of cash flows, such as the reconciling items used in the indirect method of presenting cash flows.[50]

For example, consider a company that reports an overall increase in the components of its working capital other than cash[51] with the effect of having a material decrease in net cash provided by operations in the current period. If the increase in working capital was driven principally by an increase in accounts receivable that is attributable not to an increase in sales, but rather to a revised credit policy resulting in an extended payment period for customers, these facts would need to be addressed in MD&A to the extent material, along with the resulting decrease in cash provided by operations, if not otherwise apparent. In addition, if there is a material trend or uncertainty, the impact of the new credit policy on cash flows from operations should be disclosed.[52] While a cash flow statement prepared using the indirect method would report that various individual components of working capital increased or decreased during the period by a specified amount, it would not provide a sufficient basis for a reader to analyze the change. If the company reports negative cash flows from operations, the disclosure provided in MD&A should identify clearly this condition, discuss the operational reasons for the condition if material, and explain how the company intends to meet its cash requirements and maintain operations. If the company relies on external financing in these situations, disclosure of that fact and the company's assessment of whether this financing will continue to be available, and on what terms, should be considered and may be required.

A company should consider whether, in order to make required disclosures, it is necessary to expand MD&A to address the cash requirements of and the cash provided by its reportable segments or other subdivisions of the business, including issues related to foreign subsidiaries, as well as the indicative nature of those results.[53] A company also should discuss the effect of an inability to access the cash flow and financial assets of any consolidated entities. For example, an entity may be consolidated but, because the company lacks sufficient voting interests or the assets are legally isolated, the company may be unable to utilize the entity's cash flow, cash on hand, or other assets to satisfy its own liquidity needs.

2. Financing

To the extent material, a company must provide disclosure regarding its historical financing arrangements and their importance to cash flows, including, to the extent material, information that is not included in the financial statements. A company should discuss and analyze, to the extent material:

- its external debt financing;
- its use of off-balance sheet financing arrangements;
- its issuance or purchase of derivative instruments linked to its stock;
- its use of stock as a form of liquidity; and
- the potential impact of known or reasonably likely changes in credit ratings or ratings outlook (or inability to achieve changes).

In addition to these historical items, discussion and analysis of the types of financing that are, or that are reasonably likely to be, available (or of the types of financing that a company would want to use but that are, or are reasonably likely to be, unavailable) and the impact on the company's cash position and liquidity, should be considered and may be required. For example, where a company has decided to raise or seeks to raise material external equity or debt financing, or if it is reasonably likely to do so in the future, discussion and analysis of the amounts or ranges involved, the nature and the terms of the financing, other features of the financing and plans, and the impact on the company's cash position and liquidity (as well as results of operations in the case of matters such as interest payments) should be considered and may be required.[54]

C. Debt Instruments, Guarantees and Related Covenants

There are at least two scenarios in which companies should consider whether discussion and analysis of material covenants related to their outstanding debt (or covenants applicable to the companies or third parties in respect of guarantees
or other contingent obligations)[55] may be required.[56]

First, companies that are, or are reasonably likely to be, in breach of such covenants[57] must disclose material information about that breach and analyze the impact on the company if material. That analysis should include, as applicable and to the extent material:

- the steps that the company is taking to avoid the breach;
- the steps that the company intends to take to cure, obtain a waiver of or otherwise address the breach;
- the impact or reasonably likely impact of the breach (including the effects of any cross-default or cross-acceleration or similar provisions) on financial condition or operating performance; and
- alternate sources of funding to pay off resulting obligations or replace funding.

Second, companies should consider the impact of debt covenants on their ability to undertake additional debt or equity financing. Examples of these covenants include, but are not limited to, debt incurrence restrictions, limitations on interest payments, restrictions on dividend payments and various debt ratio limits. If these covenants limit, or are reasonably likely to limit, a company's ability to undertake financing to a material extent,

the company is required to discuss the covenants in question and the consequences of the limitation to the company's financial condition and operating performance. Disclosure of alternate sources of funding and, to the extent material, the consequences (including but not limited to the cost) of accessing them should also be considered and may be required.

D. Cash Management

Companies generally have some degree of flexibility in determining when and how to use their cash resources to satisfy obligations and make other capital expenditures. MD&A should describe known material trends or uncertainties relating to such determinations. For example, a decision by a company in a highly capital-intensive business to spend significantly less on plant and equipment than it has historically may result in long-term effects that should be disclosed if material. Material effects could include more cash, less interest expense and lower depreciation, but higher future repair and maintenance expenses or a higher cost base than the company would otherwise have.

V. Critical Accounting Estimates

Many estimates and assumptions involved in the application of GAAP have a material impact on reported financial condition and operating performance and on the comparability of such reported information over different reporting periods. Our December 2001 Release reminded companies that, under the existing MD&A disclosure requirements, a company should address material implications of uncertainties associated with the methods, assumptions and estimates underlying the company's critical accounting measurements.[58] In May 2002 we proposed rules, which remain under consideration, that would broaden the scope of disclosures beyond those currently required.[59]

When preparing disclosure under the current requirements, companies should consider whether they have made accounting estimates or assumptions where:

- the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and
- the impact of the estimates and assumptions on financial condition or operating performance is material.

If so, companies should provide disclosure about those critical accounting estimates or assumptions in their MD&A.

Such disclosure should supplement, not duplicate, the description of accounting policies that are already disclosed in the notes to the financial statements. The disclosure should provide greater insight into the quality and variability of information regarding financial condition and operating performance. While accounting policy notes in the financial statements generally describe the method used to apply an accounting principle, the discussion in MD&A should present a company's analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time.

A company should address specifically why its accounting estimates or assumptions bear the risk of change. The reason may be that there is an uncertainty attached to the estimate or assumption, or it just may be difficult to measure or value. Equally important, companies should address the questions that arise once the critical accounting estimate or assumption has been identified, by analyzing, to the extent material, such factors as how they arrived at the estimate, how accurate the estimate/assumption has been in the past, how much the estimate/assumption has changed in the past, and whether the estimate/assumption is reasonably likely to change in the future. Since 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.

For example, if reasonably likely 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, the impact that could result given the range of reasonably likely outcomes should be disclosed and, because of the nature of estimates of long-term rates of return, quantified.

Amendments to the Codification of Financial Reporting Policies

The "Codification of Financial Reporting Policies" announced in Financial Reporting Release 1 (April 15, 1982) [47 FR 21028] is updated:

1. By adding to the following new sections to the Financial Reporting Codification from the release:

(III) Overall Approach to MD&A

(IV) Liquidity and Capital Resources

(V) Critical Accounting Estimates

2. By revising the footnotes from those sections of the release which contain a short form citation to include the complete citation form rather than the short form.

3. By renumbering the footnotes from those sections of the release to run in the Financial Reporting Codification consecutively from number 1 through number 37.

The Codification is a separate publication of the Commission. It will not be published in the Code of Federal Regulations System.

List of Subjects

17 CFR Part 211, 231 and 241

Securities.

Amendments to the Code of Federal Regulations.

For the reasons set forth above, the Commission is amending title 17, chapter II of the Code of Federal Regulations as set forth below:

PART 211 — INTERPRETATIONS RELATING TO FINANCIAL

REPORTING MATTERS

1. Part 211, Subpart A, is amended by adding Release No. FR-72 and the release date of December 19, 2003 to the list of interpretive releases.

PART 231 — INTERPRETATIVE RELEASES RELATING TO THE SECURITIES ACT OF 1933 AND GENERAL RULES AND REGULATIONS THEREUNDER

2. Part 231 is amended by adding Release No. 33-8350 and the release date of December 19, 2003 to the list of interpretive releases.

PART 241 — INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

3. Part 241 is amended by adding Release No. 34-48960 and the release date of December 19, 2003 to the list of interpretive releases.

By the Commission.

Margaret H. McFarland
Deputy Secretary

Dated: December 19, 2003

Endnotes

[1] The requirements are set forth in Item 303 of Regulation S-K (Management's Discussion & Analysis of Financial Condition and Results of Operations) [17 CFR 229.303], Items 303(b) and (c) of Regulation S-B (Management's Discussion & Analysis of Financial Condition and Results of Operations, and Off-balance sheet arrangements) [17 CFR 228.303(b) and (c)], Item 5 of Form 20-F (Operating and Financial Review and Prospects) [17 CFR 249.220f], and General Instruction B.(11) of Form 40-F (Off-balance sheet arrangements) [17 CFR 249.240f].

Although the wording of the MD&A requirement in Form 20-F was revised in 1999, the Commission's adopting release noted that we interpret that Item as calling for the same disclosure as Item 303 of Regulation S-K. *See* Release No. 33-7745 (Sept. 28, 1999) [64 FR 53900 at 59304]. In addition, Instruction 1 to Item 5 in Form 20-F provides that issuers should refer to the Commission's 1989 interpretive release on MD&A disclosure under Item 303 of Regulation S-K (Interpretive Release: Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Release No. 33-6835 (May 18, 1989) [54 FR 22427] (the "1989 Release")) for guidance in preparing the discussion and analysis by management of the company's financial condition and results of operations required in Form 20-F. Therefore, although this release refers primarily to Item 303 of Regulation S-K, it also is intended to apply to MD&A drafted pursuant to Item 5 of Form 20-F.

In addition, the guidance in this release applies to small business issuers that are subject to the disclosure requirements of Items 303(b) and (c) of Regulation S-B. Small business issuers, like all other companies subject to SEC reporting obligations, should consider the interpretive guidance based on their own particular facts and circumstances.

[2] Item 303(a) of Regulation S-K [17 CFR 229.303(a)].

[3] *See* Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8056 (Jan. 22, 2002) [67 FR 3746] ("January 2002 Release").

[4] *See* 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) ("Fortune 500 Summary") available at www.sec.gov/divisions/corpfin/fortune500rep.htm.

[5] In this release we sometimes use the term "financial condition and operating performance" to refer to the required subjects of MD&A of 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).

[6] Note 27 to the 1989 Release states, "MD&A mandates disclosure of specified forward-looking information, and specifies its own standards for disclosure — i.e., reasonably likely to have a material effect. The specific standard governs the circumstances in which Item 303 requires disclosure. The probability/magnitude test for materiality approved by the Supreme Court in *Basic v. Levinson*, 108 S.Ct. 978 (1988), is inapposite to Item 303 disclosure."

[7] *See, e.g., Improving Business Reporting — A Customer Focus; Meeting the Information Needs of Investors and Creditors*, Comprehensive Report of the Special Committee on Financial Reporting, American Institute of Certified Public Accountants (AICPA) (1994) ("Jenkins Report").

[8] In Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 95, *Statement of Cash Flows* (Nov. 1987), the FASB allowed 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 that method, the major classes of operating cash receipts and payments are determined indirectly by determining the change in asset and liability accounts that relate to operating income. However, in SFAS 95, the FASB encouraged companies to use the direct method of reporting net cash flow from operating activities rather than the indirect method. The direct method reports net cash flow from operations by summing major classes of gross cash receipts, such as customer payments, and gross cash payments, such as cash paid to employees. The direct method also requires a reconciliation of net income to net cash flow from operating activities. The FASB gave its opinion that the direct method is "the more comprehensive and presumably more useful approach."

While this release refers primarily to U.S. GAAP, the underlying events and circumstances described in the release ordinarily will be applicable to foreign private issuers and should be discussed to the extent material. Consistent with the Instructions to Form 20-F, however, companies using that form should focus on the primary financial statements in their discussion and analysis in Item 5 (Operative and Financial Review Prospects). Also, companies are required to discuss in Item 5 of Form 20-F any aspects of the differences between foreign and U.S. GAAP that they believe are necessary for an understanding of the financial statements as a

whole. *See* Instruction 2 to Item 5 of Form 20-F [17 CFR 249.220f].

[9] Final Rule: Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides; Integration of Securities Acts Disclosure Systems, Release No. 33-6231 (Sept. 2, 1980) [45 FR 63630].

[10] Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-6349 (Sept. 28, 1981) 23 SEC Docket 962 [Release not published in the Federal Register].

[11] Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Release No. 33-6711 (April 24, 1987) [52 FR 13715].

[12] 1989 Release.

[13] Fortune 500 Summary.

[14] *Id*.

[15] Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Release No. 33-8040 (Dec. 12, 2001) [66 FR 65013] ("December 2001 Release").

[16] On December 31, 2001 the Commission received a petition from Arthur Andersen LLP, Deloitte and Touche, LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP. The American Institute of Certified Public Accountants endorsed the petition. A copy of the petition is available at www.sec.gov/rules/petitions/petndiscl_12312001.htm.

[17] *See* January 2002 Release.

[18] *Id*.

[19] Proposed Rule: Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies, Release No. 33-8098 (May 10, 2002) [67 FR 35620] ("2002 Critical Accounting Policies Proposal").

[20] Final Rule: Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Release No. 33-8182 (Jan. 28, 2003) [68 FR 5982] ("2003 Off-Balance Sheet Release").

The overall guidance in this Interpretive Release is applicable to all MD&A discussions, including those related to off-balance sheet arrangements. As such, it should be applied to General Instruction B.(11) of Form 40-F and Item 303(c) of Regulation S-B, in addition to the other sections set out in note 1, above. We are not addressing specifically disclosures of off-balance sheet arrangements in this release, however, because we have little experience with companies' application of the new rules, which are effective for companies' registration statements, annual reports and proxy or information statements that are required to include financial statements for their fiscal years ending on or after June 15, 2003. Companies (other than small business issuers) must include the table of contractual obligations in registration statements, annual reports, and proxy or information statements that are required to include financial statements for the fiscal years ending on or after December 15, 2003. In addition, Section 401(c) of the Sarbanes-Oxley Act requires us to complete a study and report to the President and Congress next year on these types of disclosures.

[21] The tabular disclosure is not required for small business issuers by Item 303 of Regulation S-B.

[22] *See, e.g., In the Matter of Edison Schools, Inc.*, Release No. 34-45925 (May 14, 2002); *In the Matter of Sony Corporation and Sumio Sano*, Release No. 34-40305 (Aug. 5, 1998); *In the Matter of Bank of Boston Corp.*, Initial Decision Release No. 81 (Dec. 22, 1995); *In the Matter of Gibson Greetings, Inc., Ward A. Cavanaugh, and James H. Johnsen*, Release No. 34-36357 (Oct. 11, 1995); *In the Matter of America West Airlines, Inc.*, Release No. 34-34047 (May 12, 1994); *In the Matter of Salant Corporation and Martin F. Tynan*, Release No. 34-34046 (May 12, 1994); *In the Matter of Shared Medical Systems Corporation*, Release No. 34-33632 (Feb. 17, 1994); *In the Matter of Caterpillar Inc.*, Release No. 34-30532 (Mar. 31, 1992); *In the Matter of American Express Company*, Release No. 34-23332 (June 17, 1986).

[23] *See, e.g.*, Final Rule: Plain English Disclosure, Release No. 33-7497 (Jan. 28, 1998) [63 FR 6370 at 6375] (*citing Gould v. American Hawaiian Steamship Company*, 331 F. Supp. 981 (D. Del. 1971); *Kohn v. American Metal Climax, Inc.*, 322 F. Supp. 1331 (E.D. Pa. 1970), *modified*, 458 F.2d 255 (3d Cir. 1972).)

[24] *See* 1989 Release, Part III.A.

[25] *See, e.g.*, Release No. 33-6711 (Apr. 24, 1987) [52 FR 13715 at 13717] ("an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company.").

[26] 1989 Release, Part III.A (*citing* Release No. 33-6349 (Sept. 28, 1981) 23 SEC Docket 962 at 964 [Release not published in the Federal Register]).

[27] Examples of such other factors, depending on the circumstances of a particular company, can include manufacturing plant capacity and utilization, backlog, trends in bookings and employee turnover rates. *See, e.g., Quality, Transparency, Accountability*, Lynn E. Turner, Chief Accountant, Securities and Exchange Commission, Remarks before Financial Executives Institute (Apr. 26, 2001), available at www.sec.gov/news/speech/spch485.htm.

Companies should also consider disclosing information that may be peripheral to the accounting function, but is integral to the business or operating activity. Examples of such measures, depending on the circumstances of a particular company, can include those based on units or volume, customer satisfaction, time-to-market, interest rates, product development, service offerings, throughput capacity, affiliations/joint undertakings, market demand, customer/vendor relations, employee retention, business strategy, changes in the managerial approach or structure, regulatory actions or regulatory environment, and any other pertinent macroeconomic measures. Because these measures are generally non-financial in nature, we do not believe that their disclosure generally

will raise issues under Item 10(e) of Regulation S-K [17 CFR 229.10(e)] or Item 10(h) of Regulation S-B [17 CFR 228.10(h)].

[28] *See Improving Business Reporting: Insights into Enhancing Voluntary Disclosures*, Steering Committee Report of the Business Reporting Research Project of the FASB (2001) available at www.fasb.org; the Jenkins Report; Financial Accounting Series Special Report, *Business and Financial Reporting, Challenges from the New Economy* (FASB) (2001) ("Special Report on Improving Business Reporting").

[29] *See* Special Report on Improving Business Reporting.

[30] *See*, *e.g.*, the Jenkins Report; the Special Report on Improving Business Reporting.

[31] *See* the Jenkins Report.

[32] *See*, *e.g.*, Item 303(a)(1) of Regulation S-K [17 CFR 229.303(a)(1)] (requiring the identification of "known trends or known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way"). *See also* Item 303(a)(2)(i) of Regulation S-K [17 CFR 229.303(a)(2)(i)] (requiring a description of registrant's material commitments for capital expenditures).

[33] *See* Securities Act Rule 408 [17 CFR 230.408], Securities Exchange Act of 1934 Section 10(b) [15 U.S.C. §78j(b)], Exchange Act Rule 10b-5 [17 CFR 240.10b-5], and Exchange Act Rule 12b-20 [17 CFR 240.12b-20]. *See also*, *In the Matter of Edison Schools, Inc.*, Release No. 34-45925 (May 14, 2002) (finding, among other things, that the company failed to provide accurate and complete disclosure about its reported revenues); *In the Matter of Sony Corporation and Sumio Sano*, Release No. 34-40305 (Aug. 5, 1998) (finding that the company violated Section 13(a) of the Exchange Act by making inadequate disclosures about the nature and the extent of Sony Pictures' net losses and their impact on the consolidated results Sony was reporting); *In the Matter of Caterpillar Inc.*, Release No. 34-30532 (Mar. 31, 1992) (finding failure to disclose the impact of a subsidiary's foreign operations on the company's results of operations violated Section 13(a) of the Exchange Act).

[34] Instruction 3 to Item 303(a) of Regulation S-K [17 CFR 229.303(a)].

[35] *See*, *e.g.*, Instruction 4 to Item 303(a) of Regulation S-K (indicating that repetition and line-by-line analysis is not required nor is it appropriate when the causes for a change in one line item also relate to other line items and indicating that, to the extent the changes from year to year are readily computable from the financial statements, the changes need not be recited in the discussion). The 1989 Release also addressed these points directly. *See* 1989 Release, Part III.D.

Where companies believe that information from the face of financial statements is helpful to readers in MD&A, they should consider using a tabular presentation that shows the decimal percentages of components or year-over-year percentage changes of the financial statement line items. An appropriate analysis of this data, to the extent that it is material, should accompany the tabular presentation consistent with the guidance in Section III.B.3 of this Release.

[36] *See* 1989 Release, Part III.E.

[37] *See* January 2002 Release at 3748 ("two assessments management must make where a trend, demand, commitment, event or uncertainty is known: 1. Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required. 2. If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur" (*citing* the 1989 Release)).

[38] *See* 1989 Release, Part III.B.

[39] In connection with our adoption of the off-balance sheet arrangements disclosure requirements, we eliminated a portion of the instructions in Item 303 of Regulation S-K that stated that registrants were not required to provide forward-looking information. Deleting that portion of the instructions did not affect requirements to provide forward-looking information in other circumstances where required or reduce the availability of any safe harbor for forward-looking information. *See also* 2003 Off-Balance Sheet Release. *See* Securities Act Section 27A [15 U.S.C. §77z-2], Securities Act Rule 175 [17 CFR 230.175], Exchange Act Section 21E [17 U.S.C. §78u-5], and Exchange Act Rule 3b-6 [17 CFR 240.3b-6].

[40] *See* Item 303(a)(1) and (2) of Regulation S-K [17 CFR 229.303(a)(1) and (2)].

[41] *See* January 2002 Release; 2003 Off-Balance Sheet Release.

[42] *See* 1989 Release, Part III.C. *See also* Item 303(a)(1) and (2) of Regulation S-K [17 CFR 229.303(a)(1) and (2)], and Instructions 2 and 5 thereto.

[43] Short-term liquidity is defined as a period of twelve months or less and long-term is defined as a period in excess of twelve months. *See* 1989 Release, Part III.C. Note that the period of time over which a long-term discussion of liquidity is relevant is dependent upon the timing of the cash requirements of a company, as well as the period of time over which cash flows are managed. A vague reference to periods in excess of twelve months may not be sufficient.

[44] *See* Item 303(a)(2)(i) of Regulation S-K [17 CFR 229.303(a)(2)(i)].

[45] *See* Item 303(a)(5) of Regulation S-K [17 CFR 229.303(a)(5)].

[46] For example, the cash requirements for items such as interest, taxes or amounts to be funded to cover post-employment (including retirement) benefits may not be included in the tabular disclosure, but should be discussed if material.

[47] For example, debt may have been issued to fund the construction of a

new plant, which will allow the company to expand its operations into a specific geographic area. Understanding that relationship and the expected commencement date of plant operations puts the cash requirement for the debt into an appropriate context to understand liquidity.

[48] Companies are reminded of their related disclosure obligations under Item 504 (Use of Proceeds) of Regulation S-K [17 CFR 229.504] and the requirement to update this disclosure in Item 701(f) (Use of Proceeds) of Regulation S-K [17 CFR 229.701(f)].

[49] *See* Instruction 4 to Item 303(a) of Regulation S-K [17 CFR 229.303(a)].

[50] *See* SFAS No. 95.

[51] Working capital is defined as current assets less current liabilities. *See* Chapter 3, AICPA Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins* (June 1953).

[52] To the extent that this change also materially impacts results of operations, discussion and analysis would also be required in that section, but companies should attempt to avoid unnecessary or confusing duplication.

[53] *See* Item 303(a) of Regulation S-K [17 CFR 229.303(a)].

[54] We believe that disclosure satisfying the requirements of MD&A can be made consistently with the restrictions of Section 5 of the Securities Act. *See, e.g.*, Securities Act Rules 135c [17 CFR 230.135c].

[55] *See* FASB Interpretation No. (FIN) 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (Nov. 2002); 2003 Off-Balance Sheet Release; and the discussion *infra,* regarding off-balance sheet arrangements.

[56] *See In the Matter of America West Airlines, Inc.*, Release No. 34-34047 (May 12, 1994) (finding that the company failed to discuss uncertainties regarding its ability to comply with covenants).

[57] Companies also must take a similar approach to discussion and analysis with respect to mandatory prepayment provisions, "put" rights and other similar provisions.

[58] December 2001 Release.

[59] *See* 2002 Critical Accounting Policies Proposal.

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U.S. Securities and Exchange Commission

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

Monitor of the Fortune 500 by the Division of Corporation Finance

In December 2001, the Division of Corporation Finance determined it would monitor the annual reports filed by all Fortune 500 companies with the Commission in 2002 as part of its process of reviewing financial and non-financial disclosures made by public companies. This summary discusses the principal subjects of comment by the Division on these 2002 reports. It is not intended to be an evaluation of the quality of disclosure, and the fact that an area of disclosure is not addressed should not be taken as an indication that we do not see issues or potential for improvement in other areas. As indicated in December 2001, the Division focused on disclosure that appeared to be critical to an understanding of each company's financial position and results, but which, at least on its face, seemed to conflict significantly with generally accepted accounting principles or SEC rules, or to be materially deficient in explanation or clarity. As a result of this focus, comments substantially concentrated on financial reporting, including financial statements and management's discussion and analysis.

Report of the Division of Corporation Finance

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

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

Management's Discussion & Analysis Generally

We found that we issued comments on the MD&A discussions of the Fortune 500 companies more than any other topic. Item 303 of Regulation S-K

requires a company to discuss its financial condition, changes in financial condition and results of operations. A company must include in this section a discussion of its liquidity, capital resources and results of operations. In particular, forward looking information is required where there are known trends, uncertainties or other factors enumerated in the rules that will result in, or that are reasonably likely to result in, a material impact on the company's liquidity, capital resources, revenues and results of operations, including income from continuing operations. A company must focus on known material events and uncertainties that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.

We issued a significant number of comments generally seeking greater analysis of the company's financial condition and results of operations. Our comments addressed situations where companies simply recited financial statement information without analysis or presented boilerplate analyses that did not provide any insight into the companies' past performance or business prospects as understood by management. In this vein, we sought information regarding the existence of known trends, uncertainties or other factors that required disclosure that was not included. We issued comments discouraging companies from providing rote calculations of percentage changes of financial statement items and boilerplate explanations of immaterial changes to these figures, encouraging them to include instead, a detailed analysis of material year-to-year changes and trends. In addition, we issued comments addressing key areas, in particular the related topics of liquidity, cash flow and capital resources, which were given insufficient attention. We will continue to focus on this section of disclosure documents in our review efforts and encourage all companies to present useful and meaningful disclosure of their financial condition and results of operations.

In addition to these general areas, we issued a significant number of comments regarding company or industry-specific MD&A disclosure, in particular comments posing specific questions relating to information presented in the financial statements that we believed warranted more discussion in the MD&A.

Critical Accounting Policy Disclosure

We asked a number of companies to present, or expand a current presentation of, a discussion of their critical accounting policies in their MD&A. In December 2001, the Commission released FR-60 and indicated that companies should provide more discussion in MD&A about their critical accounting policies. Under an appropriate heading, companies are encouraged to disclose their most difficult and judgmental estimates, the most important and pervasive accounting policies they use, and the areas most sensitive to material change from external factors, and to provide a sensitivity analysis to facilitate an investor's understanding of the impact on the bottom line.

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

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

We found that we asked many companies to enhance their disclosure of critical accounting policies in one or more of the following areas:

- Revenue recognition;
- Restructuring charges;
- Impairments of long-lived assets, investments and goodwill;
- Depreciation and amortization expenses;
- Income tax liabilities;
- Retirement and post retirement liabilities;
- Pension income and expense;
- Environmental liabilities;
- Repurchase obligations under repurchase commitments;
- Stock based compensation;
- Insurance loss reserves; and
- Inventory reserves and allowance for doubtful accounts.

Non-GAAP Financial Information

In a large number of comments, we addressed the use of non-GAAP financial information. In general, we asked companies either to remove non-GAAP financial measures, because we believed they were misleading or susceptible to misinterpretation, or to present them less prominently with better explanation and disclosure that is more balanced. We found that we directed many of these comments to financial services companies since they often presented "managed basis" or "normalized" financial information and related discussions in the MD&A. "Managed basis" information is GAAP-based information adjusted to reverse the sale of loans and other assets under securitization arrangements. Many companies often gave limited prominence to GAAP financial information and provided limited discussions of GAAP-based results of operations and changes in assets and liabilities. Companies that presented alternative or pro-forma statements of operations were asked to remove them. We also issued comments advising companies that GAAP-based financial information was required in MD&A and that they should provide GAAP-based performance discussions with equal or greater prominence than those based on non-GAAP measures.

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

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

The Commission's rules also amended Regulation S-K to codify certain staff positions regarding filings. Companies' 2002 filings, of course, pre-dated these requirements. We believe that comments we issued on 2002 filings have been generally consistent with the new rules. We recognize that the new disclosure requirements may affect how companies respond to

comments we have issued in this area. We will continue to monitor disclosure in this area, especially in light of these new rules that will be in effect beginning March 28, 2003.

Revenue Recognition

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

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

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

Restructuring Charges

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

Financial Statements

- We asked companies to include a period-by-period analysis of restructuring charges. We asked that this analysis include the original restructuring charge, cash payments made, non-cash charges used, reversals or adjustments to the charges and non-cash write-downs (impairments, etc.), and disclosure of the adjustment or reversal for each material component of the total restructuring charges.
- We asked companies to describe the facts and circumstances leading to the restructuring plan. We asked companies to provide a complete description of each component of total restructuring charges.
- We asked companies to more fully describe the timing of cash payments to be made under the restructuring plan and to disclose when they expected the restructuring plan to be complete.
- In several instances, we asked companies to highlight the nature and reasons for adjustments or reversals of restructuring charges.

MD&A

- We asked companies to expand their MD&A to include a reasonably detailed discussion of the events and decisions that gave rise to restructuring plans, and the reasonably likely material effects of management's plans on financial position, future operating results and liquidity.
- We asked companies to provide a discussion of the nature, amount and description for each material component of total restructuring charges. We also asked companies to identify the periods in which material cash outlays are anticipated, to identify the expected source of their funding, and to discuss material revisions to the plans, and the timing of the plan's execution, including the nature and reasons for any revisions.
- We asked companies to discuss the reasonably likely material effects on future earnings and cash flows resulting from the plans (for example, reduced depreciation, reduced employee expense, etc.). We asked companies to quantify and disclose these effects and to disclose when they expected those effects to be realized.

Impairment Charges

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

Impairment of Long-Lived Assets

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

- The specific assets that were impaired, including whether those assets were held for use or held for sale;
- The facts and circumstances (specific events and decisions) that led to the impairment charge; and
- The assumptions or estimates they used to determine the amount of the impairment charge.

Impairment of Securities Held for Investment

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

Impairment of Goodwill and Other Intangible Assets

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

Pension Plans

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

- The significant assumptions and estimates used to account for pension plans and how those assumptions and estimates are determined, for example the method (arithmetic/simple averaging, or geometric/compound averaging) and source of return data used to determine the expected return assumption and the assumptions, estimates and data source used to determine the discount rate;
- The effect that pension plans had on results of operations, cash flow and liquidity, including the amount of expected pension returns included in earnings and the amount of cash outflows used to fund the pension plan;
- Any expected change in pension trends, including known changes in the expected return assumption and discount rate to be used during the next year and the reasonably likely impact of the known change in assumption on future results of operation and cash flows;
- The amount of current unrecognized losses on pension assets and the estimated effect of those losses on future pension expense; and
- A sensitivity analysis that expresses the potential change in expected pension returns that would result from hypothetical changes to pension assumptions and estimates.

Segment Reporting

We issued a significant number of comments dealing with how companies determine their operating segments in their financial statements and MD&A. Under SFAS No. 131 and our rules, an operating segment is a component of a business, for which separate financial information is available that management regularly evaluates in deciding how to allocate resources and assess performance. SFAS No. 131 and our rules specify when a company must report separate financial information about an operating segment. We asked companies questions about their segment reporting disclosure. A number of companies inappropriately aggregated multiple segments, or did not adequately explain the basis for aggregating information. We also asked questions about the various aspects of SFAS No. 131 that specify specific disclosure requirements once the operating segments are identified.

Securitized Financial Assets and Off-Balance Sheet Arrangements

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

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

arrangements. We asked many companies to explain more fully in their MD&A the nature and accounting for off-balance sheet arrangements and to expand their footnote disclosure to specify the accounting for those arrangements. With the Commission's recent adoption of new disclosure requirements in this area and new financial interpretations by the Financial Accounting Standards Board regarding both accounting for and disclosure regarding guarantees and variable interest entities, we will continue to monitor accounting and disclosure in these areas.

Environmental and Product Liability Disclosures

We issued comments relating to environmental and product liability disclosure to a number of oil and gas and mining companies, as well as to several manufacturing companies. In these comments, we pointed the companies to the guidance in SFAS 5, FIN 14, SOP 96-1 and SAB 92, which generally provide that companies with environmental and product liabilities must disclose:

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

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

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Modified: 02/27/2003

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8569 / April 18, 2005

SECURITIES EXCHANGE ACT OF 1934
Release No. 51565 / April 18, 2005

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2232 / April 18, 2005

ADMINISTRATIVE PROCEEDING
File No. 3-11902

In the Matter of **The Coca-Cola Company,** **Respondent.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") as to The Coca-Cola Company ("Coca-Cola" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings and Imposing a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:[1]

RESPONDENT

1. Coca-Cola is a Delaware corporation headquartered in Atlanta, Georgia. Coca-Cola's common stock is registered with the Commission under Section 12(b) of the Exchange Act and trades on the New York Stock Exchange under the symbol KO. Coca-Cola is the largest manufacturer, distributor and marketer of nonalcoholic beverage concentrates and syrups in the world. Coca-Cola's reported net operating revenues for the past ten years have ranged between $16 billion and $22 billion.

2. Coca-Cola offered and sold securities in registered offerings during 1997, 1999 and 2000. Specifically, Coca-Cola conducted securities offerings pursuant to employee benefit plans and S-8 Registration Statements filed with the Commission in May 1997, May 1999 and April 2000, which incorporated by reference certain Forms 10-K, 10-Q and 8-K filed by Coca-Cola during this period.

RELEVANT ENTITY

3. The Coca-Cola (Japan) Company, Ltd. ("CCJC") is a Japanese corporation and wholly-owned subsidiary of Coca-Cola. CCJC is engaged in the marketing, manufacture and distribution of Coca-Cola beverage concentrate in Japan. Historically, CCJC is one of Coca-Cola's two or three greatest sources of net operating revenue and, on a per gallon of concentrate sold basis, CCJC is the most profitable operating division of Coca-Cola throughout the world.

COCA-COLA HAD AN ESTABLISHED HISTORY OF MEETING OR EXCEEDING EARNINGS EXPECTATIONS

4. From 1990 through 1996, Coca-Cola consistently met or exceeded earnings expectations while achieving a compound annual earnings per share growth rate of 18.3 percent – more than twice the average growth rate of the S&P 500. Coca-Cola's superior earnings performance resulted in its common stock trading at a price to earnings multiple ("P/E Ratio") of 38.1 by the end of 1996, as compared to the S&P 500's P/E Ratio of 20.8.

5. In the mid-1990s, Coca-Cola began experiencing increased competition and more difficult economic environments. Nevertheless, Coca-Cola publicly maintained between 1996 and 1999 that it expected its earnings per share to continue to grow between 15 percent and 20 percent annually.

[1] The findings herein are made pursuant to Coca-Cola's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

COCA-COLA "GALLON PUSHED" IN JAPAN TO MEET BUSINESS PLAN TARGETS AND EARNINGS EXPECTATIONS

6. At or near the end of each reporting period between 1997 and 1999, Coca-Cola, through its officers and employees implemented a "channel stuffing" practice in Japan known as "gallon pushing." In connection with this practice, CCJC asked bottlers in Japan to make additional purchases of concentrate for the purpose of generating revenue to meet both annual business plan and earnings targets. The income generated by gallon pushing in Japan was the difference between Coca-Cola meeting or missing analysts' consensus or modified consensus earnings estimates for 8 out of 12 quarters from 1997 through 1999.

7. To accomplish gallon pushing's purpose, at or near the end of reporting periods CCJC offered extended credit terms to bottlers, as described below, to induce them to purchase quantities of concentrate the bottlers otherwise would not have purchased until a following period. The quantities of concentrate CCJC sold to its bottlers in connection with a gallon push were in excess of the bottlers' forecasted demand; the bottlers nevertheless purchased the concentrate to preserve their relationships with Coca-Cola.

8. Concentrate sales by CCJC to its bottlers typically track and correspond to anticipated and actual bottler sales of finished products to retailers. Increases in the inventory level of concentrate held by bottlers often anticipate increases in sales of finished products. As a result of gallon pushing, however, concentrate inventory levels at CCJC's bottlers increased more than 60 percent from the start of 1997 through the close of 1999. During this same time, bottler sales of finished products to retailers only increased approximately 11 percent.

9. Coca-Cola estimated its bottlers' inventory levels, forecasted purchasing demand, and was aware that quarter-end gallon pushing likely could not continue at existing levels and likely would cause a corresponding reduction in sales in a future period. At no point between 1997 and 1999, however, did Coca-Cola publicly disclose to shareholders the existence of gallon pushing, the impact of gallon pushing on its current income, or the likely impact of gallon pushing on its future income.

COCA-COLA GALLON PUSHED ITS MOST PROFITABLE PRODUCTS

10. In connection with gallon pushes, bottlers primarily purchased only two products: Georgia Coffee, a canned flavored coffee beverage, and branded Coca-Cola ("Coke"). Georgia Coffee and Coke were typically two of the highest sales volume products for CCJC to its bottlers. Additionally, of Coca-Cola's major products, Georgia Coffee and Coke were two of the highest profit-margin per gallon products CCJC could include in a gallon push. From Coca-Cola and CCJC's perspective, therefore, in order to generate sales sufficient to meet the additional income targets, it was most efficient to push the bottlers to purchase additional gallons of Georgia Coffee and Coke.

11. For CCJC's bottlers, however, sales of Georgia Coffee and Coke to retailers were actually *declining* from 1997 through 1999. Hence, Coca-Cola, through CCJC, was inducing its bottlers to purchase quantities of concentrate that were in excess of forecasted sales demand for the current quarter.

12. Gallon pushing for the purpose of meeting earnings expectations occurred at no Coca-Cola operating division other than CCJC. As CCJC was Coca-Cola's single most profitable division throughout the world on a per gallon of concentrate sold basis, it was by far the most efficient location from which to push additional inventory for the purpose of managing earnings.

CCJC IMPLEMENTED GALLON PUSHING THROUGH THE USE OF EXTENDED CREDIT TERMS

13. To encourage bottlers to purchase additional concentrate, CCJC extended more favorable credit terms than usual to bottlers, typically increasing payment terms from eight to twenty-eight or thirty days. No rights of return on gallons sold pursuant to gallon pushing were offered to bottlers, and no concentrate sold pursuant to gallon pushing was returned to CCJC or Coca-Cola. All concentrate sold pursuant to gallon pushing was paid for by the bottlers.

14. CCJC's extension of credit terms required the express approval of certain of Coca-Cola's officers and employees in Atlanta. In order to obtain approval for credit extensions, CCJC's finance department was required to submit formal Requests for Authorization which identified both the approximate amount of gallons of concentrate to be sold with the extended credit terms and the approximate amount of revenue to be generated by the additional sales.

15. After receiving approved Requests for Authorization back from Atlanta, CCJC's finance department then contacted its bottlers' finance departments, offering the more favorable credit terms and requesting that the bottlers purchase specific quantities of concentrate above the amounts that the bottlers already had planned to purchase to meet forecasted demand for the period. In contrast to sales made in connection with a gallon push, routine concentrate sales involved CCJC's sales and marketing departments corresponding with the bottlers' purchasing departments.

COCA-COLA'S RECURRING USE OF GALLON PUSHING TO MEET ITS BUSINESS PLAN TARGETS AND EARNINGS ESTIMATES

16. Gallon pushing shifted concentrate purchases that bottlers would have made in a future period into the then current period. As a result, the previous period's gallon push caused bottlers to start the next quarter with more inventory than they anticipated needing to meet forecasted demand and caused CCJC to start the future period with a sales "deficit." In order to avoid selling less concentrate in the future period as a result of the previous period's gallon push, and having to lower income targets, Coca-Cola instead would engage in another gallon push, again shifting future sales and income to the present period.

17. CCJC's gallon pushing practice was incorporated into its annual business plans – not simply for the purpose of increasing sales and meeting Coca-Cola's *future* earnings targets, but also to prevent a decrease in concentrate sales and corresponding decrease in earnings in the *present* period. Gallon pushing therefore became a recurrent component of CCJC's annual business plan as Coca-Cola refused to allow CCJC to suffer the sales and income declines resulting from a prior gallon push.

18. The chart below shows the estimated volume of gallons pushed and revenue generated thereby for each quarter from 1997 through 1999. In order to meet annual business plan targets and consolidated earnings estimates CCJC continually had to push more and more gallons of concentrate on the bottlers. At the end of the fourth quarter of 1999, nearly one out of every two gallons of concentrate held in inventory by CCJC's bottlers had been sold in connection with a gallon push.

Reporting Period	Bottlers Ending Inventory (in gallons)	Gallons Pushed	Revenue Generated from Gallon Push
Q1 1997	15,571,000	3,317,000	$46,201,000
Q2 1997	18,408,000	4,380,000	$64,850,000
Q3 1997	17,569,000	3,012,000	$62,949,000
Q4 1997	20,016,000	8,090,000	$131,541,000
Q1 1998	15,180,000	1,000,000	$17,061,000
Q2 1998	20,363,000	7,117,000	$98,253,000
Q3 1998	17,526,000	5,171,000	$79,807,000
Q4 1998	21,800,000	9,659,000	$181,331,000
Q1 1999	17,053,000	4,180,000	$67,644,000
Q2 1999	23,544,000	8,181,000	$126,131,000
Q3 1999	18,833,000	7,105,000	$128,519,000
Q4 1999	22,017,000	10,116,000	$208,900,000

GALLON PUSHING INCREASED BOTTLER INVENTORY LEVELS BEYOND WHAT WAS NECESSARY TO MEET FORECASTED DEMAND FOR THE PERIOD

19. For year end 1996 through year end 1999, bottler sales of finished products to retailers in Japan increased approximately 11 percent in the aggregate amount. As sales of finished products by bottlers drive the sale of concentrate by CCJC, inventory levels at CCJC's bottlers should have increased approximately by a corresponding amount during this same time period. Gallon pushing, however, caused bottler inventory levels to increase 62 percent during this time period – a rate approximately six times greater than the increase in bottler sales to retailers. Hence, gallon pushing resulted in Japanese bottlers carrying significantly higher levels of inventory than was necessary to meet forecasted demand in the current quarter.

20. The concentrate inventory versus sales of finished products disparity was even greater with respect to Georgia Coffee and Coke. Given that sales by bottlers to retailers of Georgia Coffee and Coke were in fact declining between 1997 and 1999, inventory levels of Georgia Coffee and Coke should have declined as well. Yet, it was gallon pushed sales of Georgia Coffee and Coke concentrate alone that were causing the bottlers' overall inventory levels to rise six times faster than their overall sales of finished products to retailers.

COCA-COLA'S GALLON PUSHING PUT FUTURE INCOME AT RISK

21. CCJC forecasted and tracked its actual results against its annual business plan throughout the year in monthly "rolling estimates." In addition to containing balance sheet and income statement information, CCJC's rolling estimates included concentrate sales to bottlers, bottlers' sales to retailers, and estimated bottlers' inventory levels.

22. CCJC's rolling estimates also included summary sections explaining any substantial variances within the rolling estimate as compared to the preexisting annual business plan. These variance summaries typically indicated that in the first and second month of reporting periods between 1997 and 1999, gallon sales of concentrate and the corresponding income generated by these concentrate sales were lower than expected as a result of gallon pushing in the prior period. The rolling estimates further illustrated that gallon pushing during the third and final month of a reporting period was necessary for CCJC to return to the sales and income targets contained within its annual business plan.

23. The monthly rolling estimate analyses submitted by CCJC illustrate that gallon pushing during one reporting period negatively impacted the concentrate sales and income that would be generated in the following reporting period.

24. CCJC also generated internal bottler inventory reports and bottler sales reports, typically broken down into "major brand" categories. The bottler inventory reports indicated that bottlers were carrying inventory levels of Georgia Coffee and Coke that, even considering their higher sales volume as compared to other products, were in excess of all other products. The bottler sales reports further indicated that although Georgia Coffee and Coke were two of the highest volume products for bottlers, overall bottler sales of Georgia Coffee and Coke were in fact decreasing compared to prior periods.

25. Moreover, since gallon pushing was designed to address earnings shortfalls rather than actual forecasted demand for the current quarter, gallon pushing increased bottler inventories of Georgia Coffee and Coke beyond what bottlers required to satisfy demand for the period.

26. During 1999, bottler inventory levels had increased to the point that gallon pushing could no longer be implemented at desired levels. In May 1999, a request from Coca-Cola was made to CCJC for a specific amount of income to be generated to assist Coca-Cola in eliminating a consolidated earnings shortfall for the second quarter. CCJC declined the request because CCJC had already incorporated and planned a gallon push as part of meeting its annual business plan and thought that it was impractical for bottlers to purchase even more concentrate to address Coca-Cola's anticipated earnings shortfall.

27. During the fourth quarter of 1999, CCJC conducted its largest gallon push – generating revenue in excess of $208 million. This fourth quarter 1999 gallon push contributed roughly $0.02 to Coca-Cola's consolidated earnings and, absent one time items, enabled Coca-Cola to meet its modified earnings expectations. While in the process of implementing this gallon push, employees of CCJC's finance department contacted officers and employees of Coca-Cola and informed them that gallon pushing had reached its maximum limit and was not sustainable at existing levels. Coca-Cola's future inability to gallon push at existing levels necessitated that gallon pushing either significantly decrease in scope or cease entirely – either of which would result in a substantial decrease in revenue and income flowing to Coca-Cola from CCJC.

28. At no time between 1997 and 1999 did Coca-Cola disclose any information from which investors could determine the existence of gallon pushing, the impact of such gallon pushing on current income, or the likely impact of gallon pushing on future income.

COCA-COLA ISSUED A FORM 8-K CONTAINING FALSE AND MISLEADING STATEMENTS

29. On January 26, 2000, Coca-Cola filed a Form 8-K with the Commission which disclosed, among other things, a worldwide concentrate inventory reduction planned to occur during the first half of the year 2000. The inventory reduction was to be accomplished by Coca-Cola's operating divisions, specifically including CCJC, ceasing to sell concentrate to bottlers until bottlers naturally reduced their inventory to purported "optimum" levels. The impact on Coca-Cola's earnings for the first and second quarter of 2000 was estimated to be between $0.11 and $0.13 per share.

30. In describing the inventory reduction, Coca-Cola stated that: (a) "[t]hroughout the past several months, [Coca-Cola had] worked with bottlers around the world to determine the optimum level of bottler inventory;" (b) the management of Coca-Cola and its bottlers, specifically including bottlers in Japan, had jointly determined "that opportunities exist to reduce concentrate inventory carried by bottlers;" and (c) certain bottlers throughout the world, specifically including those in Japan, had "indicated that they intend to reduce their inventory levels during the first half of the year 2000."

31. These statements are false and misleading as a review of inventory levels in the context of determining an optimum level for bottlers had not occurred throughout the past several months. Such a review did not take place until, at the earliest, January 2000 – immediately after the fourth quarter 1999 gallon push had occurred and CCJC finance employees had informed Coca-Cola that gallon pushing could not continue at existing levels. Moreover, Coca-Cola did not identify a single bottler that, prior to the Form 8-K being filed, was aware of any planned inventory reduction.

32. The Form 8-K further is misleading in that, despite its language describing the inventory reduction as a joint proactive efficiency measure between Coca-Cola and its bottlers, the inventory reduction was in fact solely a Coca-Cola initiative. In addition, the Form 8-K did not disclose that of the estimated $0.11 to $0.13 impact to earnings for the Company as a whole, more than $0.05 would be attributable to an anticipated reduction of sales for Japan. CCJC's portion of the estimated gross profit impact was more than five times greater than that of any other operating division in the world.

COCA-COLA'S VIOLATIONS OF SECTIONS 17(A)(2) AND 17(A)(3) OF THE SECURITIES ACT

33. Sections 17(a)(2) and 17(a)(3) of the Securities Act prohibit making untrue statements of fact and misleading omissions of facts in the offer or sale of a security. Section 17(a)(2) specifically proscribes obtaining "money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." Section 17(a)(3) specifically proscribes engaging "in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." To constitute a violation of Sections 17(a)(2) and 17(a)(3), the alleged untrue statements or omitted facts must be material. Information is deemed material upon a showing of a substantial likelihood that the misrepresented or omitted facts would have assumed significance in the investment deliberations of a reasonable investor. Basic, Inc. v. Levinson, 485 U.S. 224 (1988). Establishing violations of Sections 17(a)(2) and 17(a)(3) does not require a showing of scienter; negligence is sufficient. Aaron v. SEC, 446 U.S. 680 (1980); SEC v. Hughes Capital Corp., 124 F.3d 449, 453-54 (3d Cir. 1997).

34. As set forth above, Coca-Cola's Forms 10-K and 10-Q for the reporting periods between 1997 and 1999, certain of which were incorporated by reference in Coca-Cola's S-8 Registration Statements filed with the Commission, were misleading in that they failed to disclose within Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), or anywhere else within such filings, the existence of gallon pushing, the impact on Coca-Cola's current income of gallon pushing, and the likely impact of gallon pushing on its future income. In addition to the substantial likelihood that in making a decision regarding an investment in Coca-Cola, a reasonable investor, or potential investor, would have wanted to know of the existence and purpose of gallon pushing as an end of period sales practice, gallon pushing was further material in that in 8 out of 12 reporting periods from 1997 to 1999 and 6 out of 8 reporting periods from 1998 to 1999, it provided the income necessary for Coca-Cola to meet its modified earnings expectations.

35. The investing public and analysts following Coca-Cola could not discern this information from the public disclosures made by the Company. Based on the conduct described above, Coca-Cola violated Sections 17(a)(2) and 17(a)(3) of the Securities Act with respect to its Forms 10-K and 10-Q filed with the Commission between 1997 and 1999 and incorporated by reference into its S-8 Registration Statements filed with the Commission between 1997 and 2000.

36. As set forth above, Coca-Cola's January 26, 2000, Form 8-K filed with the Commission contained false statements concerning the existence of a several month long optimum inventory study conducted as a joint effort between Coca-Cola and its bottlers. Additionally, the Form 8-K was misleading by omission as it failed to disclose the impact of past gallon pushing practices in Japan in the context of the planned inventory reduction. There is a substantial likelihood that the false statements surrounding the inventory reduction and misleading omissions regarding gallon pushing within the Form 8-K would have assumed significance in the investment deliberations of a reasonable investor. Based on the conduct described above, Coca-Cola violated Sections 17(a)(2) and 17(a)(3) of the Securities Act with respect to its January 26, 2000 Form 8-K filed with the Commission and incorporated by reference into its S-8 Registration Statements filed between 1997 and 2000.

COCA-COLA'S REPORTING VIOLATIONS: SECTION 13(a) OF THE EXCHANGE ACT AND RULES 12b-20, 13a-1, 13a-11, AND 13a-13 THEREUNDER

37. Section 13(a) of the Exchange Act requires issuers such as Coca-Cola to file periodic reports with the Commission containing such information as the Commission prescribes by rule. Exchange Act Rules 13a-1, 13a-11, and 13a-13 require, respectively, issuers to file Forms 10-K, 8-K, and 10-Q. Under Exchange Act Rule 12b-20, the reports must contain, in addition to disclosures expressly required by statute and rules, such other information as is necessary to ensure that the statements made are not, under the circumstances, materially misleading. The obligation to file reports includes the requirement that the reports be true and correct. United States v. Bilzerian, 926 F.2d 1285, 1298 (2d Cir. 1991). The reporting provisions are violated if false and misleading reports are filed. SEC v. Falstaff Brewing Corp., 629 F.2d 62, 67 (D.C. Cir. 1980). Scienter is not an element of a Section 13(a) violation. SEC v. Savoy Indus., Inc., 587 F.2d 1149,1167 (D.C. Cir. 1978).

38. As set forth above, Coca-Cola's Forms 10-K and 10-Q for the reporting periods between 1997 and 1999 were materially misleading because they failed to disclose the existence of gallon pushing, the impact of gallon pushing on current earnings, and the likely impact of gallon pushing on future earnings.

39. Additionally, Regulation S-K Item 303 requires registrants to disclose in the MD&A sections of required periodic filings "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material … unfavorable impact on net sales or revenues or income from continuing operations." The failure to comply with Regulation S-K constitutes a violation under Section 13(a) of the Exchange Act.

40. Contrary to the requirements of Regulation S-K, Coca-Cola failed to disclose the material impact of gallon pushing on current and future income within its required MD&A sections.

41. As set forth above, Coca-Cola's Form 8-K filed with the Commission on January 26, 2000 was materially false and misleading.

42. Based on the conduct described above, Coca-Cola violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder.

REMEDIAL EFFORTS

43. In determining to accept the Offer, the Commission considered the following remedial efforts that the Respondent initiated prior to and during the Commission staff's investigation:

a. Coca-Cola has established an Ethics & Compliance Office to administer its Code of Business Conduct and ensure, among other things, that the Respondent conducts its business in compliance with the Code of Business Conduct and with various laws;

b. Coca-Cola has established a Disclosure Committee to assist its Chief Executive Officer and Chief Financial Officer in fulfilling their responsibility for oversight of the accuracy and timeliness of the disclosures made by Coca-Cola;

c. Coca-Cola now requires that its divisions certify quarterly that they have not changed or extended payment terms for any bottler or customer and have not granted any special or unusual credit terms or incentives to any bottler or customer, unless they received approval for such terms; and

d. Coca-Cola's Audit Committee employs independent counsel experienced in securities laws disclosure issues and will continue to employ such experienced legal counsel chosen by the Audit Committee. Such counsel shall advise the Audit Committee as to implementation of the undertakings in this Order.

UNDERTAKINGS

44. Respondent has undertaken to:

a. Permanently maintain the aforementioned remedial efforts or the functional equivalents thereof, except as may be approved by the Commission;

b. Require the Audit Committee, within 90 days of the date of this Order, to review with management of Respondent the process by which the MD&A sections of periodic reports filed by Respondent with the Commission are prepared and material information about the business and prospects, including but not limited to, trend information and known events and uncertainties that may have a material impact on liquidity or future financial performance, is identified for discussion in the MD&A sections of such reports, and to approve a set of criteria to be used by the Disclosure Committee and management to reasonably assure that appropriate items are identified and discussed. The Audit Committee will meet periodically, at least annually, with the Chair of the Disclosure Committee to review such criteria, and will review and discuss with the Chief Financial Officer the proposed MD&A section of each periodic report to be filed with the Commission;

c. Require the Disclosure Committee to: (i) use the aforementioned criteria to identify items that might need to be disclosed within the MD&A section of Respondent's periodic reports filed with the Commission; and (ii) use the aforementioned criteria to evaluate those items and recommend whether, and to what extent, disclosure is appropriate with respect to each item. The Chair of the Disclosure Committee will also report to the Audit Committee, on a quarterly basis, any recommended departures from the aforementioned criteria and the rationale supporting each such recommendation;

d. Adhere to the guidance articulated in SEC Staff Accounting Bulletin No. 101 on disclosures that are required with respect to the recognition of revenue;

e. Maintain for ten (10) years documentation sufficient to show for every of its Forms 8-K filed with the Commission, the preparers of each Form 8-K and those persons who reviewed and approved each Form 8-K; and

f. Provide a written report, within 120 days of the date of this Order, to the Commission staff that details the Respondent's implementation of the undertakings articulated herein.

45. In determining whether to accept the Offer, the Commission has considered the remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions specified in Respondent Coca-Cola's Offer.

ACCORDINGLY, IT IS HEREBY ORDERED:

Pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Coca-Cola cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act and Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder.

By the Commission.

Jonathan G. Katz
Secretary

U.S. Securities and Exchange Commission

Executive Compensation: A Guide for Investors

The federal securities laws require clear, concise and understandable disclosure about the amount and type of compensation paid to chief executive officers and other highly compensated executives of public companies. This brochure is designed to help you locate this compensation information in company reports. For tips on finding other information about a company, see Getting Information About Companies.

How to use this publication

This guide is divided into the following sections:

This publication is intended for the benefit of investors. Issuers should not rely on this brochure. The rules governing issuer disclosure of information about executive compensation are contained in Item 402 of Regulation S-K.

I. What Are Some Types of Executive Compensation?

Executive compensation takes many forms. It can include:

- salary;
- bonus;
- perquisites (or "perks") and other personal benefits;
- stock;
- stock options;
- other compensation arrangements.

II. What Information about Executive Compensation Is Filed with the SEC?

In 1992, the Commission adopted amendments to the executive officer and director compensation disclosure requirements applicable to proxy statements, periodic reports (such as annual reports on Forms 10-K), and registration statements. These amendments were designed to furnish a more understandable presentation of the nature and extent of compensation to executive officers and directors.

The linchpin of the Commission's executive compensation disclosure is the Summary Compensation Table. This tabular, three-year summary provides investors with a comprehensive, formatted presentation of compensation information regarding a company's chief executive officer and most highly-compensated executive officers. It provides an easily understood overview of executive compensation from which investors can review a company's executive compensation for the last three fiscal years, identify trends, and compare those trends with industry trends. The Summary Compensation Table is then followed by tables containing more specific data on the components of compensation for the last completed fiscal year. Additional information about a company's executive compensation policies can be found in the company's annual proxy statement.

The federal regulations governing disclosure of information about executive compensation are contained in Item 402 of Regulation S-K, a copy of which is available on the SEC's website at http://www.sec.gov/divisions/corpfin/forms/regsk.htm. Regulation S-K sets out disclosure requirements for proxy statements, registration statements, reports and other materials filed under the Securities Act of 1933 and the Securities Exchange Act of 1934.

III. Where Can I Find Information about Executive Compensation?

Several types of documents that a company files with the Commission include information about the company's executive compensation policies and practices. You can locate information about executive pay in:

1. the company's annual proxy statement;
2. the company's annual report on Form 10-K; and
3. registration statements filed by the company to register securities for sale to the public.

The easiest place to look is probably the annual proxy statement. (This is because of the three types of documents — annual proxy statements, annual reports on Form 10-K, and registration statements — the annual proxy statement is generally the shortest and so the information about compensation is very easy to locate.) The information about executive compensation in the annual proxy statement is quite comprehensive. With some exceptions, much of the same disclosure is required in the annual report on Form 10-K and in registration statements, and will appear there or will refer you to the information in the annual proxy statement.

This guide begins by walking you through the compensation information generally available in a company's annual proxy statement. When companies propose the election of directors, which most companies do in their annual proxy statements, they are required to furnish information about the compensation of directors and highly-compensated executive officers.

Proxy Statements

How can I obtain a copy of a company's annual proxy statement?

If you are a shareholder of the company, the company is required to send you a copy of its annual proxy statement prior to its annual meeting of shareholders each year. Generally, the proxy statement is sent to shareholders between 10 — 60 days prior to the date of the meeting. If your shares are held in a brokerage account or in a similar capacity (see Holding Your Securities — Get the Facts), the proxy statement first will be sent to your brokerage firm that will then forward the document to you. If you have agreed to receive corporate documents electronically, the proxy statement will either be transmitted to you or otherwise made available to you in the manner to which you have previously agreed.

A company also is required to file its annual proxy statement with the SEC no later than the date proxy materials are first sent or given to shareholders. The company files this document using the SEC's database known as **EDGAR**. You can access the

EDGAR database through the SEC's website — http://www.sec.gov/. Simply go to the section of the SEC's home page entitled "Filings and Forms (EDGAR)" and click on "Search for Company Filings." On the resulting screen entitled "Search EDGAR Database," click on "Companies and Other Filers." Enter the name of the company and then click "Find Companies." Select the appropriate company to view its SEC filings.

To view the annual proxy statement, select the most recent filing entitled "DEF 14A." It's called a "DEF 14A" because it's the "definitive," or final, proxy statement (as opposed to a preliminary proxy statement). "14A" refers to the fact that proxy statements are filed pursuant to Section 14(a) of the Securities Exchange Act of 1934.

You can also search the EDGAR database by Central Index Key (CIK) number. A CIK is the unique number that the SEC's computer system assigns to individuals and corporations who file disclosure documents with the SEC. All new electronic and paper filers, foreign and domestic, receive a CIK number. You don't need to know a company's CIK, but searching by that number will narrow your search to the exact company you want.

What information is available in proxy statements about executive compensation?

In the annual proxy statement, a company must disclose information concerning compensation paid to its chief executive officer and most highly-compensated executive officers during the last fiscal year. A company also must disclose the criteria used in reaching compensation decisions and the degree of the relationship between the company's compensation practices and corporate performance. This information can be found in several separate disclosure items. Those items, listed in the order they often appear in proxy statements, include:

- Summary Compensation Table;
- Option/SAR Grants Table;
- Option/SAR Exercises and Year-End Value Table;
- Long-Term Incentive Plans Award Table;
- Pension Plan Disclosure;
- disclosure about director compensation;
- disclosure about employment contracts and related arrangements;
- Option/SAR Repricing Table and related information;
- disclosure about compensation committee interlocks and insider participation in compensation decisions;
- Board Compensation Committee Report on Executive Compensation; and
- Performance Graph.

The Summary Compensation Table

What is the Summary Compensation Table?

The Summary Compensation Table is the cornerstone of the SEC's required disclosure on executive compensation. The Summary Compensation Table provides, in a single location, a comprehensive overview of a company's executive pay practices. The Summary Compensation Table sets forth the actual compensation paid by the company to each of the named executive officers during the last three completed fiscal years.

In two instances, the disclosure provided in the table may be reduced. First, if a company has not been subject to the reporting requirements of the Securities Exchange Act of 1934 for the prior three years, the table need only cover the shorter period that the company has been a reporting company, but must cover at least the last completed fiscal year. Second, if an individual who was a named executive officers during the last completed fiscal year was not an executive officer of the company at any time during one of the earlier years that is covered by the table, information about that individual's compensation for that year need not be disclosed.

What information is included in the Summary Compensation Table?

The table divides the compensation of the named executive officers into two broad categories — annual compensation and long-term compensation.

Annual Compensation

The disclosure about annual compensation includes:

- base salary;
- bonus; and
- other annual compensation, which includes:
    - perquisites (or "perks") and other personal benefits, securities or property
    - above-market or preferential earnings paid (or payable but deferred at the election of the executive officer) on deferred compensation, restricted stock, stock options or stock appreciation rights;
    - earnings paid (or payable but deferred at the election of the executive) on long-term incentive plan compensation;
    - amounts reimbursed for the executive for the payment of taxes; and
    - preferential discounted stock purchases.

Information about base salary and bonus must be identified and disclosed separately.

Other annual compensation may be aggregated and reported as a single amount.

Perquisites (or "perks") and other personal benefits are reportable only when the total incremental cost to the company of such perquisites or other personal benefits exceeds $50,000 or 10% of the executive officer's annual base salary and bonus. Additional disclosure is required when one of the perquisites has a value in excess of 25% of the total amount of perquisites reported. Then the type and amount is required to be disclosed.

Long-term Compensation

The disclosure about long-term compensation covers:

- restricted stock awards;
- stock option and free-standing stock appreciation right grants;
- long-term incentive plan payouts; and

- any other compensation.

A **long-term incentive plan** provides compensation that is intended to serve as an incentive for performance to occur over a period longer than one fiscal year. Payouts under these plans are reported in the Summary Compensation Table.

Any other compensation includes, but is not limited to, disclosure of compensation related to:

- retirement or other plans related to termination of employment;
- a change in control of the company;
- above-market or preferential earnings that are not paid (or payable) on deferred compensation, restricted stock, stock options or stock appreciation rights;
- earnings that are not paid (or payable) on long-term incentive plan compensation;
- company contributions to vested or unvested defined contribution plans;
- company payment of insurance premiums for term life insurance for the benefit of a named executive officer.

The Option/SAR Grants Table

What is the Option/SAR Grants Table?

The Option/SAR Grants Table provides information about stock option and free-standing stock appreciation rights (SAR) grants made during the last fiscal year to each of the named executive officers. Unlike the Summary Compensation Table (which covers the past three years), this table covers only the last completed fiscal year, and each stock option and SAR grant must be identified and discussed separately (unless the grants have the same exercise price and expiration date and are not subject to different performance thresholds).

What information is included in the Option/SAR Grants Table?

The table includes, for each grant to a named executive officer:

- the number of shares of stock underlying the stock option or SAR;
- the percentage the grant represents of the total number of stock options and SARs granted to all employees during the last fiscal year;
- the per-share exercise price of the stock option or SAR;
- if the stock option or SAR has been granted at a discount, the market price of the company's stock on the date of grant; and
- the expiration date of the stock option or SAR.

To aid shareholders in understanding the potential value of each stock option and SAR granted by the company, the table also includes either the "potential realizable value" or the "grant date value" of the grants.

The "potential realizable value" of a stock option or SAR is an estimate of what the shares of stock underlying the option or SAR would be worth assuming that the company's stock appreciated at rates of 5% and 10% annually, compounded over the term of the option or SAR. For a stock option or SAR with a 10-year term (which is customary), this translates into potential appreciation of 63% and 159% from the market price of the company's stock on the date of grant. A company that elects to disclose the "potential realizable value" of its stock option and SAR grants also may estimate the potential value of the option or SAR shares using other assumed rates of return (such as the company's historic rate of return), but must provide the estimates using the assumed 5% and 10% rates.

The "grant date value" of a stock option or SAR is an estimate of the value of the option or SAR computed under a valuation formula (such as the Black-Scholes option-pricing model) selected by the company. A company that elects to disclose the "grant date value" of its stock option and SAR grants also must describe the valuation method that it used to make the estimates and any related material information including the assumptions used in the applicable model.

A footnote to the table must set forth the material terms of each stock option and SAR grant, including the date they become exercisable, and describe any standard or formula that may cause the exercise price of an option or SAR to be adjusted (including indexing or premium pricing provisions), as well as any provision that could cause the exercise price to be reduced.

The Option/SAR Exercises and Year-End Value Table

What is the Option/SAR Exercises and Year-End Value Table?

The **Option/SAR Exercise and Year-End Value Table** provides information about stock option exercises, as well as exercises of free-standing stock appreciation rights (SARs), that occurred during the last fiscal year for each of the named executive officers. Unlike the Summary Compensation Table (which covers the last three years), this table covers only the last completed fiscal year, and all exercises are aggregated and reported as a single amount.

What information is included in the Option/SAR Exercises and Year-End Value Table?

The table includes:

- the number of shares of stock received upon exercise (or, if no shares were received, the number of shares of stock for which the stock optio or SAR was exercised); and
- the aggregate dollar amount realized upon exercise.

If a named executive officer holds unexercised stock options or SARs, the table also includes:

- the total number of unexercised stock options and SARs held at the end of the last completed fiscal year (separately identifying the exercisable and unexercisable portions); and
- the aggregate dollar value of the "in-the-money" unexercised stock options and SARs held at the end of the last completed fiscal year (separately identifying the exercisable and unexercisable portions).

The Long-Term Incentive Plan Awards Table

What is the Long-Term Incentive Plan Awards Table?

The Long-Term Incentive Plan Awards Table provides information about any long-term incentive awards made during the last fiscal year to each of the named executive officers. A Long-Term Incentive Plan, or LTIP, provides compensation intended to serve as incentive for performance over a period longer than one fiscal year. Often awards are made in one year and paid out in future years if

predetermined performance criteria for those years are met. These payouts are reported in the Summary Compensation Table.

What information is included in the Long-Term Incentive Plan Awards Table?

The table includes, for each award:

- the number of shares of stock, units or other rights awarded under each long-term incentive plan and, if applicable, the number of shares of stock underlying each unit or right;
- the performance or other time period until payout or maturation of the award (the so-called "earn-out period"); and
- the dollar value of the estimated payout, the number of shares to be awarded as the payout or a range of estimated payouts denominated in dollars or number of shares under the award (threshold, target and maximum amount), unless the payout is based on stock price.

A footnote to the table must describe the material terms of each award, including a general description of the formula or criteria to be used in determining the amounts payable. In order to protect sensitive or confidential business information related to the performance goals, a company may use general statements when describing the performance aspects of the award.

Pension Plan Disclosure

Estimated post-retirement benefits for executives under pension and other defined benefit or actuarial plans are reported separately from the Summary Compensation Table. All prospective benefits to each of the named executive officers under all defined benefit plans are required either to be (i) included in the Pension Plan Table for the principal retirement plan, or in a separate table for the supplemental and excess benefit plans (if benefits are determined by final compensation and years of service), or (ii) described in narrative format (if benefits are determined by some other method). The disclosure should be presented in a manner so that all benefits to which the named executive officers will be entitled upon retirement under actuarial and defined benefit plans (funded and unfunded) can be determined.

Disclosure about Director Compensation

What information is available about director compensation?

A company must provide information, including specific amounts, about the standard arrangements under which members of its board of directors are compensated for the services that they provide to the company as directors. This disclosure must include the additional amounts, if any, that the directors receive for serving on board committees or that they receive for taking on special assignments. Other arrangements under which directors were compensated during the last completed fiscal year for any service provided as a director also must be disclosed, stating both the name of the director and the amount paid.

Disclosure about Employment Contracts and Related Arrangements

What information is available about employment contracts and related arrangements?

Companies must disclose information about the terms and conditions of employment contracts with named executive officers. These contracts typically are filed as exhibits to the company's annual report on Form 10-K. In addition, a company must describe the terms and conditions of any other compensatory plan or arrangement with any of the named executive officers if

- the amount involved, including all periodic payments and installments, exceeds $100,000; and
- the plan or arrangement is triggered by:
  - the resignation, retirement or any other termination of the executive officer's employment;
  - a change in control of the company; or
  - a change in the executive officer's responsibilities following a change in control of the company.

Option/SAR Repricing Table and Related Information

What information is available about stock option/SAR repricings?

If, during the previous fiscal year, a company reprices any stock option or stock appreciation right (SAR) held by a named executive officer, then, in the annual proxy statement, the company must provide information about the transaction, including a report explaining the repricing and an Option/SAR Repricing Table.

What information is included in the Option/SAR Repricing Report?

In the event of a repricing of any stock option or SAR held by a named executive officer, a company must include in its annual proxy statement a report from the compensation (or similar) committee of the company's board of directors explaining the terms and conditions of the repricing, as well as the basis for the repricing.

The report is to be made over the name of each member of the compensation (or similar) committee.

What information is included in the Option/SAR Repricing Table?

The Option/SAR Repricing Table provides information about each repricings of stock options and SARs held by any executive officer during the last 10 years, including:

- the name and position of each executive officer participating in the repricing;
- the date of the repricing;
- the number of shares of stock underlying replacement or amended stock options or SARs;
- the per-share market price of the underlying shares of stock at the time of repricing;
- the original exercise price of the cancelled or amended stock option or SAR;
- the per-share exercise price or base price of the replacement stock option or SAR; and
- the amount of time remaining before the replaced or amended stock option or SAR would have expired.

The table does not need to include information about repricings that took place before the company became a reporting company under the Securities Exchange Act of 1934.

Disclosure about Compensation Committee Interlocks and Insider Participation in Compensation Decisions

What information is available about the compensation committee interlocks and insider participation in compensation decisions?

In the annual proxy statement, a company must identify each person who served as a member of the compensation (or similar) committee of the company's board of directors during the last completed fiscal year and disclose whether any committee member:

- was an officer or employee of the company or any of its subsidiaries during the fiscal year;
- was formerly an officer of the company or any of its subsidiaries; or
- had any relationship requiring disclosure by the company under the SEC's rules requiring disclosure of "related party" transactions.

If the company has no compensation (or similar) committee, the company must identify each officer and employee of the company, and any former officer of the company, who, during the last completed fiscal year, participated in deliberations of the company's board of directors concerning executive officer compensation.

The company also must provide information about any "interlocking" relationships that existed during the last completed fiscal year. These are "interlocking" relationships:

- if an executive officer of Company A (the company filing the proxy statement) served as a member of the compensation committee of Company B and one of the executive officers of Company B served on the compensation committee Company A;
- if an executive officer of Company A (the company filing the proxy statement) served as a director of Company B and one of the executive officers of Company B served on the compensation committee of Company A; and
- if an executive officer of Company A (the company filing the proxy statement) served as a member of the compensation committee of Company B and one of the executive officers of Company B served as a director of Company A.

Board Compensation Committee Report on Executive Compensation

What information is available about the compensation decisions of a company's board of directors?

In the annual proxy statement, a company must include a report from the compensation (or similar) committee of the company's board of directors on the company's executive compensation policies and practices. The report should discuss the compensation policies applicable to the company's executive officers (including the named executive officers), including the specific relationship of corporate performance to executive compensation. The report also should disclose the bases for the compensation paid for the last completed fiscal year to the company's chief executive officer, including the factors and criteria upon which the CEO's compensation was based. This should include a specific discussion of the relationship of the company's performance to the CEO's compensation for the last completed fiscal year, describing each measure of the company's performance, whether qualitative or quantitative, on which the CEO's compensation was based.

Each member of the compensation (or similar) committee must put his or her name to the report. If the board of directors has modified or rejected in any material way any action or recommendation of the compensation committee with respect to such decisions in the last completed fiscal year, the report must so indicate and explain the reasons for the board's actions and be made over the names of all the members of the board.

In order to protect proprietary and competitive information, a company is not required to disclose any factors or criteria involving confidential commercial or business information. For the same reasons, a company is not required to disclose target levels with respect to specific quantitative or qualitative performance-related factors considered by the compensation committee or the board of directors.

Performance Graph

What is the performance graph?

In the annual proxy statement, a company must include a graph showing the company's stock performance for the past five years alongside a broad-based market index (such as the S&P 500) and an index composed of peer companies or companies with similar market capitalization. This graph helps investors in assessing the company's performance vis a vis overall markets and the company's own industry. The purpose of the performance graph is to complement the discussion by the compensation committee (that appears in the Board Compensation Committee Report on Executive Compensation) of the relationship of executive compensation to corporate performance in a given fiscal year.

Annual Reports on Form 10-K

How can I obtain a copy of a company's annual report on Form 10-K?

A company is required to file an annual report on Form 10-K with the SEC at the end of the company's fiscal year. The company files this document using the SEC's database known as EDGAR. You can access the EDGAR database through the SEC's website — http://www.sec.gov/. Simply go to the section of the SEC's home page entitled "Filings and Forms (EDGAR)" and click on "Search for Company Filings." On the resulting screen entitled "Search EDGAR Database," click on "Companies and Other Filers." Enter the name of the company and then click "Find Companies." Select the appropriate company to view its SEC filings. To view the annual report on Form 10-K, select the most recent filing entitled "10-K" or "10-K 405."

You can also search the EDGAR database by Central Index Key (CIK) number. A CIK is the unique number that the SEC's computer system assigns to individuals and corporations who file disclosure documents with the SEC. All new electronic and paper filers, foreign and domestic, receive a CIK number. You don't need to know a company's CIK, but searching by that number will narrow your search to the exact company you want.

You also may request a copy of the annual report on Form 10-K by contacting the company's Investor Relations office or by visiting the company's website. Many companies post their annual report on Form 10-K on their website prior to the annual meeting of shareholders.

Is the annual report on Form 10-K different from the annual report to shareholders?

Under SEC rules, where a company distributes a proxy statement in connection with an annual meeting of shareholders at which directors are to be elected, the proxy statement must be accompanied by an annual report to shareholders. This annual report to shareholders is sometimes referred to as the "glossy" annual report because frequently companies use color photography, eye-catching graphics and high-quality materials to produce this document.

What information about executive compensation is available about in the annual report on Form 10-K?

The annual report on Form 10-K requires the same kinds of disclosure about executive compensation as is required in the annual proxy statement **EXCEPT** that the annual report on Form 10-K does not need to include an Option/SAR Repricing Table or related information, a Board Compensation Committee Report on Executive Compensation, or a Performance Graph. The information that is required in the annual report on Form 10-K can be provided directly in the Form 10-K or can be incorporated into the Form 10-K by reference to the annual proxy statement.

Registration Statements

How can I obtain a copy of a company's registration statement?

A registration statement is a disclosure document filed with the SEC to register securities for sale to the public. The registration statement contains information about the business and financial condition of the company, including business risks, the company's management and board of directors and the terms of the offering. If you are a prospective investor in a securities offering, a company is required to deliver to you a copy of the prospectus for the offering. The prospectus is the primary component of a registration statement and contains most of the detailed information about the offering and the company, including audited financial statements.

If you are not a prospective investor, or if you are conducting historical research on a company, you can obtain a copy of a registration statement, including the prospectus, by using the SEC's database known as EDGAR. A company is required to file its registration statement and any subsequent amendments to the document with the SEC. You can access the EDGAR database through the SEC's website — http://www.sec.gov/. Simply go to the section of the SEC's home page entitled "Filings and Forms (EDGAR)" and click on "Search for Company Filings." On the resulting screen entitled "Search EDGAR Database," click on "Companies and Other Filers." Enter the name of the company and then click "Find Companies." Select the appropriate company to view its SEC filings. Then select the type of registration statement you are seeking (for example, "S-1" or "S-3"). The SEC's website contains a Description of SEC Forms that describes the most widely used registration statement forms. Consult the Description of SEC Forms to identify the type of registration statement you wish to review.

You can also search the EDGAR database by Central Index Key (CIK) number. A CIK is the unique number that the SEC's computer system assigns to individuals and corporations who file disclosure documents with the SEC. All new electronic and paper filers, foreign and domestic, receive a CIK number. You don't need to know a company's CIK, but searching by that number will narrow your search to the exact company you want.

What information is available in a registration statement about executive compensation?

A registration statement requires the same kinds of disclosure about executive compensation as is required in the annual proxy statement **EXCEPT** that a registration statement does not need to include an Option/SAR Repricing Table or related information, a Board Compensation Committee Report on Executive Compensation, or a Performance Graph. The information that is required to be in a registration statement can be provided directly in the registration statement or can be incorporated into the registration statement by reference to the annual proxy statement.

IV. Supplemental Glossary

Black-Scholes Option-Pricing Model

A mathematical formula used for valuing employee stock options that considers such factors as the volatility of returns on the underlying securities, the risk-free interest rate, the expected dividend rate, the relationship of the option price to the price of the underlying securities and the expected option life.

Change in Control

A transaction that alters the ownership of a company. Mergers and consolidations, stock sales and asset sales are types of transactions that may result in a change in control.

Deferred Compensation

Compensation earned by an individual, the receipt of which is postponed until a later date, usually upon termination of employment or retirement. Typically, the deferred amounts are invested on the recipient's behalf and may be supplemented by contributions by the company. If the compensation arrangement meets certain requirements, an individual may not pay income taxes on the compensation until he or she receives a distribution of some or all of the deferred amounts.

EDGAR (Electronic Data Gathering, Analysis, and Retrieval System)

An automated computer database maintained by the SEC for the filing of registration statements, periodic reports and other filings mandated under the federal securities laws.

"In-the-Money"

A term used to describe a stock option or stock appreciation right where the value of the shares of stock underlying the option or SAR is greater than the instrument's exercise price.

Long-Term Incentive Plan

Any plan that provides compensation intended to serve as an incentive for performance to occur over a period longer than one year (where performance is measured by reference to financial performance of the company, the company's stock price or some other measure), but not including restricted stock, stock option or stock appreciation rights plans.

Named Executive Officers

A company's chief executive officer and four most highly compensated executive officers (other than the chief executive officer) who were serving as executive officers at the end of the last completed fiscal year. Additionally, if a company had more than one chief executive officer during the last completed fiscal year, all individuals who served in that capacity during the last completed fiscal year are considered to be "named executive officers." "Named executive officers" can also include up to two additional executive officers who would have been among the most highly compensated executive officers at the end of the fiscal year if they still had been serving as executive officers at the end of the fiscal year. Generally, however, executive officers whose total annual salary and bonus for the last fiscal year did not exceed $100,000 are not deemed "named executive officers."

Repricing

An adjustment or amendment to the exercise price of an outstanding, but unexercised, stock option or stock appreciation right, whether through amendment, cancellation, replacement grant or any other means, that changes the price at which the underlying shares of stock may be purchased.

Restricted Stock

A restricted stock award is an outright grant of shares of stock by a company to an individual, usually an employee, without any payment by the recipient or for only a nominal payment.

Generally, the shares of stock are subject to a contractual provision under which the granting company has the right (but not the obligation) to repurchase or reacquire the shares from the recipient upon the occurrence of a specified event (such as termination of employment). This right of repurchase or reacquisition expires after a specified period of time, either all at once or in increments. The expiration of this right is referred to as "vesting." During the period that the shares of stock may be repurchased or reacquired, the recipient is prohibited from selling or otherwise transferring the shares. This is why the shares are called "restricted" stock. (Note that "restricted stock" is different from "restricted securities" under Rule 144. See Rule 144: Selling Restricted and Control Securities.)

Stock Appreciation Rights

A stock appreciation right ("SAR") is a contractual arrangement between a company and an individual, usually an employee, in which the recipient has the right to receive an amount equal to the appreciation on a specified number of shares of stock over a specified period of time. A SAR differs from a stock option in the following ways:

- the recipient is not required to pay an amount to exercise the SAR;
- the recipient only receives the appreciation in the value of the stock between the date of grant of the SAR and the date of exercise (generally, the recipient controls the timing of exercise); and
- the recipient generally does not receive any shares of stock of the granting company (that is, the amount received by the recipient is payable in cash).

Generally, a recipient's ability to exercise a SAR is subject to a contractual "vesting" provision that expires after a specified period of time, either all at once or in increments.

Stock Options

A stock option is a contractual arrangement between a company and an individual, usually an employee, where the company offers the recipient the opportunity to purchase a specified number of shares of stock of the company at a specified, pre-determined price (typically, the market price of the company's stock on the date of grant) for a specified period of time. The recipient is under no obligation to purchase the stock being offered by the company. Typically, the recipient of a stock option is referred to as an "optionee."

Generally, an option is subject to a contractual provision under which the granting company has the right (but not the obligation) to repurchase or reacquire the option from the optionee upon the occurrence of a specified event (such as termination of employment). This right expires after a specified period of time, either all at once or in increments. The expiration of this right is referred to as "vesting."

Currently, there are two different types of stock options: (1) incentive stock options — options that meets the requirements of Section 422(b) of the Internal Revenue Code and, therefore, enable the optionee to qualify for preferential tax treatment under the federal income tax laws, and (2) non-qualified (or "non-statutory") stock options — options that do not satisfy the requirements of a statutory stock option under the Internal Revenue Code and, therefore, do not qualify for any special tax treatment. The federal securities laws do not distinguish between incentive stock options and non-qualified stock options; that is, both types of options are subject to the same disclosure requirements.

http://www.sec.gov/investor/pubs/execomp0803.htm

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SECURITIES EXCHANGE ACT OF 1934 Release No. 39157/September 30, 1997

REPORT OF INVESTIGATION PURSUANT TO SECTION 21(a) OF THE SECURITIES EXCHANGE ACT OF 1934 CONCERNING THE CONDUCT OF CERTAIN FORMER OFFICERS AND DIRECTORS OF W. R. GRACE & CO.

I. INTRODUCTION

The staff of the Division of Enforcement has conducted an investigation into whether W. R. Grace & Co. ("WRG") violated certain provisions of the federal securities laws and whether certain former officers and directors of WRG contributed to any such violations. The Commission has found that WRG violated various statutes and regulations requiring disclosure of specified information in proxy statements and periodic reports and has issued an Administrative Order ordering WRG to cease and desist from committing future violations of those statutes and regulations.<(1)> The Commission has determined that WRG's violations resulted from the conduct of certain of WRG's former officers and directors. In particular, these individuals contributed to these violations by failing to take steps which they should have taken to ensure full and proper disclosure. The Commission is issuing this Report of Investigation pursuant to Section 21(a) of the Securities Exchange Act of 1934 (the "Exchange Act") to address the conduct of these individuals.<(2)> WRG and three of these individuals have consented to the issuance of this report without admitting or denying any of the statements set forth herein.<(3)>

In the Administrative Order against WRG, the Commission found that WRG, in its 1992 annual report on Form 10-K ("1992 Form 10-K") and its 1993 proxy statement, did not fully disclose the substantial retirement benefits it had agreed to provide J. Peter Grace, Jr., effective at his retirement as chief executive officer on December 31, 1992. The Commission further found that WRG, in its 1993 annual report on Form 10-K ("1993 Form 10-K") and its 1994 proxy statement, omitted to disclose a proposed related-party transaction pursuant to which a group headed by Grace, Jr.'s son, J. Peter Grace III, sought to acquire Grace Hotel Services Corporation ("GHSC"), a wholly-owned subsidiary of WRG involved in hotel food service management. As a result, WRG violated Sections 13(a) and 14(a) of the Exchange Act and Rules 13a-1, 14a-3 and 14a-9 thereunder.

The Commission is issuing this Report of Investigation to emphasize the affirmative responsibilities of corporate officers and directors to ensure that the shareholders whom they serve receive accurate and complete disclosure of information required by the proxy solicitation and periodic reporting provisions of the federal securities laws.<(4)> Officers and directors who review, approve, or sign their company's proxy statements or periodic reports must take steps to ensure the accuracy and completeness of the statements contained therein, especially as they concern those matters within their particular knowledge or expertise. To fulfill this responsibility, officers and directors must be vigilant in exercising their authority throughout the disclosure process.

In this case, both Grace, Jr., then the chairman of WRG's board of directors, and J. P. Bolduc, then WRG's chief executive officer and a member of WRG's board of directors, knew of Grace, Jr.'s substantial retirement benefits and the proposed transaction with Grace III. Eben Pyne, a non-management member of the board, also was aware of Grace, Jr.'s benefits. Charles Erhart, another non-management member of the board, was aware of the proposed related-party transaction. All four of these officers and directors reviewed all or portions of the relevant documents, and all but Pyne signed the relevant reports. Although the record does not demonstrate that Bolduc, Pyne, and Erhart acted in bad faith, the Commission concludes that they did not fulfill their obligations under the federal securities laws. Bolduc, Pyne, and Erhart each assumed, without taking the steps necessary to confirm their assumptions, that WRG's procedures would produce drafts of disclosure documents describing all matters that required disclosure.<(5)> Each also assumed, without taking steps necessary to confirm their assumptions, that other corporate officers, including counsel, had conducted full and informed reviews of the drafts. Bolduc, Pyne, and Erhart each had a responsibility to go beyond the established procedures to inquire into the reasons for non-disclosure of information of which they were aware.

II. BACKGROUND

At the time of the events discussed in this Report, WRG was a New York corporation with its principal executive offices in Boca Raton, Florida. WRG's primary businesses were packaging, specialty chemicals and health care services. WRG's securities were registered with the Commission pursuant to Section 12(b) of the Exchange Act and its common stock was listed on the New York and Chicago Stock Exchanges. On December 31, 1992, 89,892,000 shares of WRG common stock were issued and outstanding, and WRG had 20,869 common shareholders of record.<(6)>

GHSC was a wholly-owned subsidiary of WRG during the relevant period. GHSC was in the business of providing food and beverage service to hotels.

<(1)> In the Matter of W. R. Grace & Co., Exchange Act Release No. 34-39156. WRG consented to the issuance of this Order without admitting or denying the findings therein.

<(2)> Section 21(a) of the Exchange Act authorizes the Commission, in its discretion, to publish information "concerning any . . . violations" and to investigate "any facts, conditions, practices or matters which it may deem necessary or proper" in fulfilling its responsibilities under the Exchange Act.

<(3)> A fourth individual, J. Peter Grace, Jr., died on April 19, 1995..

<(4)> The Commission previously has noted that corporate directors must act aggressively to fulfill their responsibilities to ensure that their company's public statements are candid and complete. See Report of Investigation in the Matter of the Cooper Companies, Inc. As It Relates to the Conduct of Cooper's Board of Directors, Exchange Act Release No. 35082 (December 12, 1994). See also Report of Investigation in the Matter of National Telephone Co., Inc., Exchange Act Release No. 14380 (Jan. 16, 1978); Report Regarding the Investigation of Gould, Inc., Exchange Act Release No. 13612 (June 9, 1977); and Report of Investigation in the Matter of Stirling Homex, Exchange Act Release No. 11516 (July 2, 1975). Each of these Reports focused on the failure of non-management directors to act effectively when confronted with evidence of management's involvement in possible securities fraud. The present matter, in contrast, deals with the obligations of officers and directors where a company's violations do not constitute fraud. .

J. Peter Grace, Jr. was the chief executive officer of WRG from 1945 until 1992, when he retired from that position. He was chairman of WRG's board of directors during substantial periods from 1945 until his death on April 19, 1995.

J. P. Bolduc, age 56, was the president and chief executive officer of WRG from 1992 until his resignation in March 1995. During the relevant period, Bolduc was also a member of WRG's board of directors.

Eben W. Pyne, age 78, was a director of WRG from 1960 until 1995. He also served as chairman of the Compensation, Employee Benefits and Stock Incentive Committee of WRG's board of directors during 1992. Pyne did not

<(5)> Indeed, this matter demonstrates that corporate disclosure mechanisms cannot compensate for the failures of individuals. WRG's procedures failed because, among other reasons, Grace, Jr. did not disclose some of his retirement benefits and the proposed transaction with his son in questionnaires which WRG distributed to officers and directors to gather information for disclosure in WRG's proxy statements and periodic reports.

<(6)> On September 30, 1996, WRG's packaging and specialty chemicals businesses were reorganized as a Delaware corporation as part of the spin-off and combination of its National Medical Care subsidiary with the dialysis business of Fresenius AG, a German health care corporation.

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stand for re-election to WRG's Board of Directors in 1995.<(7)>

Charles H. Erhart, Jr., age 72, spent his entire business career with WRG. From 1968 to 1990 he served at various times as WRG's chief financial officer, vice chairman, chairman of the executive committee and president. After his retirement as an officer of WRG in 1990, he served as a director of WRG. Erhart also did not stand for re-election to WRG's board of directors in 1995.

J. Peter Grace III, age 54, is a son of J. Peter Grace, Jr. He was chairman of the board of directors of GHSC from its formation in July 1990 until he resigned in November 1994.

III. GRACE, JR., BOLDUC, AND PYNE FAILED TO TAKE STEPS TO ENSURE THAT GRACE, JR.'S RETIREMENT BENEFITS WERE FULLY DISCLOSED.

During the latter part of 1992, Grace, Jr.'s health was deteriorating. Pursuant to delegated authority from WRG's board of directors, WRG's Compensation, Employee Benefits and Stock Incentive Committee (the "Compensation Committee") entered into negotiations with Grace, Jr., which resulted in his retirement from WRG as its chief executive officer, effective on December 31, 1992. Pyne, then chairman of the Compensation Committee, met several times with Grace, Jr. during November and December 1992. The negotiations resulted in an agreement in principle with respect to Grace, Jr.'s proposed retirement benefits. Among the provisions of this agreement in principle was an understanding that Grace, Jr. would continue to receive in retirement various substantial perquisites which he had received while chief executive officer. On December 7, 1992, WRG's board of directors approved Grace, Jr.'s proposed retirement benefits.

Subsequently, Grace, Jr. and Pyne, on behalf of WRG, executed a letter agreement dated December 21, 1992 (the "Retirement Agreement"), which reflected the terms of this agreement in principle.<(8)> The Retirement Agreement provided, among other things, that immediately following Grace, Jr.'s retirement:

> [A]ll other benefits and arrangements currently provided to you [Grace, Jr.] as chief executive officer (including, but not limited to, the use of office space and corporate aircraft) will continue to be provided to you.

<(7)> Since 1995, WRG's Board of Directors has been reduced in size from twenty-four members to its current size of nine members.

<(8)> Bolduc and Pyne each assert that they assumed that this letter agreement, because it was drafted by WRG's legal counsel, would receive full consideration in WRG's disclosure process.

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Pursuant to this provision of the Retirement Agreement, Grace, Jr. received the following benefits, among others, from WRG in 1993: (a) continued use of a Company-owned and maintained apartment with a market value estimated by WRG to be in excess of $3 million, with services of a cook, who was a WRG employee; (b) use of a company limousine and driver on a 24 hour basis; (c) the services of full-time secretaries and administrative assistants; (d) the use of corporate aircraft for personal and business travel; (e) home nursing services; and (f) security services.

While there was general knowledge within management that Grace, Jr.'s Retirement Agreement provided for the continuation of benefits that he had received before retirement, specific information about Grace, Jr.'s benefits was not generally available to WRG's management. Only non-management directors were involved in the negotiation or approval of Grace, Jr.'s retirement benefits. Members of WRG's then-current management, including Bolduc and WRG's secretary and chief disclosure counsel, were asked to leave board and/or Compensation Committee meetings at which Grace, Jr.'s retirement benefits were discussed. However, Grace, Jr. and Pyne met with Bolduc in December 1992 to discuss Grace, Jr.'s retirement benefits after the negotiations over these benefits were completed. At that time, Bolduc became aware of each of the "other benefits" that WRG was providing to Grace, Jr.

The Company provided Grace, Jr. with directors' and officers' questionnaires ("D&O Questionnaires") in the course of preparing its 1992 Form 10-K and 1993 proxy statement and its 1993 Form 10-K and 1994 proxy statement.<(9)> These questionnaires contained questions asking whether Grace, Jr. received certain benefits from the Company during the preceding year, including, among other things, use of Company property, including apartments; housing and other living expenses (including domestic service) provided at his principal and/or vacation residence; and other perquisites. Grace, Jr. incorrectly responded "no" to these questions.

The final version of WRG's 1993 proxy statement contained language discussing Grace, Jr.'s Retirement Agreement, including a statement that Grace, Jr. would receive "certain other benefits." WRG filed the Retirement Agreement as an exhibit to its 1992 Form 10-K, but did not further describe Grace, Jr.'s "other benefits," nor did WRG disclose the costs of providing them in any of its proxy statements or periodic reports

<(9)> During the development of WRG's annual reports and proxy statement disclosure, the Company used information from annual questionnaires sent to (a) all WRG officers and directors and (b) the chief financial officers of WRG's reporting units.

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filed with the Commission before 1995.<(10)>

Because WRG's senior management was excluded from the negotiation and approval of Grace, Jr.'s retirement benefits, WRG's disclosure counsel made arrangements for Pyne to review the executive compensation section of WRG's draft 1993 proxy statement, and Pyne did so. Bolduc, in his capacity as WRG's CEO, reviewed drafts of WRG's 1993 proxy statement and signed WRG's 1992 Form 10-K, which incorporated the proxy statement's section on executive compensation by reference. Grace, Jr., in his capacity as chairman, also signed the 1992 Form 10-K. Although Grace, Jr., Bolduc, and Pyne knew about the "other benefits" WRG had agreed to provide Grace, Jr. upon his retirement, they did not question the absence of information about these "other benefits" in WRG's disclosure of Grace, Jr.'s retirement benefits. Even if Bolduc and Pyne, as each asserted, assumed that WRG's legal counsel (whose office had participated in drafting the Retirement Agreement) had considered the adequacy of the disclosure concerning Grace, Jr.'s benefits, they should not have relied upon that assumption. They should have raised the issue of disclosure of Grace, Jr.'s "other benefits," for example, by discussing the issue specifically with disclosure counsel, telling counsel exactly what they knew about the benefits, and asking specifically whether the benefits should be disclosed.<(11)> As a result, WRG's 1992 Form 10-K and 1993 proxy statement failed to disclose specific information about the "other benefits."

IV. GRACE, JR., BOLDUC AND ERHART FAILED TO TAKE STEPS TO ENSURE THAT THE PROPOSED GHSC TRANSACTION WAS DISCLOSED.

In February 1993, WRG decided to dispose of GHSC because GHSC's restaurant operations were not one of WRG's "core" businesses and GHSC had failed to meet certain financial targets. This decision was part of a general program to concentrate WRG's assets in certain core industries and to divest certain non-core businesses. During February or early March 1993, Grace III, who was then the chairman of GHSC, proposed to WRG that he acquire GHSC from the Company.

Negotiations between Grace III and WRG took place over the next few

<(10)> After information concerning Grace, Jr.'s "other benefits" became public, WRG disclosed in its 1995 proxy statement that the benefits provided to Grace, Jr. pursuant to the "other benefits" provision cost the Company $3,601,500 in fiscal year 1993, of which approximately $2,700,000 was attributable to Grace, Jr.'s having access to corporate aircraft.

<(11)> This might have established that counsel was not in fact fully informed about these benefits or that Grace, Jr. had incorrectly filled out his D&O questionnaires regarding these benefits.

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months. On November 5, 1993, Grace III and WRG executed an agreement in principle expiring on April 15, 1994, which set forth the terms for the acquisition of GHSC by a new company to be formed by Grace III and others, later known as HSC Holding Co., Inc. ("HSC"). Grace III and his other investors agreed that they would execute a note for $1.3 million in exchange for ownership of GHSC. In addition, Grace III and HSC agreed that they would raise $2.5 million in a private placement of equity securities to a group of investors to fund the ongoing operations of the new company. During the negotiations, Bolduc was kept apprised of the status of both the negotiations and the terms of the agreement in principle. In early 1994, Grace III had a conversation with Erhart concerning HSC's private placement. Furthermore, in early 1994, Grace III sent both Grace, Jr. and Erhart a draft copy of a private placement memorandum, which discussed the agreement in principle and to which a copy of the agreement was attached. After the expiration of the agreement in principle, WRG informed Grace III that it would remain receptive to consummating the sale were he able to obtain financing. The transaction was abandoned by WRG in late 1994 because, among other things, Grace III and HSC were unable to obtain the necessary equity financing from the private placement.<(12)>

As in past years, the D&O Questionnaires circulated to Grace, Jr. and the Company's other directors and officers for purposes of preparing the Company's 1993 Form 10-K and 1994 proxy statement contained a question concerning any transactions or proposed transactions since January 1, 1992, "to which the Company . . . was or is to be a party and . . . which you and/or any of your associates have direct or indirect interest."<(13)> The term "associates" was defined to include family members. Grace, Jr. knew about the November agreement in principle setting forth the terms and conditions of the proposed related-party transaction as well as Grace III's efforts to raise the required equity investment. Nevertheless, his response to this question on the D&O Questionnaire for the Company's 1993 Form 10-K and 1994 proxy statement was "None."

During early 1994, Erhart and Bolduc reviewed drafts of WRG's 1993 Form 10-K and 1994 proxy statement, which omitted any discussion of the

<(12)> During late 1994, WRG alleged that Grace III and HSC had misappropriated approximately $1.3 million belonging to GHSC to fund the operations of HSC. In 1995, WRG increased its claim by approximately $133,000. Pursuant to a negotiated settlement and arbitration award, Grace III and HSC repaid substantially all of the money claimed by WRG.

<(13)> A questionnaire sent from WRG to GHSC in early 1994 requested substantially the same information concerning related-party transactions or proposed related-party transactions involving GHSC. In response to this request, an officer of GHSC incorrectly stated "Nothing to report".

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proposed related-party transaction. Furthermore, Grace, Jr., in his capacity as chairman, Erhart, in his capacity as a director, and Bolduc, in his capacity as CEO, signed WRG's 1993 Form 10-K, which incorporated by reference the 1994 proxy's disclosure of related-party transactions. Although Grace, Jr., Bolduc, and Erhart knew about the proposed related-party transaction, they did not question the absence of disclosure concerning it. Even if Bolduc and Erhart, as each asserted, assumed that WRG counsel had considered whether the proposed transaction had to be disclosed,<(14)> they should not have relied on that assumption. They should have raised the issue of disclosure of this proposed transaction specifically with disclosure counsel.<(15)> As a result,

WRG's 1993 Form 10-K (filed on March 28, 1994) and 1994 proxy statement (filed on April 11, 1994) failed to disclose any information about the proposed GHSC transaction.

V. CONCLUSION

Serving as an officer or director of a public company is a privilege which carries with it substantial obligations. If an officer or director knows or should know that his or her company's statements concerning particular issues are inadequate or incomplete, he or she has an obligation to correct that failure. An officer or director may rely upon the company's procedures for determining what disclosure is required only if he or she has a reasonable basis for believing that those procedures have resulted in full consideration of those issues.<(16)>

Grace, Jr., Bolduc, Pyne, and Erhart did not fulfill their obligations under the federal securities laws. Grace, Jr., Bolduc, and Pyne knew or should have known that Grace, Jr.'s retirement benefits were not fully disclosed in drafts of WRG's 1993 proxy statement and 1992 Form 10-K. Grace, Jr., Bolduc, and Erhart knew or should have known that the proposed GHSC transaction was not disclosed in drafts of WRG's 1994 proxy statement and 1993 Form 10-K. As noted, Grace, Jr. failed to identify information relating to both of these issues in his D&O questionnaires. Grace, Jr., Bolduc, Pyne, and Erhart, given their positions as directors or senior officers and their particular knowledge of these transactions, should have inquired as to whether the securities laws required disclosure of this

<(14)> WRG's Office of Legal Counsel participated in drafting the letter of intent between Grace III and GHSC.

<(15)> Such action might have revealed that Grace, Jr. had incorrectly filled out his D&O questionnaire concerning the proposed transaction.

<(16)> Procedures or mechanisms established to identify and address disclosure issues are effective only if individuals in positions to affect the disclosure process are vigilant in exercising their responsibilities.

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information. This inquiry could have included seeking the specific and fully informed advice of counsel. If they were not reasonably satisfied as to the answers they received, they should have insisted that the documents be corrected before they were filed with the Commission.<(17)>

WRG's violations resulted, in part, from its corporate culture, which reflected Grace, Jr.'s substantial influence over the Company.<(18)> Given this circumstance, Bolduc, Pyne, and Erhart should have been more attentive to issues concerning disclosure of information relating to Grace, Jr. or the Grace family. Bolduc, Pyne, and Erhart did not adequately follow through on fostering accurate and complete disclosure, which should have been their touchstone as members of WRG's board of directors or as officers of WRG.

Since Grace, Jr.'s death, WRG has substantially revised the composition of its board of directors. Because of the unique circumstances presented here (including the death of Grace, Jr.), the Commission has determined not to issue cease-and-desist orders or take other action against Bolduc, Pyne, and Erhart in this matter. However, the Commission remains resolved to take enforcement action, where appropriate, against individual directors and officers who have violated or caused violations of the federal securities laws.

<(17)> Bolduc, Pyne, and Erhart would each bear this responsibility even if, as each asserted, each assumed that WRG's internal mechanisms for preparing the relevant disclosure documents, including review of counsel, would address these issues.

<(18)> There is some evidence that Bolduc recognized that Grace, Jr. exercised a degree of influence over WRG which was inappropriate for a public corporation and attempted to limit that influence.

======END OF PAGE 9======.

September 30, 1997

DISSENT OF COMMISSIONER STEVEN M.H. WALLMAN

In the Matter of W.R. Grace & Co.

The Section 21(a) report In the Matter of W.R. Grace & Co.(the

Report) articulates a certain legal standard,<(19)> and then applies that standard to these facts. I take issue with that standard

<(19)> As stated in the Report:

> The Commission is issuing this Report of Investigation to emphasize the affirmative responsibilities of corporate officers and directors to ensure that the shareholders whom they serve receive accurate and complete disclosure of information required by the proxy solicitation and periodic reporting provisions of the federal securities laws. Officers and directors who review, approve, or sign their company s proxy statements or periodic reports must take steps to ensure the accuracy and completeness of the statements contained therein, especially as they concern those matters within their particular knowledge or expertise. To fulfill this responsibility, officers and directors must be vigilant in exercising their authority throughout the disclosure process.

======END OF PAGE 10======.

specifically to the extent it suggests that officers and directors must ensure the accuracy and completeness of company disclosures. Moreover, I do not agree that, when the appropriate legal standard is applied to the particular facts of this case as described in the Report itself, there has been a violation of law on the part of the three individuals cited.

Certain of the disclosures of W.R. Grace & Co. (the Company) relating to perquisites and related party transactions were not in compliance with applicable requirements. The Company has consented to the issuance of a cease and desist order with respect to these matters.

As for individual liability, the record suggests that were J. Peter Grace, Jr. (Grace, Jr.) still alive, further examination as to whether he was a cause of the Company s improper disclosures would be in order. But in attempting to find other individuals who were responsible for the Company s conduct, I disagree with the Commission s conclusion that, on this record, J.P. Bolduc (Bolduc), Eben Pyne (Pyne) and Charles Erhart (Erhart) failed to fulfill their obligations under the federal securities laws.<(20)> To conclude otherwise is to impose strict liability for such a disclosure failure -- which simply is not the law.

In this case, as stated in the Report, Grace, Jr. exerted an unusual amount of control over the Company. But the Company also had policies and procedures in place designed to satisfy the Company s disclosure obligations. The Company prepared and distributed appropriate director and officer questionnaires requesting information concerning, specifically, the receipt of perquisites and other benefits, and actual and proposed related party transactions. The Company also surveyed the chief financial officers of the Company s operating units for the same information. Draft documents were circulated among senior management (including Bolduc) and members of the board for their review and comment. A substantial number of people were involved in the creation or review of the relevant disclosure documents. From the record, there do not appear to have been any red flags or warnings to indicate that this system -- which included the employment of respected and competent securities counsel -- was breaking down, or was inadequate to produce documents that would comply with the federal securities laws. Yet, even though appropriate procedures were in place, and followed, insufficient disclosures were made.

The Report states that the violations resulted from the conduct of Bolduc, Pyne and Erhart. In particular, according to the Report, these three individuals contributed to these violations by failing to take steps which they should have taken to ensure full and proper disclosure. The Report describes the specific knowledge that these three individuals

<(20)> I understand that Grace, Jr. received compensation and perquisites that many believe were inappropriate, and that many believe the board or others in management should have taken action to reduce those benefits. But we at the Commission do not administer the corporate law, which is the proper venue for those complaints.

======END OF PAGE 11======.

possessed of the relevant facts, their assumption that the system for the creation of disclosure documents was working appropriately, and their failure to reach behind and beyond the established procedures to inquire into the reasons for non-disclosure of information of which they were aware.

Whether disclosure of certain matters is required under the federal securities laws is a legal (or mixed legal and factual) determination that ultimately has to be made by counsel after being informed of the relevant facts. Bolduc, Pyne and Erhart were aware of the documents relevant to the two questioned disclosures at issue in this case: the non-binding letter of intent with Grace, Jr. s son (of which Bolduc and Erhart were aware) and the retirement agreement with Grace, Jr. (of which Bolduc and Pyne were aware). The existence of these documents also was known to various attorneys in the Office of Legal Counsel (OLC) -- the office whose job it was to prepare disclosure in accordance with legal requirements, and the same office that drafted these documents.

Bolduc, Pyne and Erhart were each aware that OLC was preparing disclosure based on these agreements. And Bolduc, Pyne and Erhart do not appear to have had any reason whatsoever to believe that the appropriate legal distinctions were not being made by OLC attorneys.

The two questioned disclosures in this case both turn on fine line legal interpretations. Bolduc, Pyne and Erhart were not lawyers; they were not versed in SEC line item disclosure requirements; they were not possibly capable of making the fine judgment calls on whether disclosure of the items at issue here was sufficient or warranted. These decisions were the domain of counsel. Bolduc, Pyne and Erhart were not in a position to second-guess this type of disclosure and had every right to rely on a system designed to produce appropriate disclosure. If there were any attorneys in OLC who were unsure, or unaware, of the significance, or specifics, of the terms of either the retirement agreement or the non-binding letter of intent, and clarification was needed to make a determination of what the law required in terms of disclosure, then it was the responsibility of those attorneys to ask the appropriate questions.

The issue then is simple: did legal counsel have the necessary facts to do the job that was required -- and if not, did these three individuals know (or, perhaps, should these three individuals have known) that counsel did not have the necessary facts.

It is clear that disclosure counsel in particular was well aware of the facts regarding Grace, Jr. s retirement package since he was supplied with an actual copy of the retirement agreement -- an agreement filed publicly as an exhibit to the Company s Form 10-K. The agreement specifically provided that:

All other benefits and arrangements currently provided [Grace, Jr.] as chief executive officer (including, but not limited to, the use of office space and corporate aircraft) will continue to be provided to [him].

======END OF PAGE 12======.

There was no change in the benefits being granted Grace, Jr. from previous years -- what he received as CEO he was to continue to receive in retirement.<(21)> Disclosure counsel, knowing these facts, then apparently made the determination that the description of these continued benefits as certain other benefits was adequate disclosure under Item 402(h) of Regulation S-K, and presented drafts with that disclosure to Bolduc and Pyne.

Bolduc and Pyne knew that disclosure counsel had reviewed this certain other benefits language and the retirement agreement and appeared to be in possession of all relevant facts, including that Grace, Jr. was now retired. Bolduc and Pyne relied on disclosure counsel to make the legal determination as to what the law required regarding disclosure of the retirement agreement, including the level of detail regarding disclosure of any specific terms or conditions.<(22)> Given the plain language of both the disclosure and the relevant portion of the retirement agreement, I fail to see where the red flag exists that would require non-lawyers to question the explicit determinations of their disclosure counsel as to the level of disclosure detail.

Moreover, details regarding the benefits in question -- all of which Grace, Jr. had been receiving while he was still Chief Executive Officer -- were not disclosed in previous filings with the Commission made prior to his retirement.<(23)> I would venture to say that many securities lawyers would not know that the Company s summary disclosure of these very same benefits in a later filing would somehow now be inadequate because of Grace, Jr. s retirement and change in status from executive officer and director to non-employee director/consultant. In fact, I would suspect that most securities lawyers would believe that less, not more, disclosure would be required upon such a change. It is simply not the law to require non-securities law experts to guess at the legal significance from a federal securities law disclosure standpoint of such a change in status and, therefore, be required to question the articulated judgment of their disclosure counsel and the resultant level of disclosure.

With regard to the pending acquisition, the facts in the record are a bit murkier. It is not clear whether disclosure counsel was aware of the possible transaction. It is clear, however, that one or more lawyers in

<(21)> In fact, approximately 75% of the cost of the other benefits supplied to Grace, Jr. in 1993 was attributable to the use of corporate aircraft. The fact that Grace, Jr. was receiving this benefit (although not the quantification of its value) was specifically referenced in the retirement agreement.

<(22)> Again, if disclosure counsel was unsure of the specific details that might be relevant from a line-item disclosure perspective, then it was the responsibility of disclosure counsel to ask questions and obtain these details.

<(23)> The Report s finding regarding the inadequacy of the disclosure of these benefits is limited to the 1992 Annual Report on Form 10-K and the 1993 proxy statement. The Report, however, does not address whether the Company was required to make these disclosures in any earlier or later filings.

OLC did know about the possible transaction because lawyers in that office drafted the non-binding letter of intent relating to it -- a transaction that many at the Company may have thought had little possibility whatsoever of consummation and that, in fact, never proceeded past the non-binding letter of intent stage. Obviously, if disclosure counsel had knowledge of the potential transaction, he made a legal determination as to whether the facts of this situation rose to the level of a currently proposed transaction -- a matter on which I believe lawyers might reasonably differ. But, no matter what, it is lawyers that make these decisions. CEOs and outside directors do not. Assuming that disclosure counsel was ignorant of the transaction, what results is a breakdown in the procedures within OLC itself, coupled with Grace, Jr. s failure to note the transaction in his directors and officers questionnaire, that led to the lack of disclosure (assuming disclosure was necessary). Bolduc or Erhart had no obligation to second guess their counsel on this matter and raise their hand to ask an affirmative question.

The Report seems to suggest that had they done so, the disclosures might have been accurate (as we define accurate which, as mentioned, is not open and shut on these facts). But that is irrelevant. Here, there did not appear to be any reason for these senior managers to question their disclosure counsel and OLC s procedures in the first instance. Moreover, no case can be made that there is any disclosure so obviously required that non-securities lawyers should know that it would be needed regardless of whether counsel believes it to be or not.

If the facts were different, it might be possible to conclude that these three individuals knew or had reason to know that the process had not worked appropriately, and there then might be reason to impose upon them a duty of inquiry that might rise to the level of querying and second-guessing counsel s judgments and disclosures. Examples might include knowing that Grace, Jr. had intentionally or otherwise not completed his questionnaire properly, or the presence of past mistakes or omissions in the Company s disclosure documents that would have alerted them to the fact that their disclosure process was failing. But those are not the facts of this record or as stated in the Report.

The Commission is understandably wary about pursuing lawyers for their legal judgments. I share that wariness and believe that when professionals -- whether lawyers, accountants or others -- are acting in their capacity as such they must be given the opportunity to exercise their professional judgment without fear that a mistake, no matter how innocent -- or difference of judgment with the Commission -- will result in their being viewed as having violated the federal securities laws.<(24)> We need to recognize that in those circumstances where such judgments are made, there simply may be no person that will be individually liable. Holding the

<(24)> See the dissent of Commissioner Johnson in In the Matter of David J. Checkosky and Norman A. Aldrich, Admin. Proc. File No. 3-6776, Securities Exchange Act Release No. 38183 (January 21, 1997), and the dissent of Commissioner Wallman in In the Matter of Robert D. Potts, Admin. Proc. File No. 3-7998, Securities Exchange Act Release No. 39126 (September 24, 1997).

======END OF PAGE 14======.

client liable for not questioning the legal judgment of counsel is not the answer.

If the Commission believes it has a case against these three individuals, then it should have brought it. The record, however, did not support any such case. There is a well-known maxim bad facts make bad law. Here, we have bad circumstances. The Report is only a Section 21(a) report -- negotiated by the parties in lieu of any further or other action of the Commission. It puts this matter to rest for these individuals. There is no appeal and no court ruling on the law. My hope is that the Report will be limited to the very specific facts of this very specific case, and go no further.

I respectfully dissent.

U.S. Securities and Exchange Commission

U.S. SECURITIES AND EXCHANGE COMMISSION

Litigation Release No. 19208 / April 28, 2005

***SEC v. Tyson Foods, Inc. and Donald Tyson,* Civil Action No. 05 0841 (JDB)**

In the Matter of Tyson Foods, Inc. and Donald Tyson, Exchange Act Rel. No. 34-51625/April 28, 2005

SEC SUES TYSON FOODS AND FORMER CHAIRMAN DON TYSON FOR MISLEADING DISCLOSURE OF PERQUISITES

TYSON FOODS AND DON TYSON SETTLE AND PAY PENALTIES OF $1.5 MILLION AND $700,000

The Securities and Exchange Commission announced today that it has instituted settled enforcement proceedings against Tyson Foods, Inc. and its former Chairman and CEO Donald "Don" Tyson. The SEC charged that in proxy statements filed with the Commission from 1997 to 2003, Tyson Foods made misleading disclosures of perquisites and personal benefits provided to Don Tyson both prior to and after his retirement as senior chairman in October 2001. The SEC also charged the company with failing to maintain adequate internal controls over Don Tyson's personal use of company assets. Don Tyson was separately charged in the administrative proceeding with causing the company's violations and in the complaint with aiding and abetting the company's violations.

Both parties agreed to settle the charges by consenting to the entry of a final judgment in a civil action filed today in the U.S. District Court for the District of Columbia that orders Tyson Foods to pay a $1.5 million penalty and orders Don Tyson to pay a $700,000 penalty. In addition, both parties separately consented to the entry of an SEC Order that orders the company to cease and desist from violating the proxy solicitation and periodic reporting provisions of the federal securities laws and orders Don Tyson to cease and desist from causing such violations. The Order also orders Tyson Foods to cease and desist from violating the internal controls provisions of the securities laws. The company and Don Tyson agreed to the settlements without admitting or denying the findings or allegations in the SEC's Order and complaint.

The SEC's Order finds that while Don Tyson was employed as senior chairman from 1997 to 2001, the company provided approximately $3 million of perquisites and personal benefits to him, his wife, his daughters and three individuals with whom he had close personal relationships. The Order finds that Don Tyson caused disclosure failures with respect to many of these perquisites because his responses to director and officer questionnaires were inadequate. The Order also finds that many of those perquisites had not been raised with or authorized by the company's compensation committee. According to the Order, the $3 million in perquisites included:

1. $689,016 in personal expenses for him and two of his friends, including a $20,000 purchase for oriental rugs, an $18,000 purchase for antiques, a $15,000 vacation in London, an $8,000 horse and other substantial purchases of clothing, jewelry, artwork, vacations and theater tickets, which were paid through cash advances from the company's accounts, directly billed to the company or charged to three company credit cards that had been issued in the mid 1990s to Don Tyson and two of his friends;

2. $464,132 in personal use by Don Tyson and his family and friends of company-owned homes in the English countryside and in Cabo San Lucas, Mexico, including use of the company-paid chauffeur, cook and housekeeper at the English home and the company's crewed boat in Cabo San Lucas;
3. $426,086 of personal use of company-owned aircraft by him and his family and friends, including regular use by his family and friends with and without him on board;
4. $203,675 in housekeeping provided at five different homes where Don Tyson and his family and friends lived and/or vacationed;
5. $84,000 in lawn maintenance at five different homes where he and his family and friends lived;
6. $46,110 to maintain nine automobiles owned and used by Don Tyson and his family and friends;
7. $36,554 in telephone services for him and his family and friends;
8. $15,000 in Christmas gift certificates that were provided to Don Tyson's family and friends; and
9. $1,072,699 to cover Don Tyson's personal income tax liability associated with his receipt of these benefits.

The Order further finds that in its proxy statements filed for 1997 to 2001, the company:

- failed to disclose over $1 million of these perquisites, including $424,121 in housekeeping, lawn maintenance, automobile maintenance and telephone service that were not disclosed due to the company's internal control failures, and an additional $595,656 of perquisites (including gross-up payments for taxes thereon) that were mischaracterized in the company's 1998, 1999 and 2000 proxy statements as "performance-based bonuses," instead of as perquisites, due to a strategy to preserve the company's tax deduction for Don Tyson's compensation;
- used the misleading expression "travel and entertainment costs" to describe perquisites that could not be considered "travel" or "entertainment," such as over $372,539 in personal expenses received by Don Tyson and his friends;
- failed to separately identify by type and amount perquisites that exceeded 25 percent of Don Tyson's total perquisites, such as personal expenses, use of company homes, personal use of company aircraft and/or residential services.

In addition, according the Order, the company's 2002 and 2003 proxy statements used the same misleading terms "travel and entertainment" to describe the continuation of Don Tyson's perquisites pursuant to an October 2001 retirement agreement with the company and failed to disclose fully the nature and scope of those benefits.

The SEC also finds and alleges that due to internal control failures at Tyson Foods throughout most of 1997 to 2003, many of the perquisites described above (totaling approximately $1.5 million) were neither raised with nor authorized by the company's compensation committee or its board of directors. Thus, for example, the board members were unaware until the SEC's investigation that the company was paying for substantial personal expenses incurred by Don Tyson and two of his friends or that Don Tyson's family and friends regularly used the company aircraft while he was not on board. Nor was the board aware until November 2002, as a result of an internal company review of perquisites, of the housekeeping, lawn maintenance, telephone services and automobile maintenance provided to Don Tyson and his family and friends.

Finally, the SEC finds and alleges that Don Tyson, who signed the company's annual reports that incorporated the proxy statements for each fiscal year from 1997 to 2003, caused and aided and abetted the company's disclosure failures. In each year from 1997 to 2003, he signed director and officer questionnaires used to prepare the company's proxy statements that failed to identify or quantify various perquisites. Before signing them, he failed to read the questionnaires or take action to ensure the accuracy of the company's disclosure of his perquisites even though he was the only individual who possessed certain information necessary to accurately complete the questionnaires. In addition, he provided the company an incomplete list of perquisites that he had received for 2002, which omitted the fact that the company had paid for personal expenses for him and two of his friends and had provided housekeeping, lawn maintenance, automobile maintenance and telephone services to him and his family and friends.

As a result of these and other findings, the SEC's Order finds that Tyson Foods violated Sections 13(a), 13(b)(2)(B) and 14(a) of the Securities Exchange Act of 1934 (Exchange Act) and Rules 13a-1, 14a-3 and 14a-9 thereunder, and orders the company to cease and desist from committing any violations and any future violations of these statutory provisions and rules. The SEC's Order also finds that Don Tyson caused the company's violations of Sections 13(a) and 14(a) of the Exchange Act and Rules 13a-1, 14a-3 and 14a-9 thereunder, and orders Don Tyson to cease and desist from causing any violations and any future violations of the foregoing statutory provisions and rules. The SEC's federal court complaint alleges the same violations as the SEC's administrative Order.

➤ Administrative Proceeding Release No. 3-11917

➤ SEC Complaint in this matter

http://www.sec.gov/litigation/litreleases/lr19208.htm

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U.S. Securities and Exchange Commission

General Electric Settles SEC Action for Disclosure Failures in Connection with Its Former CEO's Benefits Under His Employment and Retirement Agreement

FOR IMMEDIATE RELEASE
2004-135

Washington, D.C., Sept. 23, 2004 — The Securities and Exchange Commission announced today that it has instituted settled enforcement proceedings against General Electric Company. The Commission charged that GE failed to fully describe the substantial benefits it had agreed to provide its former chairman and CEO John F. "Jack" Welch, Jr., under an "employment and post-retirement consulting agreement." GE settled the proceedings by consenting to the entry of an Order that it cease and desist from violating the proxy solicitation and periodic reporting provisions of the federal securities laws.

"Shareholders have a clear interest in knowing how public companies compensate their top executives," said Paul R. Berger, Associate Director of the SEC's Division of Enforcement. "Compliance with SEC disclosure rules ensures that shareholders are provided a full and accurate understanding of senior executives' compensation arrangements."

The Commission found that in proxy statements and annual reports filed with the Commission from 1997-2002, GE failed to fully and accurately describe the retirement benefits Welch was entitled to receive from the company. In December 1996, GE and Welch entered into an "employment and post-retirement consulting agreement" under which Welch agreed to continue as CEO until he was 65 and serve as a consultant thereafter. In the agreement, Welch received, as his principal form of compensation, lifetime access to the perquisites and benefits he had received as GE's chairman and CEO. GE's proxy statements only referred to Welch's entitlement to "...continued lifetime access to Company facilities and services comparable to those that are currently made available to him by the Company," but did not provide any other specific information about the "facilities and services" Welch would receive in retirement.

The agreement itself, which was appended as an exhibit to GE's 1996 annual report, stated that Welch was entitled to receive in retirement "continued access to Company facilities and services comparable to those provided to him prior to his retirement, including access to Company aircraft, cars, office, apartments, and financial planning services," but did not provide further meaningful and complete disclosure of those "facilities and services." Moreover, GE made no other disclosures in its SEC filings that allowed investors to understand the nature and scope of Welch's retirement benefits-specifically, investors could not learn from GE's previously filed proxy statements many of the most significant "facilities and services" Welch had been provided prior to his retirement, including personal use of GE-owned aircraft, personal use of chauffeured limousines and home security systems.

The Commission further found that in the first year following Welch's retirement in September 2001, Welch received approximately $2.5 million in benefits under the agreement, which included access to GE aircraft for unlimited personal use and for business travel; exclusive use of a furnished New York City apartment that, according to GE, in 2003, had a rental value of approximately $50,000 a month and a resale value in excess of $11 million; unrestricted access to a chauffeured limousine driven by professionals trained in security measures; a leased Mercedes Benz; office space in both New York City and in Connecticut; the services of professional estate and tax advisors; the services of a personal assistant; communications systems and networks at Welch's homes, including television, fax, phone and computer systems, with technical support; bodyguard security for various speaking engagements, including a book tour to promote his autobiography *Jack: Straight from the Gut*; and installation of a security system in one of Welch's homes and continued maintenance of security systems GE previously installed in three of Welch's other homes.

The Commission concluded that GE's inadequate disclosures violated Sections 13(a) and 14(a) of the Securities Exchange Act of 1934 and Rules 13a-1, 14a-3 and 14a-9 thereunder. Without admitting or denying the Commission's findings, GE consented to the issuance of the Order, which orders GE to cease and desist from committing or causing any violations and any future violations of the foregoing statutory provisions and rules.

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➤ Additional materials: Administrative Proceeding Release 34-50426

http://www.sec.gov/news/press/2004-135.htm