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SEC Proposes New Rules: MD&A Requirements Regarding Critical Accounting Policies

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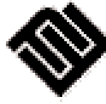

SEC Proposes New Rules: MD&A Requirements Regarding Critical Accounting Policies

On May 10, 2002, the SEC proposed rules that would require new disclosures in Management's Discussion and Analysis related to critical accounting policies. These rule proposals are an offshoot of the SEC's December 2001 cautionary advice regarding MD&A disclosure of critical accounting policies. If adopted, each public company would be required:

- to make disclosures about critical accounting estimates that it makes in applying its policies; and
- to make disclosure about its initial adoption of accounting policies that have a material impact on its financial presentation.

These proposals are part of the SEC's continuing effort to improve the transparency of public company disclosure of financial information. In particular, these proposals are designed to help investors understand that estimates are a necessary part of a company's financial statements, to help them understand the potential impact of those estimates on the company's financial results and to help them appreciate the impact of changes in those estimates. We recommend that you begin to plan for new disclosures of this sort, although the precise outlines of the final rules remain uncertain.

These proposed rules can be found at:

http://www.sec.gov/rules/proposed/33-8098.htm

Disclosures Regarding Critical Accounting Estimates
Under the rule proposals, companies would be required to disclose information about "critical accounting estimates" in a new separately captioned section of MD&A.[1] An accounting estimate[2] would be a "critical accounting estimate" if:

- it requires the company to make assumptions about matters that are highly uncertain at the time the accounting estimate is made;[3] and

[1] For example, titled "Application of Critical Accounting Policies."

[2] An accounting estimate is defined as an approximation made by management of a financial statement element, item or account.

[3] A matter involves a high degree of uncertainty if it is dependent on events remote in time that may or may not occur, or it is not capable of being readily calculated from generally accepted methodologies or derived with some degree of precision from available data. A matter that is highly uncertain requires management to use significant judgment in making assumptions about that matter.

- different estimates that the company reasonably could have used in the relevant period, or changes in the accounting estimate that are reasonably likely to occur from period-to-period, would have a material impact on the presentation of the company's financial condition, changes in financial condition or results of operations.

In the rule proposals, the SEC has indicated that it believes that few of a company's accounting estimates generally would meet these thresholds. While the SEC has not currently proposed an outside limit to the number of accounting estimates that a company must discuss under the proposals, it has indicated that it expects most companies to have somewhere in the range of three to five critical accounting estimates.

Under the rule proposals, a company would be required to:

- Provide basic disclosures needed to understand each critical accounting estimate and management's view of the importance of the estimate, including:
  - the nature of the estimate;
  - the methodology used in determining the estimate;
  - the assumptions underlying the estimate that relate to matters highly uncertain at the time the estimate was made;
  - any other underlying assumptions that are material;
  - any known trends, demands, commitments, events or uncertainties that are reasonably likely to occur and materially affect the methodology or assumptions described;
  - why different estimates that would have had a material impact on the company's financial presentation could have been used in the current period, if applicable;
  - why the accounting estimate is reasonably likely to change from period to period with a material impact on the financial presentation, if applicable.
- Provide information regarding the impact of each critical accounting estimate on the company's financial condition, changes in financial condition and results of operations, including:
  - the significance of the accounting estimate to the company's financial condition, changes in financial condition and results of operations;
  - where material, the line items in the financial statements affected by the accounting estimate.

- Provide disclosures regarding the sensitivity of the company's reported operating results and financial condition to changes in critical accounting estimates or their underlying assumptions, including:
  - a quantitative discussion of changes in overall financial performance (and line items to the extent material) if the company were to assume that the accounting estimate were changed, either:
    - — by using reasonably possible near-term changes (both negative and positive) in the most material assumptions underlying the estimate;[4] or
    - — by using the reasonably possible range (including the upper end and lower end) of the accounting estimate;[5]
  - a quantitative and qualitative discussion of any material changes made to the accounting estimate in the past three years,[6] the reasons for the changes and the effect on line items in the financial statements and overall financial performance.
- State whether senior management discussed the development and selection of the critical accounting estimates, and the associated MD&A disclosure, with the audit committee;[7]
- If the company operates in more than one segment, identify the segments of the company's business that the critical accounting estimates affect and discuss the critical accounting estimates on a segment basis, to the extent that failure to present that information would result in an omission that renders the disclosure materially misleading.

To assist companies in preparing compliant disclosures, the rule proposals include three

[4] "Reasonably possible" means the chance of a future transaction or event occurring is more than remote but less than likely. "Near-term" means a period of time going forward up to one year from the date of the financial statements. Companies would be required to select meaningful changes in material assumptions for purposes of these disclosures. If a company was not able to select a single most material assumption or believed that using a single assumption would not provide meaningful sensitivity information for investors, it could demonstrate the effects of near-term reasonably possible changes in more than one material assumption underlying the critical accounting estimate.

[5] For purposes of these sensitivity analyses, a company should disclose the likelihood of occurrence of the changes it selects, such as estimated probabilities of occurrence or standard deviations, where applicable and available. In addition, a company is required to discuss any material impact on its liquidity and capital resources that would occur if any of the changes being assumed for purposes of the sensitivity analysis were in effect.

[6] Small business issuers would only have to provide this discussion for the past two years. In addition, there is a phase-in period for all companies. When a small business issuer or other company files its first covered SEC report or statement following adoption of the proposed rules, the rules would require it to provide the disclosures regarding past changes only for the past one year (for small business issuers) or two years (for all other companies).

[7] By these rules, the SEC is attempting to encourage greater involvement by audit committees in understanding the company's critical accounting estimates and thereby to improve the quality and transparency of the company's financial disclosures. The SEC is not currently proposing that the substance of the discussions between senior management and the audit committee be disclosed.

examples of disclosures regarding critical accounting estimates. We have included a copy of these examples at the end of this alert.

Disclosures Regarding Initial Adoption of Accounting Policies That Have a Material Impact on Financials

The rule proposals also envision new disclosure, in the same separately captioned section of MD&A, regarding a company's initial adoption of an accounting policy, if the accounting policy had a material impact on the company's financial condition or results of operations. Initial adoption of an accounting policy occurs when events or transactions affecting the company occur for the first time, or were previously immaterial in their effect but become material, or when events or transactions occur that are clearly different in substance from previous ones.[8] Initial adoption of these accounting policies would not have to be described if the adoption was due solely to new accounting literature issued by a recognized accounting standard setter.

Under the rule proposals, companies would be required to disclose:

- The events that gave rise to the initial adoption;
- The accounting principle that has been adopted and the method of applying it;
- The impact (discussed qualitatively) on the company's financial condition, changes in financial condition and results of operations;
- If the company is permitted a choice between acceptable principles, an explanation that it made such a choice, what the alternatives were, and why it made the choice it did (including, where material, qualitative disclosure of the impact on the company's financial presentation that the alternatives would have had); and
- If no accounting literature exists that governs the accounting for the events or transactions giving rise to the initial adoption, an explanation of its decision regarding which accounting principle to use and which method of applying that principle to use.

Timing, Location and Presentation of Disclosures

The new disclosures regarding critical accounting policies would be required under a separately captioned heading in MD&A sections of Forms 10-K, annual reports to shareholders, registration statements and proxy and information statements that otherwise include MD&A. The SEC has emphasized that these disclosures should be presented in language, and a format, that is clear, concise and understandable to the average investor. In particular, the SEC has indicated that companies should separately discuss each critical

[8] For example, a company may for the first time enter into a transaction involving derivate instruments, such as interest rate swaps, or may begin selling a new type of product that has delivery terms and conditions that are different from those associated with the products that the company has previously been selling.

accounting estimate and each new accounting policy (rather than aggregating the disclosures regarding these matters in a single discussion). The SEC has acknowledged that these proposed disclosures will include forward-looking information and that, as a result, companies may find it beneficial to include disclosures that take advantage of available safe harbors for forward-looking statements. However, the SEC has cautioned companies that the required disclosures should not be overshadowed by blanket disclaimers of legal responsibility for the application and development of the company's critical accounting estimates.

These disclosure requirements would apply to all companies except small business issuers that have not had revenues from operations during the last two fiscal years. The proposed MD&A disclosure requirements would cover the most recent fiscal year and any subsequent interim period for which financial statements are required to be presented. Companies would be required to update their annual disclosures on a quarterly basis by including additional disclosures in a separately captioned section of MD&A for each Form 10-Q. These Form 10-Q disclosures would address newly identified critical accounting estimates and material changes regarding previously described critical accounting estimates that are necessary to make the prior disclosures not materially misleading.[9]

Commenting on the Proposed Rules

Commentators have until July 19, 2002 to comment on these proposals. The SEC will make a decision about whether to adopt these rules (or some modified version of them) following the end of this comment period. The SEC has requested comments with respect to numerous aspects of these proposed rules, including the potential cost to companies of compliance with these rules, whether these rules would create competitively harmful effects upon public companies and whether required disclosures under certain of these rules should be expanded or reduced. In addition, the SEC has requested comments about whether it should require greater involvement by the outside auditors in the preparation of MD&A, including whether it should require critical accounting estimate disclosures under MD&A (or other MD&A disclosures) to be "examined" by outside auditors under current Attestation Standards.[10]

9 Companies would not be required to update on a quarterly basis the quantitative and qualitative discussion concerning past material changes in already-reported critical accounting estimates.

10 Under these Attestation Standards, an auditor examines the company's MD&A in order to express an opinion on: (i) whether the MD&A presentation includes in all material respects the required elements of the disclosure mandated by the SEC; (ii) whether the historical financial amounts have been accurately derived, in all material respects, from the company's financial statements; and (iii) whether the underlying information, determinations, estimates and assumptions of the company provide a reasonable basis for the disclosures contained in the MD&A. As explained in the proposing release, in connection with an examination, an auditor must examine documents and records and accumulate sufficient evidence in support of the disclosures and assumptions and take other steps to get reasonable assurance of detecting both intentional and unintentional misstatements that are material to the MD&A presentation. Currently, auditor examinations of MD&A disclosures are undertaken on relatively few occasions.

Comments can be submitted in writing by sending three copies to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609 or electronically to rule-comments@sec.gov. All comments should refer to file number S7-16-02 (and this number should appear in the subject line for electronically submitted comments).

Next Steps

It is difficult to say whether and how these proposals may be modified in light of public reaction, but it seems likely that some rule changes will be adopted in this area. We would be happy to provide you with additional information on these proposals and will provide further information on the final rules when they are announced. In addition, in the release relating to these rule proposals, the SEC indicated that it is continuing to consider other ways to improve MD&A, including requiring a more meaningful summary, requiring more discussion of the material matters on which the company is focusing, requiring more disclosures regarding related party, off-balance sheet and similar types of transactions, and requiring disclosure of more trend information. As a result, we expect to see additional proposals from the SEC regarding enhanced MD&A disclosures, and we will provide you with updates regarding likely changes as further rule proposals are made.

If you have any questions, please contact any member of the Fenwick & West team or fwscu@fenwick.com.

SEC Examples of Disclosures of Critical Accounting Policies

EXAMPLE 1

Background

Alphabetical Company manufactures and distributes electrical equipment used in large-scale commercial pumping and water treatment facilities. The company operates in four business segments. The company's equipment carries standard product warranties extending over a period of 6 to 10 years. If equipment covered under the standard warranty requires repair, the company provides labor and replacement parts to the customer at no cost. Historically, the costs of fulfilling warranty obligations have principally related to providing replacement parts, with labor costs representing the remainder. Over the past 3 years, the cost of copper included in replacement parts constituted approximately 35% to 40% of the total cost of warranty obligations.

A liability for the expected cost of warranty-related claims is established when equipment is sold. The amount of the warranty liability accrued reflects the company's estimate of the expected future costs of honoring its obligations under the warranty plan. Because of the long-term nature of the company's equipment warranties, estimating the expected cost of such warranties requires significant judgment. Based on management's evaluation of analysts' forecasts for copper prices, management believes a 30% decrease in copper prices or a 50% increase in copper prices is reasonably possible in the near term. In each of the last three years, warranty expense represented approximately 19% to 22% of cost of sales.

Possible MD&A disclosure under the proposal

> ***Application of Critical Accounting Policies.*** *Alphabetical's products are covered by standard product warranty plans that extend 6 to 10 years. A liability for the expected cost of warranty-related claims is established when equipment is sold. The amount of the warranty liability accrued reflects our estimate of the expected future costs of honoring our obligations under the warranty plan. We believe the accounting estimate related to warranty costs is a "critical accounting estimate" because: changes in it can materially affect net income, it requires us to forecast copper prices in the distant future which are highly uncertain and require a large degree of judgment, and copper is a significant raw material in the replacement parts used in warranty repairs. The estimate for warranty obligations is a critical accounting estimate for all of our four segments.*
>
> *Historically, the costs of fulfilling our warranty obligations have principally related to replacement parts, with labor costs representing the remainder. Over the past 3 years, the cost of copper included in our parts constituted approximately 35% to 40% of the total cost of warranty repairs. Over that same period, warranty expense represented approximately 19% to 22% of cost of sales.*

Over the past 10 years, the price of copper has exhibited significant volatility. For example, during 1994, the price of copper rose by approximately 72%, while in 2001 the price decreased by approximately 19%. Our hedging programs provide adequate protection against short-term volatility in copper prices, as described in "Risk Management," but our hedging does not extend beyond 5 years. Accordingly, our management must make assumptions about the cost of that raw material in periods 6 to 10 years in the future. Management forecasts the price of copper for the portion of our estimated copper requirements not covered by hedging. Our forecasts are based principally on long-range price forecasts for copper which are published by private research companies specializing in the copper markets.

Each quarter, we reevaluate our estimate of warranty obligations, including our assumptions about the cost of copper. During 2001, we decreased our estimated cost of unhedged copper purchases over the next 10 years by 15%, reflecting a growing excess of supply over forecasted demand, which reduced our accrued warranty costs and our cost of sales (and, accordingly, increased operating income) by $15 million. In contrast, during 2000, long-term price forecasts were essentially unchanged, so we made no adjustments to our estimated cost of unhedged copper purchases over the next 10 years. During 1999, copper prices increased by approximately 28% over the prior year. Long-term prices also reflected increases in prices over those projected in 1998. Thus, in 1999, we increased our estimated cost of unhedged copper purchases over the next 10 years (through 2009) by 15%. That increase in our estimate resulted in an $18 million addition to our accrued warranty cost and our cost of sales, and an equal reduction in our operating income.

If, for the unhedged portion of our estimated copper requirements, we were to decrease our estimate of copper prices as of December 31, 2001 by 30%, our accrued warranty costs and cost of sales would have been reduced by approximately $27 million or 6% and 4%, respectively, while operating income would have increased by 9%. If we were to increase our estimate as of December 31, 2001 by 50%, our accrued warranty costs and cost of sales would have been increased by approximately $45 million or 10% and 7%, respectively, while our operating income would have been reduced by 23%.

A very significant increase in our estimated warranty obligation, such as one reflecting the increase in copper prices that occurred in 1994, could lower our earnings and increase our leverage ratio (leverage refers to the degree to which a company utilizes borrowed funds). That, in turn, could limit our ability to borrow money through our revolving credit facilities described in "Liquidity and Capital Resources."

Our management has discussed the development and selection of this critical accounting estimate with the audit committee of our board of directors and the audit committee has reviewed the company's disclosure relating to it in this MD&A.

EXAMPLE 2

Background
MQB Corp. is a developer and publisher of desktop publishing software that operates in two segments. MQB distributes its products primarily through third-party distributors, resellers, and retailers (customers). Like many companies in the software industry, MQB has a product return policy and has historically accepted significant product returns. MQB permits its customers to return software titles published and distributed by the company within 120 days of purchase.

MQB recognizes revenues under SOP 97-2, "Software Revenue Recognition." The company ships its products FOB (Free on Board) shipping point. Therefore, legal title to the products passes to the customers upon shipment, and the company has no legal obligation for product damage in transit. Accordingly, MQB recognizes revenue upon shipment of its software products, provided that collection of payment is determined to be probable and no significant obligations on MQB's part remain. Payment is due from customers 30 days after shipment. At the time revenue is recorded, MQB accounts for estimated future returns by reducing sales by its estimate of future returns and by reducing accounts receivable by the same amount. For example, MQB reduced its gross sales and accounts receivable by 12% for its fiscal year ended December 31, 2001 to reflect estimated product returns. In the last three years, the range in which the company has reduced its gross sales and accounts receivable to reflect product returns has been between 11% and 13%.

MQB receives weekly reports from distributors and retailers regarding the amount of MQB products in their inventory. A historical correlation exists between levels of inventory held by distributors and retailers (together, the distribution channel) and the amount of returns that actually occur. The weekly reports from distributors and retailers provide the company with visibility into the distribution channel such that MQB has the ability to estimate future returns. In each of the past few years, actual returns have varied from period to period, although they have not exceeded the estimated amounts by more than 5%. The company's products are, however, subject to intense marketplace competition, including several recently introduced competing products. If actual returns significantly exceed the previously estimated amounts, it would result in materially lower sales and net income before taxes in one or more future periods.

Possible MD&A disclosure under the proposal

> ***Application of Critical Accounting Policies.*** *Our recognition of revenue from sales to distributors and retailers (the "distribution channel") is impacted by agreements we have giving them rights to return our software titles within 120 days after purchase. At the time we recognize revenue, upon shipment of our software products, we reduce our*

measurements of those sales by our estimate of future returns and we also reduce our measurements of accounts receivable by the same amount.

For our products, a historical correlation exists between the amount of distribution channel inventory and the amount of returns that actually occur. The greater the distribution channel inventory, the more product returns we expect. For each of our products, we monitor levels of product sales and inventory at our distributors' warehouses and at retailers as part of our effort to reach an appropriate accounting estimate for returns. In estimating returns, we analyze historical returns, current inventory in the distribution channel, current economic trends, changes in consumer demand, introduction of new competing software and acceptance of our products.

In recent years, as a result of a combination of the factors described above, we have materially reduced our gross sales to reflect our estimated amount of returns. It is also possible that returns could increase rapidly and significantly in the future. Accordingly, estimating product returns requires significant management judgment. In addition, different return estimates that we reasonably could have used would have had a material impact on our reported sales and thus have had a material impact on the presentation of the results of operations. For those reasons, we believe that the accounting estimate related to product returns is a "critical accounting estimate." Our estimate of product returns is a critical accounting estimate for both of our segments. Management of the company has discussed the development and selection of this critical accounting estimate with the audit committee of our board of directors and the audit committee has reviewed the company's disclosure relating to it in this MD&A.

We are aware of several recently introduced products that compete with several of our significant products. These new competitive factors have not, to date, materially impacted returns; therefore, we have made no adjustment as a result of these factors in our estimated returns for 2001. In our highly competitive marketplace, these factors have some potential to increase our estimates of returns in the future. The introduction of new competing products has impacted our estimate of returns in the past. In 1999, we increased our estimate of returns over the previous year by 1%, as a percentage of gross sales, because of increased inventory in the distribution channel due to new products introduced by two of our competitors.

In preparing our financial statements for the year ended December 31, 2001, we estimated future product returns for all of our products to be $145 million, and we reduced our gross sales by that amount. Our 2001 estimate for returns was $20 million greater than our estimate in 2000 and $15 million greater than our estimate in 1999. From 1999 to 2000, products introduced by two of our competitors in 1998 lost market share to our products and our sales increased. Due to our increased sales in 2000, the

distribution channel inventory declined over levels in 1999, which also resulted in a 2% decline in the estimated amount of returns, as a percentage of gross sales. In 2001, with the slow down in consumer spending over the prior period, distribution channel inventory grew faster than sales, necessitating an increase in the estimated returns equal to 1% of gross sales. The estimates for returns represented approximately 12%, 11% and 13% of our gross sales for 2001, 2000 and 1999, respectively.

If we were to assume that our estimate of future product returns for all of our products was changed to the upper end or lower end of the range we developed in the course of formulating our estimate, the estimate for future returns as of December 31, 2001 would range from $130 million to $160 million. Accordingly, the amounts by which we would reduce gross sales and operating income also would range from $130 million to $160 million as compared to the recorded amount of $145 million. In each of the years in the three-year period ended 2001, our actual returns have not deviated from our estimates by more than 5%. Our actual returns for 2000 and 1999 were $129 million and $134 million, respectively. If we were to change our estimate of future product returns to the high end of the range, there would be no material impact on our liquidity or capital resources.

EXAMPLE 3

Background

Betascott Company manufactures and sells data storage devices including computer hard drives. The hard drive industry is subject to intense competition and significant shifts in market share amongst the competitors. In the last three years, Betascott has reported falling sales and market share, which has contributed to a fiscal year 2001 loss from operations in the hard drive segment. (This trend is separately discussed in MD&A.)

As of December 31, 2001, the company had $200 million in property, plant and equipment ("PP&E") used in producing hard drives. The company's accounting policies require that it test long-lived assets for impairment whenever indicators of impairment exist. The 2001 fiscal year loss from operations in that segment, coupled with the company's falling sales and market share, are indicators of a potential impairment of the hard drive-related PP&E.

The company follows the provisions of FASB SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.96 That accounting standard requires that if the sum of the future cash flows expected to result from the assets, undiscounted and without interest charges, is less than a company's reported value of the assets, then the asset is not recoverable and the company must recognize an impairment. The amount of impairment to be recognized is the excess of the reported value of the assets over the fair value of those assets.

The hard drive-related PP&E accounts for approximately 67% of Betascott's PP&E. The sum of Betascott's current estimate of expected future cash flows from its hard drive-related PP&E, undiscounted and without interest charges, is near the reported value of that PP&E. In the year ended December 31, 2001, Betascott would have been required to recognize an impairment loss of approximately $30 million if its estimate of those future cash flows had been 10% lower.

Possible MD&A disclosure under the proposal

> ***Application of Critical Accounting Policies***. *We evaluate our property, plant and equipment ("PP&E") for impairment whenever indicators of impairment exist. Accounting standards require that if the sum of the future cash flows expected to result from a company's asset, undiscounted and without interest charges, is less than the reported value of the asset, an asset impairment must be recognized in the financial statements. The amount of impairment to recognize is calculated by subtracting the fair value of the asset from the reported value of the asset.*
>
> *As we discuss in the notes to the financial statements, we operate in four segments, one of which is the hard drive segment. In our hard drive segment, we reviewed our hard drive-related PP&E for impairment as of December 31, 2001, due to a trend of declining sales and market share. We determined that the undiscounted sum of the expected future cash flows from the assets related to the hard drive segment exceeded the recorded value of those assets, so we did not recognize an impairment in accordance with GAAP. The PP&E in our hard-drive segment represents approximately two-thirds of our total PP&E.*
>
> *We believe that the accounting estimate related to asset impairment is a "critical accounting estimate" because: (1) it is highly susceptible to change from period to period because it requires company management to make assumptions about future sales and cost of sales over the life of the hard drive-related PP&E (generally seven years); and (2) the impact that recognizing an impairment would have on the assets reported on our balance sheet as well as our net loss would be material. Management's assumptions about future sales prices and future sales volumes require significant judgment because actual sales prices and volumes have fluctuated in the past and are expected to continue to do so. Management has discussed the development and selection of this critical accounting estimate with the audit committee of our board of directors and the audit committee has reviewed the company's disclosure relating to it in this MD&A.*
>
> *In estimating future sales, we use our internal budgets. We develop our budgets based*

on recent sales data for existing products, planned timing of new product launches, customer commitments related to existing and newly developed products, and current unsold inventory held by distributors.

Our estimates of future cash flows assume that our sales of hard drive inventory will remain consistent with current year sales. While actual sales have declined by an average of approximately 2% per year during the last three years, our introduction of the Stored line of hard drives in August 2001 has resulted in a 0.5% increase in market share over the last five months of 2001, and a corresponding increase in sales of 5% over the comparable 5-month period last year. We therefore have assumed that sales will not continue to decline in the future. We have also assumed that our costs will have annual growth of approximately 2%. This level of costs is comparable to actual costs incurred over the last two years, following the 1999 restructuring of the hard drive division (which is described in the note 2 to the financial statements).

In each of the last two years, we have tested the hard drive-related PP&E for impairment and in each year we determined that, based on our assumptions, the sum of the expected future cash flows, undiscounted and without interest charges, exceeded the reported value and therefore we did not recognize an impairment. Because 2001 sales were lower than those in 2000 and 1999, despite the improvement in the latter part of the year, and because our estimates of future cash flows are assumed to be consistent with current year sales, the current year impairment analysis includes estimated sales that are 2% and 5% less than those assumed in the 2000 and 1999 impairment tests, respectively.

As of December 31, 2001, we estimate that our future cash flows, on an undiscounted basis, are greater than our $200 million investment in hard drive-related PP&E. Any increases in estimated future cash flows would have no impact on the reported value of the hard drive-related PP&E. In contrast, if our current estimate of future cash flows from hard drive sales had been 10% lower, those cash flows would have been less than the reported amount of the hard drive-related PP&E. In that case, we would have been required to recognize an impairment loss of approximately $30 million, equal to the difference between the fair value of the equipment (which we would have determined by calculating the discounted value of the estimated future cash flows) and the reported amount of the hard drive-related PP&E. A $30 million impairment loss would have reduced PP&E and Total Assets as of December 31, 2001 by 10% and 3%, respectively. That impairment loss also would have increased Net Loss Before Taxes, for the year ended December 31, 2001, by 100%.

If we had been required to recognize an impairment loss on our hard-drive related PP&E, it would likely not have affected our liquidity and capital resources because, even with

the impairment loss, we would have been within the terms of the tangible net-worth covenant in our long-term debt agreement discussed in note 5 to the financial statements.