SEC PROPOSES NEW DISCLOSURES RELATING TO CRITICAL ACCOUNTING POLICIES

SIMPSON THACHER & BARTLETT LLP

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On May 10, 2002, the Securities and Exchange Commission (the "SEC") issued a release[1] (the "Release") that proposes new disclosure requirements intended to enhance investors' understanding of the application of companies' critical accounting policies in order to improve the transparency of reported financial information. The Release represents the latest SEC initiative in response to the continuing controversies regarding the quality, consistency and clarity of financial disclosures. The Release follows more general guidelines set out in the SEC's release "Cautionary Advice Regarding Disclosure About Critical Accounting Policies"[2] issued on December 12, 2001 and "Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations"[3] issued on January 22, 2002, that are discussed in our memorandum of January 30, 2002.

The revised regulations proposed in the Release would require additional disclosure to be included at least annually in "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A") sections. The revised regulations would mandate new MD&A disclosure on two topics:

- accounting estimates[4] reflected in a company's financial statements that require a company to make assumptions about matters that are highly uncertain at the time of estimation; and

- the initial adoption by a company of an accounting policy that has a material effect on its financial condition or results of operations.

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1 SEC Release Nos. 33-8098; 34-45907 (May 10, 2002)

2 SEC Release Nos. 33-8040; 34-45149 (December 12, 2001)

3 SEC Release Nos. 33-8048, 34-45189 (January 22, 2002)

4 The proposed revised regulations would define "accounting estimate" to mean "an approximation made by management of a financial statement element, item or account in the financial statements."

If the revised regulations are adopted as proposed, companies would be required to present information addressing these topics in a new separate section of the MD&A in their annual reports, registration statements and proxy and information statements. In addition, companies would be required to update the information regarding critical accounting policies to disclose material changes in such policies in the MD&A section of quarterly reports. The proposed disclosure requirements would apply to all reporting companies, domestic and foreign, other than certain small business issuers.

PROPOSED DISCLOSURE ABOUT CRITICAL ACCOUNTING ESTIMATES

The Release proposes to amend Item 303 of Regulation S-K and the parallel provisions of Regulation S-B and Form 20-F to require new accounting estimate disclosure in a separate "Application of Critical Accounting Policies" subsection of the MD&A. The new section would include disclosure both about accounting estimates resulting from the application of critical accounting policies and the initial adoption of accounting policies that have a material impact on a company's financial presentation.

The Release indicates that a company must answer two questions in order to identify critical accounting estimates which may need to be disclosed:

- Did a particular accounting estimate require the company to make assumptions about matters that were highly uncertain at the time the accounting estimate was made?

- Would different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, have a material impact on the presentation of its financial condition, changes in financial condition or results of operations?

If the answer to both questions is yes, then the accounting estimate should be regarded as a "critical accounting estimate" requiring disclosure. The Release indicates that the SEC expects that only a limited number of a company's accounting estimates would require disclosure under these standards. Although the SEC declined to propose an outside limit to the number of estimates to be disclosed, it did provide guidance that it expected that a very few companies would have no critical accounting estimates at all and that the large majority of companies would be expected to have three to five critical accounting estimates.

The proposed revised regulations would require that each critical accounting estimate be separately identified and described. A company would have to discuss the methodology used at arriving at the accounting estimate and any assumptions underlying the accounting estimate, particularly assumptions about highly uncertain matters which would make the accounting estimate highly susceptible to change. In addition, a company would have to disclose known trends, demands, commitments, events or uncertainties that are reasonably likely to occur and that would materially affect the assumptions made or the methodology used.

Once a particular critical accounting estimate has been described, a company would have to discuss its importance to the company's financial condition, changes in financial condition and results of operations and, where material, describe its effect on the line items in the company's financial statements. The Release indicates that this disclosure is regarded as particularly important because the existence and impact of critical accounting estimates may not be readily apparent from a company's financial statements. Accordingly, this disclosure would be expected to provide additional information to investors and to increase the transparency of the financial disclosure.

In addition, disclosure regarding the impact of critical accounting policies on segments of a company's business may be required. In accordance with the interpretive guidance provided in 1989 on segment reporting[5], a company operating in more than one segment would have to identify the segments affected by a critical accounting estimate if fewer than all of its segments are affected. Additionally, disclosure on a segment basis would be required to the extent the presentation on a company-wide basis would result in materially misleading disclosure.

QUANTITATIVE DISCLOSURES TO DEMONSTRATE SENSITIVITY

The Release contemplates the presentation of two types of quantitative disclosure to illustrate the sensitivity of critical accounting estimates: (1) quantitative disclosure showing the sensitivity of financial results to changes made in connection with each critical accounting estimate and (2) quantitative disclosure of historical changes in a company's critical accounting estimate over the past three years. This quantitative disclosure is proposed in order to demonstrate the sensitivity of a company's financial performance to critical accounting estimates. Because the purpose of the disclosure is to show the degree of sensitivity of a company's financial performance, the impact on financial performance would need to be discussed regardless of the magnitude of the impact.

In formulating this quantitative disclosure, a company would have two choices of the changes to be assumed in order to present the sensitivity analysis. First, a company might assume that the most material assumption or assumptions in the critical accounting estimate had changed and alter them at least twice to reflect reasonably possible changes that might occur within one year from the date of the financial statements. Alternatively, a company might assume that the critical accounting estimate itself changes. In either case, a company will also be required to discuss whether the assumed changes could have a material effect on the company's liquidity or capital resources and what that effect might be.

5 *See* Securities Act Release No. 6835 (May 18, 1989)

QUANTITATIVE AND QUALITATIVE DISCLOSURES CONCERNING PAST CHANGES IN ACCOUNTING ESTIMATES

Current MD&A disclosure rules require discussion of the effects of changes in accounting estimates where those changes are material to an investor's understanding of a company's financial position or results of operations. In the Release, the SEC is proposing additional disclosures regarding past changes in critical accounting estimates. The Release contemplates that all companies, except for small business issuers, would need to include a qualitative and quantitative discussion of material changes to critical accounting estimates over the past three fiscal years. This disclosure is expected to encompass the impact of the changes on the financial statements and overall financial performance as well as the reasons for the changes. The Release indicates that this requirement would be phased-in over a period of two years: a company filing within the first year of the effective date of the revised regulations would only need to cover changes in accounting estimates in the prior two years. Filings submitted more than one year following the effective date of the revised regulations would be required to provide information for the past three years.

SENIOR MANAGEMENT'S DISCUSSIONS WITH THE AUDIT COMMITTEE

Consistent with the SEC's recent actions encouraging increased oversight by audit committees, the proposed revised regulations would require a company to disclose whether or not senior management has discussed its critical accounting estimates with the audit committee. If no such discussion has taken place, a company would be required to disclose that fact and the reasons behind it. Companies that do not have audit committees would need to provide disclosure about discussions with a committee carrying out equivalent duties, and if no such committee exists, with the entire board of directors. Disclosure of the substance of the review would not required.

QUARTERLY UPDATES

The Release contemplates that companies would update disclosure on critical accounting estimates in their reports on Form 10-Q if a new critical accounting estimate has been identified during the relevant quarter or if material changes have occurred that would result in the critical accounting estimates in the latest report being materially out of date or otherwise materially misleading.

PROPOSED DISCLOSURE ABOUT INITIAL ADOPTION OF ACCOUNTING POLICIES

In addition to disclosure relating to critical accounting estimates, the Release contemplates new disclosure about the initial adoption of certain accounting policies. Although disclosure relating to the adoption of material accounting policies is now typically included in the first note to the financial statements, the SEC believes more complete disclosure would be beneficial in order to more adequately describe the impact of the initially adopted accounting policy on a company's financial presentation. Accordingly, the proposed revisions to the regulations would require the inclusion of new disclosures in MD&A describing the initial adoption of accounting policies where a material impact exists. Such disclosures would encompass:

- the events or transactions that gave rise to the initial adoption of an accounting policy;
- the accounting principle that has been adopted and the method of applying that principle; and
- the impact (discussed qualitatively) resulting from the initial adoption of the accounting policy on the company's financial condition, changes in financial condition and results of operations.

If a company has selected the policy from among acceptable alternatives, then the company would also be required to explain the election and identify the alternatives. Where material, the company would also have to describe qualitatively the impact on the company's financial condition, changes in financial condition and results of operations that the alternatives would have had. If the company has developed an accounting policy in the absence of accounting literature governing the particular events or transactions giving rise to the adoption of the policy, the company would be required to explain its decision and how it intends the principle to be applied.

APPLICATION OF SAFE HARBORS FOR FORWARD-LOOKING INFORMATION

The SEC observes in the Release that some of the proposed new disclosures would constitute "forward-looking statements." Accordingly, once the final regulations are adopted, companies preparing disclosures responsive to the new requirements will want to consider the terms, conditions and scope of the safe harbor protections for forward-looking information contained in the Exchange Act and the Securities Act as well as the SEC's safe harbor rules (Rule 175 under the Securities Act and Rule 3b-6 under the Exchange Act). In light of the proposals to specifically require disclosures that constitute forward-looking information, the Release indicates that the SEC intends to eliminate the language in the existing MD&A regulations that states that companies are not required to make forward-looking statements under those rules.

EXAMPLES OF PROPOSED DISCLOSURE ABOUT CRITICAL ACCOUNTING ESTIMATES

In order to assist in understanding the proposals contained in the Release, the SEC has included three examples of possible disclosure about critical accounting estimates in the text of the Release. Copies of these examples are attached to this Memorandum as Annex A for your reference.

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If you have any questions concerning the Release, please contact John D. Lobrano (212-455-2890; jlobrano@stblaw.com); Michael D. Nathan (212-455-2538; mnathan@stblaw.com); or Vincent Pagano (212-455-3125; vpagano@stblaw.com) of our Firm.

SIMPSON THACHER & BARTLETT LLP

ANNEX A

EXAMPLES OF PROPOSED DISCLOSURE ABOUT CRITICAL ACCOUNTING ESTIMATES

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***
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> *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.* 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.*
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> *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.