Scrutinizing Topical Accounting Issues

Third Annual Edition Sheds More Light on Footnote Disclosures

Special Report

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Analysts

Judi M. Rossetti CFA/CPA
+1 312 368-2077
judi.rossetti@fitchratings.com

Olu Sonola CFA/CPA
+1 212 908-0583
olu.sonola@fitchratings.com

Footnote Disclosures Improve: Fitch Ratings evaluates recent accounting guidance, including enhanced footnote disclosures for multi-employer pensions and fair value. Changes in guidance for goodwill, changes in presentation for comprehensive income, as well as topical issues regarding pensions, taxes, and convergence are also discussed. Increased disclosure and transparency can provide warnings of trouble spots in corporate earnings and/or cash flow. However, new standards are not expected to have a material impact on financial statements or be the sole cause of credit rating changes.

MEPPs Reveal Red Zones: FASB now requires enhanced disclosure regarding employers' financial obligations to multi-employer pension and postretirement plans (MEPPs). Among other disclosures, the funding status for each MEPP is shown (red zone is generally less than 65% funded, yellow zone is 65% to less than 80% funded, and green zone is at least 80% funded). The new disclosure goes a long way in revealing a better estimate of a company's share of its pension liability related to MEPPs and the potential impact on future cash flow.

Pension Liabilities Generally Increased: Pension liabilities generally increased during 2011, driven by the decline in discount rates. Also, weak equity returns in 2011 were not able to offset increased liabilities, causing wider funding gaps. This problem was exacerbated for lower rated companies with materially underfunded pension plans and increased funding requirements. Proposed legislation would allow companies to use a higher discount rate for funding purposes, likely resulting in lower required contributions. However, permitting lower contributions could worsen underfunding problems in the future.

Bonus Depreciation Impact Continues: The Unemployment Insurance Reauthorization and Job Creation Act of 2010 (Tax Relief Act) allowed for 100% bonus depreciation through the end of 2011 and also allows for 50% bonus depreciation in 2012. If elected, bonus depreciation results in a temporary boost to cash flows by allowing issuers to quickly depreciate the cost of eligible newly installed equipment. This election should not affect book earnings, as the bonus depreciation only impacts the tax return.

Qualitative Assessment of Goodwill: New guidance for intangibles provides an option to perform a qualitative assessment to determine if potential impairment is "more likely than not" before performing the two-step quantitative impairment test. If goodwill impairment is not determined to be likely, the quantitative test is not required. This amendment allows companies more discretion, which could delay goodwill impairment recognition.

GAAP and IFRS Converge: There are various degrees to which countries are adopting IFRS. The U.S. plan to incorporate IFRS into U.S. GAAP is moving forward slowly and cautiously. Standards regarding financial instruments, revenue recognition, and leases are critical to the convergence process. New disclosures regarding financial instruments improve comparability but add complexity.

Red Flags Highlighted: This report also summarizes common accounting red flags to be aware of when reviewing corporate financial statements *(see Appendix C)*. Aggressive accounting practices may artificially boost revenue or change the timing of recognition, artificially reduce expenses or change the timing of recognition, or reduce on-balance sheet liabilities.

Accounting Standards Codification (ASC) Topic 715-80 (ASU 2011-09) — Multi-Employer Pension and Postretirement Benefit Plans

Guidance Amended: In September 2011, FASB amended the ASC to provide enhanced disclosure about an employer's financial obligations to MEPPs. The new disclosures provide additional quantitative and qualitative information regarding an employer's participation in individually significant plans and the level of the employer's participation in the plan. Disclosures include each MEPP name, employer identification number (EIN), Pension Protection Act (PPA) zone status (red zone is generally less than 65% funded, yellow zone 65% to less than 80% funded, and green zone is at least 80% funded), financial improvement or rehabilitation plan status, contributions by the company, whether there has been a surcharge to contributions, and expiration dates of the collective bargaining agreements.

Example: See Dean Foods Co. in Appendix B for a concise example of the new required disclosures.

Previous Guidance: Previously, employers were only required to disclose their total contributions to all MEPPs in which they participate and certain year-to-date changes in circumstances.

Effective Date: Effective for fiscal years ending after Dec. 15, 2011, and applied retrospectively for prior periods presented.

Impact for Corporates: Adoption requires expanded footnote disclosure but is not likely to immediately affect financial results. The expanded footnotes provide additional information for analysts and investors. This information is important, because if a participating employer stops contributing to the plan, the unfunded obligations of the plan may be borne by the remaining participating employers. Plans in the "red zone" are significantly underfunded and are of greatest concern.

Multi-employer plans span a wide range of industries with particular concentrations in the supermarkets, construction, and transportation sectors. Safeway Inc. and United Parcel Service, Inc. (UPS) are examples of companies with sizable multi-employer pension plans. Withdrawing from a multi-employer plan can be complex and costly. For example, UPS had to pay approximately $6 billion in 2007 to withdraw from a large multi-employer plan.

Disclosure Still Falls Short: The enhanced disclosures still do not require a company to recognize a balance-sheet liability similar to single-employer pension plans or to disclose the amount of withdrawal liability if the company withdraws from the MEPP. Fitch would like to see this additional information in the future. Also, it is extremely difficult, if not impossible, to judge the number of obligors in an MEPP, determine the financial health of those obligors, or estimate the probability, amount, or timing of a potential material increase in the liability.

To estimate a balance-sheet liability, additional information can be gleaned from a pension plan's annual report, Form 5500, filed with the Department of Labor. Form 5500s can be somewhat dated, as there is usually a significant lag in the public disclosure, given the timing of filing requirements. Using the EIN disclosed in the footnote, the disclosed total contribution of a plan relative to the total contribution into the MEPP can be used as an estimate of the portion of the company's liability in the MEPP.

ASC Topic 350 (ASU 2011-8) Intangibles — Goodwill and Others

Guidance Amended: In September 2011, FASB amended the guidance for intangibles — goodwill and others. The objective of the amendment was to simplify how companies test goodwill for impairment in response to concerns about the cost and complexity of performing the two-step quantitative test of an impairment loss. This guidance provides an option to perform a qualitative assessment to determine if potential impairment is “more likely than not” (having a likelihood of more than 50%) before performing the two-step quantitative goodwill impairment test. If goodwill impairment is determined to be unlikely, the quantitative two-step impairment test is not required. Also, interim goodwill evaluation has been modified to make it consistent with the new annual qualitative approach. This amendment diverges from IFRS which only requires a single step quantitative goodwill test. Qualitative assessment is not an option in IFRS.

Two-Step Test Details: Companies were previously required to test goodwill and intangible assets for impairment at least annually, and whenever there was an indication of potential impairment. In step one, a company must estimate the fair value of a reporting unit and compare it to its carrying value (book value). If the carrying value is greater than the fair value, a potential impairment exists for the difference in these values. For intangible assets, the total undiscounted cash flows expected to be generated by the asset over its remaining economic life is computed. If the carrying value exceeds this fair value of the asset, the difference results in an impairment loss.

Effective Date: The amendments are effective for interim and annual periods beginning after Dec. 15, 2011, with early adoption permitted.

Impact for Corporates: Adoption provides enhanced footnote disclosure but is not expected to immediately impact consolidated financial results for corporates. However, it appears that the amendment allows companies more discretion regarding goodwill and intangibles impairment, which could delay impairment recognition and should be monitored closely.

Example: Kraft Foods, Inc. adopted the guidance effective Oct. 1, 2011 and incorporated the guidance in its annual goodwill impairment test, as shown in the table on page 4.

Example: Kraft — Goodwill Impairment Process

Note 1. Summary of Significant Accounting Policies

Goodwill and Intangible Assets: We test goodwill and non-amortizable intangible assets for impairment at least annually on Oct. 1. We assess goodwill impairment risk by first performing a qualitative review of entity-specific, industry, market, and general economic factors for each reporting unit. If significant potential goodwill impairment risk exists for a specific reporting unit, we apply a two-step quantitative test.

The first step compares the reporting unit's estimated fair value with its carrying value. We estimate a reporting unit's fair value using a 20-year projection of discounted cash flows, which incorporates planned growth rates, market-based discount rates, and estimates of residual value. For reporting units within our Kraft Foods North America and Kraft Foods Europe geographic units, we used a market-based, weighted-average cost of capital of 6.8% to discount the projected cash flows of those operations. For reporting units within our Kraft Foods Developing Markets geographic unit, we used a risk-rated discount rate of 9.8%.

Estimating the fair value of individual reporting units requires us to make assumptions and estimates regarding our future plans, industry and economic conditions, and our actual results and conditions may differ over time. If the carrying value of a reporting unit's net assets exceeds its fair value, the second step is applied to measure the difference between the carrying value and implied fair value of goodwill. If the carrying value of goodwill exceeds its implied fair value, the goodwill is considered impaired and reduced to its implied fair value. We test non-amortizable intangible assets for impairment by comparing the fair value of each intangible asset with its carrying value. Fair value of non-amortizable intangible assets is determined using planned growth rates, market-based discount rates, and estimates of royalty rates. If the carrying value exceeds fair value, the intangible asset is considered impaired and is reduced to fair value. We record intangible asset impairment charges within asset impairment and exit cost.

Note 5. Property, Plant, and Equipment

Asset Impairments: We did not record any asset impairments in 2011. During 2010, we recorded an asset impairment of $12 million on a biscuit plant and related property, plant, and equipment in France. During 2009, we recorded a $9 million asset impairment charge to write off an investment in Norway. These charges were recorded within asset impairment and exit costs."

Source: Kraft Foods Inc. Form 10-K, dated Dec. 31, 2011.

ASC Topic 220 (ASU 2011-05) — Comprehensive Income

Guidance Amended: In June 2011, FASB amended the guidance for comprehensive income. The objective of the amendment was primarily to increase the prominence of items reported in other comprehensive income. The new guidance changes the presentation of comprehensive income; however, there are no changes to the components that are recognized in net income or other comprehensive income under GAAP. The new guidance requires that other comprehensive income be presented in either one continuous statement or in two separate consecutive statements. The components of other comprehensive income can no longer be shown as part of the statement of changes in stockholders' equity.

Effective Date: The amendments are effective for interim and annual periods beginning after Dec. 15, 2011, with early adoption permitted.

Impact for Corporates: The adoption of these standards is not expected to have a material impact on corporate financial results but will change the presentation of future consolidated financial statements for all issuers.

Example: Time Warner Inc. is an early adopter of the new standard. See the Consolidated Statement of Comprehensive Income table on page 5.

Consolidated Statement of Comprehensive Income — Time Warner Inc.

($ Mil., Year Ended Dec. 31)	2011	2010	2009
Net Income	2,882	2,571	2,512
Other Comprehensive Income, Net of Tax			
Foreign Currency Translation Adjustments	(54)	(131)	222
Unrealized Gains (Losses) on Securities			
Unrealized Gains (Losses) Occurring During the Period	4	(2)	1
Less Reclassification Adjustment for (Gains) Losses Realized in Net Income	—	1	(13)
Net Gains (Losses) on Securities	4	(1)	(12)
Benefit Obligations			
Unrealized Gains (Losses) Occurring During the Period	(209)	27	111
Less Reclassification Adjustment for Losses Realized in Net Income	13	28	72
Net Benefit Obligations	(196)	55	183
Derivative Financial Instruments Gains (Losses)			
Unrealized Gains (Losses) Occurring During the Period	7	(1)	(4)
Less Reclassification Adjustment for Losses Realized in Net Income	19	26	39
Net Gains on Derivative Financial Instruments	26	25	35
Other Comprehensive Income (Loss)	(220)	(52)	428
Comprehensive Income	**2,662**	**2,519**	**2,940**
Less Comprehensive (Income) Loss Attributable to Noncontrolling Interest	4	7	(36)
Comprehensive Income Attributable to Time Warner Inc. Shareholders	**2,666**	**2,526**	**2,904**

Source: SEC filing.

ASC Topic 820 (ASU 2011-04) — Fair Value Measurement

Guidance Amended: In May 2011, FASB amended guidance intended to result in convergence between U.S. GAAP and IFRS requirements for fair-value measurement and disclosure. The standard provides clarification about applying the existing fair value measurement and disclosure requirements and expands disclosure, particularly for Level 3 fair value measurements. The amendment requires that Level 3 disclosures include more information on inputs and assumptions for measurement, valuation processes, and sensitivity to inputs.

The amended guidance also requires a company to provide fair value measurement disclosures for each class of assets and liabilities and disclose information about both the valuation techniques and inputs used in estimating Level 2 and Level 3 fair value measurements. Minor differences remain between U.S. GAAP and IFRS requirements for fair value measurement.

Effective Date: Effective during interim and annual periods, beginning after Dec. 15, 2011, on a prospective basis. Early adoption is not permitted.

Impact for Corporates: The adoption of this amendment requires expanded disclosure in the notes to a company’s consolidated financial statements but is not expected to affect financial results for corporates.

Review of Other Topical Accounting Issues

GAAP Convergence Toward IFRS

IFRS Adoption Strategies Vary

Although some countries have adopted IFRS as issued by the International Accounting Standards Board (IASB), many countries are unwilling to adopt this wholesale approach. Countries such as those in the European Union (EU) have adopted the “endorsement” approach, where accounting standards issued by the IASB are ratified individually by a local regulator before becoming law. This approach preserves the flexibility to address country-specific issues and results in some variability across countries. The other approach, which has arguably been the U.S. approach until now, is the “convergence” approach. The convergence approach does not formally incorporate IFRS into local GAAP but tries to converge local GAAP to IFRS.

U.S. IFRS Plans Forthcoming

The U.S. has been actively evaluating the adoption of IFRS for years, and the U.S. decision on a plan to incorporate IFRS into U.S. GAAP is moving forward at a slow pace and in a cautious manner. The SEC is looking to the standard-setters to substantially complete three high-priority convergence projects, including financial instruments, revenue recognition, and leases, which are critical to that decision.

Financial Instrument Standards Progress

Classification and measurement of financial instruments, credit impairment, hedge accounting, and the netting of financial assets and liabilities are moving forward. These rules are less relevant for corporates than for financial institutions, but certain aspects may be encountered in corporates. Currently, convergence of hedge accounting rules is uncertain, with IASB likely to significantly relax its threshold to achieve hedge accounting, and FASB unclear on whether to narrowly simplify the rules or revamp it like IASB. The FASB and IASB have not aligned their differences on the netting of financial assets and liabilities, particularly for derivatives, on the balance sheet. New disclosures on pledged collateral and credit risk should improve balance sheet comparability; however, they contribute to the increasing complexity of financial statements. The new disclosures are mandatory beginning in January 2013 but may be seen in 2012.

Leases and Revenue Recognition

Leases and revenue recognition could also see some progress in 2012. For simple customer transactions and revenue contracts, the proposed revenue model does not change existing revenue recognition methods. However, in manufacturing and construction contracts where revenue can be recognized over time, revenue recognition may be delayed until the very end of the transaction. The elimination of almost all operating leases is also planned for completion in 2012, effectively moving most off-balance sheet leases onto the balance sheet. Fitch already treats operating leases largely as debt obligations, generally applying a multiple of 8x total rent expense for North American corporate issuers, so the impact on credit ratings is expected to be minimal. However, material changes in corporate behavior could lead to a reassessment of the overall impact on a company’s credit profile.

The Move Towards Global Standards — Status of G-20 Countries

Country	Status for Listed Companies as of December 2011
Argentina	Required for fiscal years beginning on or after Jan. 1, 2012.
Australia	Required for all private-sector reporting entities and as the basis for public-sector reporting since 2005.
Brazil	Required for consolidated financial statements of banks and listed companies from Dec. 31, 2010, and for individual company accounts progressively since January 2008.
Canada	Required from Jan. 1, 2011, for all listed entities and permitted for private sector entities, including not-for-profit organizations.
China	Substantially converged national standards.
European Union	All member states of the EU are required to use IFRS as adopted by the EU for listed companies since 2005.
France	Required via EU adoption and implementation process since 2005.
Germany	Required via EU adoption and implementation process since 2005.
India	India is converging with IFRS on a date to be confirmed.
Indonesia	Convergence process ongoing; a decision about a target date for full compliance with IFRS is expected to be made in 2012.
Italy	Required via EU adoption and implementation process since 2005.
Japan	Permitted from 2010 for a number of international companies; decision about mandatory adoption by 2016 expected around 2012.
Mexico	Required from 2012.
Republic of Korea	Required from 2011.
Russia	Required from 2012.
Saudi Arabia	Required for banking and insurance companies. Full convergence with IFRS currently under consideration.
South Africa	Required for listed entities since 2005.
Turkey	Required for listed entities since 2005.
United Kingdom	Required via EU adoption and implementation process since 2005.
United States	Allowed for foreign issuers in the U.S. since 2007; target date for substantial convergence with IFRS is 2012/2013, and a decision about possible adoption for U.S. companies is expected in 2012.

Source: ifrs.org.

U.S. GAAP Versus IFRS Comparison

	U.S. GAAP	IFRS	Likely Impact on U.S. Companies
Inventory	Inventory is carried at the lower cost or market. LIFO method of valuation is permitted if used for taxes. Inventory writedowns cannot be reversed.	Inventory is carried at the lower of cost or net realizable value. LIFO is prohibited. Inventory writedowns can be reversed.	U.S. companies will have to add LIFO reserve back on balance sheet. Could affect taxes, cash flows, and future profitability.
Fixed Assets	Fixed assets are valued at historical cost. Reversal of PP&E impairments is not permitted.	Permits fair value of assets. Permits reversal of impairment to fair value.	Some U.S. companies may opt for fair-value fixed assets to capture higher market values.
Impairment of Fixed Assets	A qualitative assessment, followed by a two-step process if necessary. Two-step approach to impairment requires that a recoverability test be performed first and then an impairment test, if necessary.	One step approach requires an impairment test if indicators of impairment exists.	May lead to more writedowns under IFRS.
Revenue Recognition (Currently Undergoing Convergence Efforts)	Very detailed and industry-based revenue recognition guidance.	Very broad revenue recognition guidance.	More judgment is ceded to management on revenue recognition.
Research and Development	Development costs are expensed as incurred with an exception for software-related development cost.	Development costs can be capitalized.	More development costs will be capitalized. This change will likely not affect the tax treatment of development costs. Therefore, actual cash flow impact is expected to be minimal.

LIFO – Last in first out. PP&E – Property, plant, and equipment.
Source: Fitch Ratings, FASB, IFRS.

Pension Plans

Contributions to Rise

Lower discount rates in 2011 have driven up pension liabilities. For example, the discount rate for The Goodyear Tire & Rubber Company's U.S. pension plans fell from 5.20% in 2010 to 4.52% in 2011. Looking back even further, the difference is even greater. In 2008 Goodyear's U.S. plans discount rate was 6.50%. In Fitch's view, all other factors being equal, a one percentage point decrease in the discount rate could raise a pension plan's liabilities by approximately 10% to 20%.

At the same time, as pension liabilities have risen, pension plan underfunding has expanded due to relatively weak equity-market performance in 2011. Using the S&P 500 as a broad domestic market proxy, total equity returns were approximately 2% in 2011. Fixed income returns were stronger, with the Barclay's Aggregate Bond Index up approximately 7.8% for the year. While equity market returns were strong in first-quarter 2012, volatility remains and returns for full-year 2012 are uncertain.

Solid investment grade companies typically contribute higher-than-minimum required levels. However, companies with weaker credit profiles and materially underfunded pension plans can have difficulty funding even at minimally required levels. Goodyear is one of many U.S. corporations with significantly underfunded pension plans. Goodyear has taken advantage of provisions of the Pension Relief Act of 2010 to meaningfully defer contributions until after 2015. Barring a meaningful rise in asset values and/or long-term interest rates, or the potential funding relief discussed in the next section, Goodyear could be required to make very large cash pension contributions in the post-2015 period. As of year-end 2011, Goodyear's global defined benefit plans were 64% funded on a projected benefit obligation (PBO) basis, with a PBO of $8.7 billion and total assets of $5.6 billion. The funding level is down from 69% at the end of 2010.

Example: The Goodyear Tire & Rubber Company — Pension Underfunding

"Our pension plans are significantly underfunded and, in the future, the underfunding levels of our pension plans and our pension expense could materially increase. Although we have frozen a number of our pension plans globally, including our U.S. salaried pension plans, and closed participation in our primary U.S. hourly pension plan, many of our employees participate in, and many of our former employees are entitled to benefits under, defined benefit pension plans. Over time, we have experienced periods of declines in interest rates and pension asset values. As a result, our pension plans are significantly underfunded. Further declines in interest rates or the market values of the securities held by the plans, or certain other changes, could materially increase the underfunded status of our plans in 2012 and beyond, and affect the level and timing of required contributions in 2013 and beyond.

"The unfunded amount of the projected benefit obligation for our U.S. and non-U.S. pension plans was $2,452 million and $645 million, respectively, at Dec. 31, 2011, and we currently estimate that we will be required to make contributions to our funded U.S. pension plans of approximately $425 million to $450 million in 2012, and $425 million to $475 million in 2013. The current underfunded status of our pension plans will, and a further material increase in the underfunded status of the plans would, significantly increase our required contributions and pension expense, which could impair our ability to achieve or sustain future profitability and adversely affect our financial condition."

Source: The Goodyear Tire & Rubber Company, Form 10-K, dated Dec. 31, 2011.

Goodyear Tire & Rubber Company (The)

Pension Assets	2011
U.S. Plan	3,523.00
Non-U.S. Plan	2,091.00
Total Plan Assets	**5,614.00**
Asset Allocation (%)	
U.S. Plan	
Fixed Income	34
Equity	63
Cash and Short-Term Investments	1
Alternative Investments	1
Total	**100**

Source: Goodyear.

Goodyear's Global Plans — 2011

	U.S.	Non-U.S.	Total
Cash Contribution	193.00	40.00	233.00
Unfunded Liabilities	2,452.00	645.00	3,097.00
Actuarial Loss	(452.00)	(84.00)	(536.00)

Source: Goodyear

Goodyear's Discount Rates — 2008–2011

(%)	2008	2009	2010	2011
U.S.	6.50	5.75	5.20	4.52
Non-U.S.	6.31	5.68	5.54	5.07

Source: Goodyear

Pension Funding Stabilization

The U.S. Senate passed the Surface Transportation bill (Highway Bill) on March 14, 2012. The bill's main purpose is to reauthorize surface transportation programs that would have expired on March 31, 2012; however, near the end of the bill it contains a provision that would change how companies calculate discount rates for defined benefit pension plan funding purposes. As stated previously, low interest rates have led to low discount rates, which result in larger pension liabilities and higher funding requirements.

The proposed pension provision allows companies with defined benefit pension plans to choose a discount rate within 10% of its 25 year historical average rate. The 10% window increases by 5% each year to 30% in 2016. This discount rate smoothing will allow the current period of very low interest rates to have less of an impact on funding levels, and to better reflect long-term expectations. Currently, the discount rate is based on high quality corporate bond yields over the past two years. Fitch is concerned that utilizing interest rates over a very long period may not reflect reality, and could exacerbate the underfunding problems of many pension plans if lower contributions are permitted.

The U.S. House of Representatives (House) recently passed a temporary three-month extension of the previous transportation legislation, followed by passage of the temporary extension by the Senate. Although the pension provision may be considered again in June when the temporary legislation expires, it is currently uncertain when or if it will take effect.

Taxes

Bonus Depreciation Benefits Capital-Intensive Industries

Bonus depreciation is a tax break that allows companies to immediately write off capital expenditures instead of capitalizing them and depreciating them over time. The Tax Relief Act, which President Barack Obama signed in December 2010, temporarily increases allowable bonus depreciation at the option of the company.

Effective Date: The law granted up to 100% bonus depreciation for qualified business investments placed in service between Sept. 9, 2010, and Dec. 31, 2011. Bonus depreciation of 50% applies to assets placed in service during 2012. Previously, the Small Business Jobs Act of 2010 had allowed a 50% depreciation bonus for purchases made between Jan. 1, 2010, and Sept. 7, 2010.

Industries/Companies that May Benefit Most: Capital-intensive industries such as automakers, utilities, and heavy equipment manufacturers, among others.

Example: Sempra Energy — Bonus Depreciation

“Due to the extension of bonus depreciation, Sempra Energy has generated a large U.S. federal net operating loss (NOL) in 2011 and is currently projecting a large U.S. federal NOL in 2012. We currently project the total NOL will not be fully utilized until 2016. Because of these projected NOLs, and the carryforward of U.S. federal income tax credits discussed below, Sempra Energy expects no U.S. federal income tax payments in years 2012 through 2015. However, because bonus depreciation only creates a temporary difference, versus a permanent difference, between Sempra Energy’s U.S. federal income tax return and its U.S. GAAP financial statements, it does not impact Sempra Energy’s effective income tax rate. We expect larger U.S. federal income tax payments in the future as these temporary differences reverse.

“Bonus depreciation, in addition to impacting Sempra Energy’s U.S. federal income tax payments, will also have a temporary impact on Sempra Energy’s ability to utilize its U.S. federal income tax credits, which primarily are investment tax credits and production tax credits generated by Sempra Energy’s current and future renewable energy investments. However, based on current projections, Sempra Energy does not expect, based on more-likely-than-not criteria required under U.S. GAAP, any of these income tax credits to expire prior to the end of their 20-year carryforward period, as allowed under current U.S. federal income tax law. We also expect bonus depreciation to increase the deferred tax component of SDG&E’s and SoCalGas’ rate base, which reduces rate base.”

Source: Sempra Energy Form 10-K, dated Dec. 31, 2011.

Discussion/Credit Impact

Bonus depreciation allows companies to reduce their tax bills when buying new equipment by front-loading depreciation expenses for tax purposes. This results in lower taxable income and cash taxes, which is a temporary boost to cash flows. There is no impact on book earnings. Higher bonus depreciation is not likely to drive any rating changes. However, Fitch anticipates the extra cash flow generated will be beneficial for capital-intensive industries such as utilities during a period when high capital expenditures would otherwise put downward pressure on ratings. While there is cash tax savings in the first year of implementation, this benefit reverses over time. In addition, the bonus depreciation generates a larger deferred tax liability on the balance sheet, reflecting the expectation of higher taxable income and cash taxes when the impact reverses in future.

Bonus depreciation is anticipated to again improve FFO and associated credit ratios (e.g. FFO interest coverage and FFO-to-debt) for certain utility and power companies in 2012 as a result of the associated tax deferrals. In later years, FFO credit metrics and cash flow could become pressured as deferred taxes payable become cash taxes. Fixed-income investors should watch out for these potential boomerangs. Fitch notes that for regulated utilities the offset from a cash perspective could be increased rates in the future for ultimate recovery of investments

made. The cash flow effect of bonus depreciation is not reflected in EBITDA or in EBITDA-based credit metrics, resulting in a significant divergence of EBITDA-based credit measures versus FFO-based credit measures.

Tax Holiday Would Benefit U.S. Multinationals

Given the continued push by multinational executives for Washington to re-evaluate the corporate tax code, including taxes on international earnings, a new tax holiday could be a possibility in the near term. A tax holiday would allow U.S. multinationals to repatriate billions of dollars of profits earned overseas at low tax rates.

Overseas cash balances have grown, because U.S. tax policy allows companies to defer taxes on overseas earnings unless the profits are repatriated to the U.S. Furthermore, companies are generally hesitant to bring the funds to the U.S. due to the high taxes that would be incurred in the absence of a temporary tax holiday. Critics of a temporary tax holiday consider it a temporary fix rather than a permanent overhaul of corporate taxes. There eventually may be more comprehensive changes to taxation of overseas income to align it closer to other countries that do not tax multinationals' overseas income.

Given that approximately 20% of repatriated funds from The American Jobs Creation Act of 2004 (2004 tax holiday) came from third-party debt funding, there is a potential risk of incremental leverage resulting from any new tax holiday designed to allow multinationals to repatriate overseas earnings at a reduced tax rate.

Fitch believes a tax holiday is most likely to occur in conjunction with broader tax reform similar to what the Obama administration proposed in February 2012. This would include a lower corporate tax rate combined with the elimination of various deductions and expenditures. In Fitch's view, the biggest question related to tax reform would revolve around whether or not the U.S. would move to a territorial system or maintain the worldwide system but eliminate the deferral on overseas earnings. Fitch believes that maintaining a worldwide deferral system will likely prove to be insufficient in trying to get companies to repatriate international cash flows more often. Please see Fitch's report "U.S. Tax Reform Impact on Corporate Issuers," dated June 22, 2011, for additional details.

Effective Date: Uncertain.

Industries That May Benefit Most: Multinational companies with large overseas exposure, particularly technology companies.

Discussion/Credit Impact

In 2004, U.S. companies were given a one-year window to repatriate foreign income for a blended tax rate of 5.25%, versus the typical statutory rate of up to 35%. Since the 2004 tax holiday allowed foreign subsidiaries to repatriate the amount deemed as permanently reinvested foreign earnings, rather than just cash on hand, initial borrowings for certain companies were material. Borrowings could also be substantial if the rules are similar this time. However, restrictions on the use of the repatriated funds, such as a requirement to use the funds for job creation, may limit borrowings. Unrestricted repatriation may encourage borrowings for additional shareholder-friendly activities.

If the repatriation of overseas earnings is financed with debt, leverage ratios would likely increase. However, Fitch would generally expect companies that engage in large repatriation of cash to use future cash flow to quickly repay any debt incurred. As long as debt is repaid in a timely manner, it is not likely to affect credit ratings.

Appendix A

General Filing Deadlines

	Deadlines for Filing Periodic Reports	
Category of Filer	**Form 10-K Deadline**	**Form 10-Q Deadline**
Large Accelerated Filer (public float of $700 million or more)	60 Days	40 Days
Accelerated Filer ($75 million or more and less than $700 million)	75 Days	40 Days
Non-accelerated Filer (Less than $75 million)	90 Days	45 Days
Foreign Firms – Form 20-F	6 Months	Not Required

Source: SEC

Upcoming Filing Due Dates

Large Accelerated Filers:

10-Q: for quarterly period ended 03/31/12, due Thursday, May 10, 2012
10-K: for fiscal year ended 03/31/12, due Wednesday, May 30, 2012
10-Q: for quarterly period ended 04/30/12, due Monday, June 11, 2012
10-K: for fiscal year ended 04/30/12, due Friday, June 29, 2012

Accelerated Filers:

10-Q: for quarterly period ended 03/31/12, due Thursday, May 10, 2012
10-K: for fiscal year ended 02/29/12, due Monday, May 14, 2012
10-Q: for quarterly period ended 04/30/12, due Monday, June 11, 2012
10-K: for fiscal year ended 03/31/12, due Thursday, June 14, 2012

Non-Accelerated Filers:

10-Q: for quarterly period ended 03/31/12, due Tuesday, May 15, 2012
10-K: for fiscal year ended 02/29/12, due Tuesday, May 29, 2012
10-Q: for quarterly period ended 04/30/12, due Thursday, June 14, 2012
10-K: for fiscal year ended 03/31/12, due Friday, June 29, 2012

Foreign Firms:

20-F: for fiscal year ended 11/30/11, due Wednesday, May 30, 2012
20-F: for fiscal year ended 12/31/11, due Monday, July 02, 2012

Source: SEC.

Appendix B

Example of Footnote Disclosure Changes: Dean Foods Co. Multi-Employer Pension Plans

"Certain of our subsidiaries contribute to various multi-employer pension and other postretirement benefit plans, which cover a majority of our full-time union employees and certain of our part-time union employees. Such plans are usually administered by a board of trustees composed of labor representatives and the management of the participating companies. The risks of participating in these multi-employer plans are different from single-employer plans in the following aspects:

- Assets contributed to a multi-employer plan by one employer may be used to provide benefits to employees of other participating employers.
- If a participating employer stops contributing to the plan, the unfunded obligations of the plan may be borne by the remaining participating employers.
- If we choose to stop participating in one or more of our multi-employer plans, we may be required to pay those plans an amount based on the underfunded status of the plan, referred to as a withdrawal liability.

At this time, we have not established any significant liabilities, because withdrawal from these plans is not probable or reasonably possible.

Our participation in these multi-employer plans for the year ended Dec. 31, 2011, is outlined in the table below. Unless otherwise noted, the most recent Pension Protection Act (PPA) Zone Status available in 2011 and 2010 is for the plans' year-end at Dec. 31, 2010, and Dec. 31, 2009, respectively. The zone status is based on information that we obtained from each plan's Form 5500, which is available in the public domain and is certified by the plan's actuary. Among other factors, plans in the red zone are generally less than 65% funded, plans in the yellow zone are less than 80% funded, and plans in the green zone are at least 80% funded. The FIP/RP Status Pending/Implemented column indicates plans for which a funding improvement plan (FIP) or a rehabilitation plan (RP) is either pending or has been implemented. Federal law requires that plans classified in the yellow zone or red zone adopt a funding improvement plan or rehabilitation plan, respectively, in order to improve the financial health of the plan. The Extended Amortization Provisions column indicates plans which have elected to utilize the special 30-year amortization rules provided by the Pension Relief Act of 2010 to amortize its losses from 2008 as a result of turmoil in the financial markets. The last column in the table lists the expiration date(s) of the collective-bargaining agreement(s) to which the plans are subject.

Pension Fund	Employer Identification Number	Pension Plan Number	PPA Zone Status 2011	PPA Zone Status 2010	FIP/RP Status Pending/Implemented	Extended Amortization Provisions	Expiration Date of Associated Collective Bargaining Agreement(s)
Western Conference of Teamsters Pension Plan[a]	91-6145047	001	Green	Green	N.A.	No	Feb. 28, 2012–May 31, 2016
Central States, Southeast and Southwest Areas Pension Plan[b]	36-6044243	001	Red	Red	Implemented	No	April 30, 2012–July 30, 2016
New York State Teamsters Conference Pension Plan	16-6063585	074	Red	Red	Implemented	No	Oct. 26, 2014
Retail, Wholesale & Department Store International Union and Industry Pension Fund[c]	63-0708442	001	Green	Yellow	N.A.	Yes	June 3, 2012–Sept. 10, 2016
Dairy Industry — Union Pension Plan for Philadelphia Vicinity[c]	23-6283288	001	Red	Yellow	Implemented	No	Sept. 30, 2012–Oct. 1, 2014

[a]We are party to approximately 30 collective bargaining agreements that require contributions to this plan. These agreements cover a large number of employee participants and expire on various dates between 2012 and 2016. We do not believe that any one agreement is substantially more significant than another as none of these agreements individually represent greater than 15% of the total employee participants covered under this plan. [b]There are approximately 20 collective bargaining agreements that govern our participation in this plan. The agreements expire on various dates between 2012 and 2016. The four agreements expiring in 2012 represent approximately 30% of our total employee participants in this plan. The remaining agreements have a wide variety of expiration dates between 2013 and 2016 and do not individually represent a significant percentage of our overall participants to this plan. [c]We are subject to approximately 10 collective bargaining agreements with respect to this plan. Approximately 55% and 40% of our employee participants in this plan are covered by the agreements expiring in 2012 and 2014, respectively. [d]We are party to three collective bargaining agreements with respect to this plan. The agreement expiring in September 2012 is the most significant as more than 85% of our employee participants in this plan are covered by that agreement. Information regarding our contributions to our multi-employer pension plans is shown in the table below. There are no changes that materially affected the comparability of our contributions to each of these plans during the years ended Dec. 31, 2011, 2010 and 2009. N.A. – Not applicable.

Pension Fund	Employer Identification Number	Pension Plan Number	Dean Foods Company Contributions ($ Mil.) 2011	2010	2009	Surcharge Imposed[c]
Western Conference of Teamsters Pension Plan	91-6145047	001	16.3	16.1	15.6	No
Central States, Southeast and Southwest Areas Pension Plan	36-6044243	001	8.6	8.5	7.9	No
New York State Teamsters Conference Pension Plan	16-6063585	074	0.8	0.7	0.6	Yes
Retail, Wholesale & Department Store International Union and Industry Pension Fund[a]	63-0708442	001	1.2	1.3	1.2	No
Dairy Industry — Union Pension Plan for Philadelphia Vicinity[a]	23-6283288	001	1.5	1.5	1.5	Yes
Other Funds[b]			1.2	0.7	2.8	
Total Contributions			**29.6**	**28.8**	**29.6**	

[a]During the 2009 and 2010 plan years, our contributions to these plans exceeded 5% of total plan contributions. At the date of filing of this Annual Report on Form 10-K, Forms 5500 were not available for the plan years ending in 2011. [b]Amounts shown represent our contributions to all other multi-employer pension and other postretirement benefit plans, which are immaterial both individually and in the aggregate to our Consolidated Financial Statements. [c]Federal law requires that contributing employers to a plan in critical status pay to the plan a surcharge to help correct the plan's financial situation. The amount of the surcharge is equal to a percentage of the amount we would otherwise be required to contribute to the plan and ceases once our related collective bargaining agreements are amended to comply with the provisions of the rehabilitation plan.

Source: Dean Foods Co., Form 10-K, dated Dec. 31, 2011.

Appendix C: Common Accounting Red Flags

Accounting is more of an art than a science, allowing for judgments, estimates, assumptions, options, and varying policies. This flexibility offers management the ability to present a company's financial position and performance in the best possible light. This can sometimes be achieved by selecting accounting policies in order to achieve a desired result.

Analysts and investors should be aware of the many ways accounting guidelines can be manipulated in order to distort a firm's real financial condition. Aggressive accounting practices are myriad. Generally, they seek to achieve three broad goals: 1) Artificially boost revenues or change the timing of revenue recognition, 2) artificially reduce expenses or change the timing of expense recognition, and 3) reduce on-balance sheet liabilities.

Artificially Boost Revenues or Change the Timing of Revenue Recognition

Channel Stuffing

One common method employed to inflate revenues is widely known as "channel stuffing." This involves the use of significant concessions — discounts, right of return, extended payment terms — to generate sales for goods that would likely be returned unsold by distributors later on. This practice significantly affects accounts receivable and sales.

Large increases in the accounts receivable relative to sales could be an indication of low-quality revenue.

Accounts receivable and sales usually grow in tandem. However, large increases in the accounts receivable relative to sales could indicate low-quality revenue. It can show that a company is lowering its credit terms in order to attract more sales from parties that may not be creditworthy — what is known as channel stuffing. This practice ultimately leads to an uptick in bad debts in future quarters or significant returns. Analysts should be asking more questions if the rate of growth in accounts receivable far outstrips revenue growth.

Recording Investment Income and Asset Sales as Revenue

Selling assets in the ordinary course of business is a perfectly legitimate business transaction. However, selling assets just to meet net income targets or cover earnings shortfalls should be regarded as a red flag. Even more egregious is the practice of classifying the gains from those asset sales as revenues. Gains from assets sales are usually noncore and should be classified on the income statement as non-operating.

Recording Revenue Prematurely

Accounting guidelines indicate that revenue can only be recognized when it is realized or realizable, and earned. This usually means when a service has been performed or a good has been delivered, irrespective of when the cash is received. Deferred/unearned revenue is created when cash has been collected but the service or good has not been delivered.

Deferred/unearned revenue accounts typically are recorded by companies with long-dated contracts (e.g. aerospace contractors) or multiple deliverables (e.g. technology companies). Unusual swings in the deferred revenue account, particularly an unusual decrease in the account, usually warrant additional questions. Furthermore, unusual growth in the unbilled receivables/unbilled revenues accounts should also be duly scrutinized. In the past, some companies have used these accounts to conveniently boost revenues to ensure consistent revenue growth by accelerating revenues that have not been earned.

Intentionally Inflating Reserves to Be Released Later as Revenues

Usually referred to as creating “cookie jar” reserves, this practice involves creating excess reserve accounts by inflating accrual accounts (e.g. sales returns, warranty costs, loan losses). This excess reserve is then released as income as the need arises, usually to meet earnings targets. This effectively defers profits from a relatively strong quarter to an expected weaker quarter. Acquisition-related reserves and restructuring reserves can also be exploited to manipulate current and future income. Acquisition-related reserves should be offset against goodwill, so operating expenses may not be recognized in the current period income statement.

Analysts should review the supplemental “Schedule II” included in 10-K forms. This schedule provides a reconciliation of beginning and ending balances of reserve accounts such as loan losses, inventory losses, warranty reserves, etc. A full understanding of this schedule may lead analysts to spot under- or over-reserving trends, which may be solely for earnings-management purposes.

Artificially Reduce Expenses or Change the Timing of Expense Recognition

Improper Capitalization of Operating Expenses

The decision on whether to capitalize expenses related to noncurrent assets like property, plant, and equipment (PP&E) is largely discretionary. Expenses that provide long-term benefits are generally expected to be capitalized (set up as an asset) and depreciated or amortized over time, while expenses that provide short-term benefits are generally expected to be expensed as incurred.

Improperly capitalizing current-year operating costs artificially increases earnings by reducing current-year expenses. Expenses are then recognized/amortized over multiple quarters and years rather than in one single quarter or year.

FCF metrics are likely to be more relevant when excessive capitalization is suspected.

Improperly capitalizing operating expenses can be used to distort metrics based on overstated cash flow from operations and funds flow from operations, as capitalized costs are classified as part of cash flow from investing. Additionally, EBITDA would also be overstated. The end result of improper capitalization of operating expenses is more robust leverage and coverage metrics. This tactic could also be used to manage and meet financial covenants related to these metrics. FCF metrics are likely to be more relevant when excessive capitalization is suspected.

Amortizing Costs Too Slowly

When asset lives are lengthened or when the salvage value is increased, depreciation expenses fall, resulting in a boost in earnings. If costs are being amortized too slowly, FCF metrics are again more likely to be more relevant.

Reviewing the accounting policies on PP&E is essential in determining whether a company is amortizing costs too slowly or whether changes in accounting estimates pertaining to PP&E, intangibles, leasehold improvements, etc., are providing one-time boosts to earnings. These changes can significantly distort earnings in capital-intensive businesses.

Special/Restructuring Charges

The use of special or restructuring charges to “clean the slate” is a practice that can artificially boost future profits if the charges are overstated. Analysts should understand these charges, especially when they coincide with a change in management. A new management eager to take credit for a turnaround may opt for “writing off the kitchen sink.” Also notable is the continual use of

restructuring charges to label normal operating expenses as "noncash and nonrecurring." If restructuring charges become the norm year after year, analysts should be inclined to include them as normal operating expenses in their adjustments to GAAP financial statements.

Reduce On-Balance-Sheet Liabilities

Moving Debt and Commitments Off the Balance Sheet

This area of accounting has endured heavy criticism for more than a decade, starting with the bankruptcy of Enron Corporation. Off-balance-sheet entities (special purpose entities, joint ventures, etc.) may mask hidden risks and leverage. The accounting rules in this area have been ineffective, with disclosures also proving to be inadequate. Accounting rules implemented in 2010 make it more difficult to avoid the recognition of off-balance sheet entities.

Analysts' review of additional footnote disclosure in this area should make the risks more transparent. Enhanced disclosures were introduced by the FASB in the aftermath of the financial crisis and the added required disclosures have been beneficial to analysts and investors.

Analysts should fully understand changes to pension-related assumptions to be sure that the assumptions are not outliers which are artificially reducing pension liabilities on the balance sheet.

Changing Pension-Related Assumptions to Reduce Pension Liabilities

Pension accounting is dependent on multiple assumptions, including the discount rate, expected rate of return, mortality rate, etc. The discount rate is the most important obligation-related assumption in pension accounting and, historically, companies have maintained significant latitude in their selection of this rate. The effect of the discount rate can be considerable. Generally, for pension plans, each percentage point increase in the discount rate leads to approximately a 10%–20% decline in pension liabilities. Analysts should fully understand changes to pension-related assumptions to ensure that the assumptions are not outliers that are artificially reducing pension liabilities on the balance sheet.

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