**Stanford Law School**
**Directors' College**

**Audit Committee Issues Related to Competence of Committee Members**

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# Report and Recommendations

of the

# Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees

and a certain basic “financial literacy.” Such “literacy” signifies the ability to read and understand fundamental financial statements, including a company’s balance sheet, income statement, and cash flow statement. Directors who have limited familiarity with finance can achieve such “literacy” through company-sponsored training programs.

Because of the audit committee’s responsibilities and the complex nature of the accounting and financial matters reviewed, the committee merits significant director resources, both in terms of the number of directors dedicated to the committee and the time each director devotes to committee matters.

## Recommendation 3

**The Committee recommends that the NYSE and the NASD require listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) to have an audit committee comprised of a minimum of three directors, each of whom is financially literate (as described in the section of this Report entitled “Financial Literacy”) or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee, and further that at least one member of the audit committee have accounting or related financial management expertise.**

**The Committee recommends that the NYSE and the NASD maintain their respective current audit committee size and membership requirements for companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).**

## Audit Committee Structure and Process

A key attribute of a good board is its own diligence in defining the board’s role, responsibilities, structure, and processes. An effective board is self-aware and determines how best to carry out its important tasks. Likewise, a well-functioning audit committee will be concerned about and spend a significant amount of time defining the scope of its over-

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## 303.00 Corporate Governance Standards

### 303.01 Audit Committee

(A) Audit Committee Policy. Each company must have a qualified audit committee.

(B) Requirements for a Qualified Audit Committee.

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(2) Composition/Expertise Requirement of Audit Committee Members.

(a) Each audit committee shall consist of at least three directors, all of whom have no relationship to the company that may interfere with the exercise of their independence from management and the company ("Independent");

**(b) Each member of the audit committee shall be financially literate,** as such qualification is interpreted by the company's Board of Directors in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee; and

(c) At least one member of the audit committee must have accounting or related financial management expertise, as the Board of Directors interprets such qualification in its business judgment.

….

**[emphasis added]**

reporting and internal control over financial reporting, such as the independence of the audit committee members from management and the clarity with which the audit committee's responsibilities are articulated (for example, in the audit committee's charter) and how well the audit committee and management understand those responsibilities. The auditor might also consider the audit committee's involvement and interaction with the independent auditor and with internal auditors, as well as interaction with key members of financial management, including the chief financial officer and chief accounting officer.

58. The auditor might also evaluate whether the right questions are raised and pursued with management and the auditor, including questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates, and the responsiveness to issues raised by the auditor.

59. Ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting should be regarded as at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists.

60. *Identifying Significant Accounts*. The auditor should identify significant accounts and disclosures, first at the financial-statement level and then at the account or disclosure-component level. Determining specific controls to test begins by identifying significant accounts and disclosures within the financial statements. When identifying significant accounts, the auditor should evaluate both quantitative and qualitative factors.

61. An account is significant if there is more than a remote likelihood that the account could contain misstatements that individually, or when aggregated with others, could have a material effect on the financial statements, considering the risks of both overstatement and understatement. Other accounts may be significant on a qualitative basis based on the expectations of a reasonable user. For example, investors might be interested in a particular financial statement account even though it is not quantitatively large because it represents an important performance measure.

> Note: For purposes of determining significant accounts, the assessment as to likelihood should be made without giving any consideration to the effectiveness of internal control over financial reporting.

- level of involvement and interaction with the external auditor, including the committee's role in the appointment, retention, and compensation of the external auditor
- level of involvement and interaction with internal audit, including the committee's authority and role in appointing and compensating employees in the internal audit function
- interaction with key members of financial management, including the chief financial officer and chief accounting officer
- extent of questions raised by the audit committee and its responsiveness to concerns raised by the external auditors
- the audit committee's compliance with exchange listing standards
- the level of financial expertise among the audit committee members
- any ongoing training for audit committee members on accounting and/or industry specific matters

## Risk Assessment

Another component of internal control is risk assessment. For an entity to exercise effective control, it must establish objectives and understand the risks it faces in achieving those objectives. As part of its risk assessment process, management should determine and consider the implications of relevant risks that could hinder the achievement of its objectives. Management must then provide a basis for managing the risks. For purposes of management's Section 404 assessment, the Standard indicates that management should identify the risks of material misstatement in the significant accounts and disclosures and related assertions of the financial statements. Management should implement controls to prevent or detect errors or fraud that could result in material misstatements. An example provided in the Standard is that management should assess how it considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.

The process of identifying and analyzing risks is an ongoing iterative process. The sub-components for the risk assessment include:

- Business Risk Assessment
  - Entity-wide objectives – Does the entity have approved entity-wide objectives that are aligned with the strategic plan?
  - Activity-level objectives – Are activity-level objectives consistent with entity-wide objectives and are they relevant?
  - Risk analysis – Are there mechanisms to identify risks and to prevent the entity from achieving its objectives from both internal and external sources? Is the process thorough and relevant?
  - Mechanisms for change – Are there adequate mechanisms to identify change for routine events and for events that may have a pervasive impact on the entity?
- Inherent Risks
- Fraud Risks

**Illustration of Financial Literacy Criteria, Based on Kodak's Disclosure**

We illustrate the 4-point criteria for financial literacy using Kodak management's disclosure of its critical accounting policies and estimates. Kodak mentions inventory issues in its note: "Kodak reduces the carrying value of its inventory based on estimates of what is excess, slow-moving and obsolete, as well as inventory whose carrying value is in excess of net realizable value…."[1]

1. Understand the transactions that cause management to have to make a judgment about inventory carrying value.

   Kodak purchases more raw materials or manufactures other items for inventory than it sells during a period. It has ending inventories on its balance sheet. The accounting equation requires a valuation [Kodak calls it *carrying value*] of those inventories in order to measure cost of good sold. Kodak tells us this importantly affects its reported numbers.

2. What choices do GAAP/IFRS provide among accounting methods and estimates for management in reporting on those transactions?

   In Kodak's case, management must make four sorts of choices to measure inventory carrying value: cost basis (for example, historical cost, replacement cost, lower of cost or market), frequency of inventory calculations (periodic or perpetual), cost inclusion rules for manufactured inventory (where on the spectrum of direct versus absorption costing to put itself), and whether to use a cost flow assumption and if so, which one (specific identification or a choice between LIFO, FIFO, weighted average). This illustration focuses only the last of these, the cost flow assumption.

   Which unit's costs flow into cost of goods sold during the period—the cost of the first units produced (FIFO), or the cost of the last units produced (LIFO), or the cost of the next unit produced (NIFO), or an averaging approach, or even specific identification. US GAAP allow all of these except NIFO; other countries forbid LIFO as well.

3. Why did management choose a LIFO cost flow assumption? From the outside, we can guess that Kodak chose LIFO because of its effects on deferrals of tax payments. An audit committee member needn't guess and can judge that such choice meshes with corporate policy.

4. Most important. A financially literate board member needs to understand the implications for financial reporting of management's choice, including the potential this choice gives management to manipulate income.

   For example, choosing LIFO instead of FIFO means reporting lower income in times of rising prices, but deferring income tax payments until the company dips into old LIFO layers.

   And: management can manipulate end-of-period purchases to manipulate income under LIFO.

   And: the audit committee should be ready to understand why entering a new line of business will enable avoiding decrements to LIFO layers and avoiding higher tax payments than would occur without the new line.

[1] This sentence appears in Kodak's annual reports for all the years 2002-05 in the MD&A section.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The accompanying consolidated financial statements and notes to consolidated financial statements contain information that is pertinent to management's discussion and analysis of financial condition and results of operations. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and the related disclosure of contingent assets and liabilities.

Eastman Kodak Company (the Company or Kodak) believes that the critical accounting policies and estimates discussed below involve additional management judgment due to the sensitivity of the methods and assumptions necessary in determining the related asset, liability, revenue and expense amounts.

## REVENUE RECOGNITION

Kodak recognizes revenue when it is realized or realizable and earned. For the sale of multiple-element arrangements whereby equipment is combined with services, including maintenance and training, and other elements, including software and products, the Company allocates to, and recognizes revenue from, the various elements based on verifiable objective evidence of fair value (if software is not included or is incidental to the transaction) or Kodak-specific objective evidence of fair value if software is included and is other than incidental to the sales transaction as a whole. For full service solutions sales, which consist of the sale of equipment and software which may or may not require significant production, modification or customization, there are two acceptable methods of accounting: percentage of completion accounting and completed contract accounting. For certain of the Company's full service solutions, the completed contract method of accounting is being followed by the Company. This is due to insufficient historical experience resulting in the inability to provide reasonably dependable estimates of the revenues and costs applicable to the various stages of such contracts as would be necessary under the percentage of completion methodology. When the Company does have sufficient historical experience and the ability to provide reasonably dependable estimates of the revenues and the costs applicable to the various stages of these contracts, the Company will account for these full service solutions under the percentage of completion methodology.

The Company records reductions to revenue for customer incentive programs offered including cash and volume discounts, price protection, promotional, cooperative and other advertising allowances, slotting fees and coupons. The liability for the incentive programs is recorded at the time of sale. The Company determines the amount of the incentives that are based on estimates by using historical experience and internal and customer data. To the extent actual experience differs from estimates, additional reductions to revenue could be recorded. If market conditions were to decline, the Company may take actions to expand these customer offerings, which may result in incremental reductions to revenue.

## ALLOWANCE FOR DOUBTFUL ACCOUNTS

Kodak regularly analyzes its customer accounts and, when it becomes aware of a specific customer's inability to meet its financial obligations to the Company, such as in the case of bankruptcy filings or deterioration in the customer's overall financial condition, records a specific provision for uncollectible accounts to reduce the related receivable to the amount that is estimated to be collectible. The Company also records and maintains a provision for doubtful accounts for customers based on a variety of factors including the Company's historical experience, the length of time the receivable has been outstanding and the financial condition of the customer. If circumstances related to specific customers were to change, the Company's estimates with respect to the collectibility of the related receivables could be further adjusted. However, losses in the aggregate have not exceeded management's expectations.

## INVENTORIES

Kodak reduces the carrying value of its inventory based on estimates of what is excess, slow-moving and obsolete, as well as inventory whose carrying value is in excess of net realizable value. These write-downs are based on current assessments about future demands, market conditions and related management initiatives. If, in the future, the Company determined that market conditions and actual demands are less favorable than those projected and, therefore, inventory was overvalued, the Company would be required to further reduce the carrying value of the inventory and record a charge to earnings at the time such determination was made. However, if in the future the Company determined that inventory write-downs were overstated and, therefore, inventory was undervalued, the Company would recognize the increase to earnings through higher gross profit at the time the related undervalued inventory was sold. However, actual results have not differed materially from management's estimates.

## VALUATION OF LONG-LIVED ASSETS INCLUDING GOODWILL AND PURCHASED INTANGIBLE ASSETS

The Company reviews the carrying value of its long-lived assets, including goodwill and purchased intangible assets, for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. The Company assesses the recoverability of the carrying value of long-lived assets, other than goodwill and purchased intangible assets with indefinite useful lives, by first grouping its long-lived assets with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities (the asset group) and, secondly, estimating the undiscounted future cash flows that are directly associated with and expected to arise from the use of and eventual disposition of such asset group. The Company estimates the undiscounted cash flows over the remaining useful life of the primary asset within the asset group. If the carrying value of the asset group exceeds the estimated undiscounted cash flows, the

## Exhibit 1: Audit Committee Scores of 200 Largest Companies in 2000 and 2004

Audit Committee Score in 2004 (columns); Audit Committee Score in 2000 (rows)

| Audit Committee Score in 2000 | 111 | 211 | 221 | 222 | 311 | 321 | 322 | 331 | 332 | 333 | 411 | 421 | 422 | 431 | 432 | 433 | 441 | 442 | 443 | 444 | *n* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 444 | | | | | | | | | | | | | | | | | | | | | |
| 443 | | | | | | | | | | | | | | | | | | | Dow | | *1* |
| 442 | | | | | | | | | | | | | | | | | | | | | |
| 441 | | | | | | | | | | | | | | | | | | | | | |
| 433 | | | | | | | | | | Trav | | | | | 3 | 1 | | | Aetna | | *6* |
| 432 | | | | | | IBM | | | | | | | | | 4 | | | | Conoco | | *6* |
| 431 | | | | | | | | | | | | | | | | | | | | | |
| 422 | | | | Citi | | | | | 1 | | | | 5 | | 1 | | | | | | *8* |
| 421 | | | | | | | | | | | | | {1,1*} | 1 | | | | | | | *3* |
| 411 | | | | | | | | | | | | | | | | | | | | | |
| 333 | | | | | | | 1 | | 3 | 5 | | | | | 1 | 2 | | | | | *12* |
| 332 | | | | | | 3 | 2 | | 13 | 2 | | | 4 | | 3 | 2 | | | | | *29* |
| 331 | | | | | | | | 1 | | 2 | | | | | | | | | | | *3* |
| 322 | | | | 7 | | | 20 | | 13 | 4 | | Lehman | 7 | | 4 | 4 | | | Qwest | | *61* |
| 321 | | | | 2 | | 1 | 5 | | 1 | | | | | 1 | | | | | | | *10* |
| 311 | | | | | | | | | | | | | | | | | | | | | |
| 222 | | | CVS | 21 | | | 14 | | 3 | 2 | | | 3 | | | 3 | | Abbott | | | *48* |
| 221 | | | | 3 | | | 3 | | | | | | 1* | | 2 | | | | | | *9* |
| 211 | | | | BRKS* | | | | | Healthnet | Wyeth | | | | | | | | | | | *3* |
| 111 | | | | | | | | | | | | | | MBNA | | | | | | | *1* |
| ***n*** | | | *1* | *35* | | *5* | *45* | *1* | *35* | *17* | | *1* | *22* | *3* | *18* | *12* | | *1* | *4* | | *200* |

**Notes:**

| | |
|---|---|
| No Change = | 72 |
| Change Indeterminate = | 12 |
| Change for Better = | 93 |
| Change for Worse = | 23 |
| | 200 |

**Color Coding**

- White
- Gray (or, in monochrome version, medium gray)
- Blue (or, in monochrome version, dark gray)
- Yellow (or, in monochrome version, light gray)

- The "Change Indeterminate" count includes three companies, marked with asterisks in the table, that had fewer than three audit committee members in 2000.
- The observed proportion of "more qualified" outcomes among the 116 classifiable changes was 80.2%. Specifying as our null hypothesis that, conditional on observing a classifiable change, changes for the better and for the worse are equally probable, the two-sided p-value based on these data is less than 0.0001.
- Potential for financial literacy was coded as follows: 4 = Career Path includes accounting, such as public accountant or controller; 3 = Career Path includes Financial Executive, such as Treasurer or Investment Banker, but no explicit accounting functions; 2 = Non-financial business executive, including CEO's without explicit accounting functions; and 1 = Career Path as non-business executive, academic without accounting function, not-for-profit executives, politicians, diplomats, government bureaucrats.
- For example, the entry "14" in row 222 and column 322 indicates that 14 audit committees scored 222 in 2000 and 322 in 2004.

  The entry "{1,1*}" in row 421 and column 422 indicates that two companies were scored accordingly in 2000 and 2004, one of which had only two audit committee members in 2000, although 3 in 2004.

Exhibit 4

## Association of Cumulative Abnormal Returns with Audit Committee Composition

| Composition of Audit Committee in 2000 | Cumulative Abnormal Returns 2000-2003 by Change in Composition of Audit Committee | | | Annualized Abnormal Returns |
|---|---|---|---|---|
| | Not Improved | Improved | Difference | (1 + **[3]**)^.25 - 1 |
| | [1] | [2] | [3] = [2] - [1] | [4] |
| **222 or worse** | -33.27% *(n=30)* | -27.74% *(n=53)* | 5.53% | 1.35% |
| **311-322** | -33.43% *(n=46)* | -2.34% *(n=54)* | 31.09% | 7.00% |
| **331-333** | -26.85% *(n=32)* | 37.15% *(n=15)* | 64.00% | 13.17% |
| **411 or better** | -22.24% *(n=22)* | -4.92% *(n=9)* | 17.32% | 4.07% |
| **All** | -30.02% *(n=130)* | -10.28% *(n=131)* | 19.73% | 4.61% |

**Note:** We calculate the "Cumulative Abnormal Returns" reported in columns [1] and [2] as the exponential function of cumulative abnormal returns in logarithmic form, minus 1.

## Exhibit 5: Results of Financial Literacy Quiz, 2002-2005

**Chicago/Stanford/Wharton Directors' College/Consortium ["DC"] Participants' Performance on Schipper/Weil Financial Literacy Quiz Compared to That of GSB MBA Students**

| Topic (Ordered from Worst to Best Performance by All DC Particpants on Corresponding Quiz Item) | Percent Correct: DC Participants, on Entire 25-Item Quiz | Percent Correct: MBA Students, on 13 Quiz Items Included in MBA Final Exam | Level of Item: Basic [Audit Committtee] | Level of Item: Basic [First-Year MBA Course] | Level of Item: Advanced | Item No. on Quiz |
|---|---|---|---|---|---|---|
| | | | | | | |
| Income Manipulation | 5% | | • | | | 23 |
| SEC Mandates to Audit Committee | 11% | | • | | | 21 |
| Materiality | 12% | | • | | | 24 |
| Mandatory Reporting to Audit Committee | 34% | | • | | | 25 |
| | | | | | | |
| Purchase Commitments | 9% | 30% | | • | | 17 |
| Deferred Income Taxes | 16% | 13% | | • | | 14 |
| Operating Leases | 28% | 83% | | • | | 12 |
| LIFO Accounting | 28% | 50% | | • | | 4 |
| Statement of Cash Flows | 33% | 53% | | • | | 9 |
| Retained Earnings | 39% | 50% | | • | | 20 |
| Impairment of Property, Plant, Equipment | 40% | 33% | | • | | 5 |
| Goodwill | 45% | 37% | | • | | 2 |
| Gains and Losses on Property, Plant, Equipment | 48% | 47% | | • | | 7 |
| Equity Method | 48% | 97% | | • | | 8 |
| Marketable Securities | 59% | 57% | | • | | 1 |
| Asset Impairment | 72% | 60% | | • | | 15 |
| Deferred Revenue | 74% | 63% | | • | | 11 |
| | | | | | | |
| Restructuring charges | 6% | | | | • | 6 |
| Barter Transactions | 14% | | | | • | 22 |
| Special Purpose Entities | 17% | | | | • | 3 |
| Derivatives | 26% | | | | • | 16 |
| Stock Options | 27% | | | | • | 13 |
| Issue Shares for I.O.U | 30% | | | | • | 10 |
| Reserves, Concepts | 36% | | | | • | 18 |
| Reserves, Measurement | 36% | | | | • | 19 |
| **Median Score - Aggregated** | 28% | 51% | | | | |
| **Median Score - Disaggregated** | 58% | 77% | | | | |
| *n* | *1,466* | *30* | | | | |

**Notes:**

Subjects included in the analysis were all DC Participants through February 2005, and top 30 (of 155) Fall 2002 UofC MBA Students.
All quiz items are multiple choice questions. Many have more than one correct response. For such items, the instructions say, "indicate all that apply." We scored such items in two ways. In the "Aggregated" scoring, the quiz-taker would have to correctly give all that apply in order to receive credit for the item. If, for example, the item had four choices "that apply," but the answer shows only three, then we mark that answer as wrong. In the "Disaggregated" scoring, each of the multiple answers is treated like a separate true-false item and the answer for that each one is either right or wrong. If the item had four choices "that apply," and the answer shows three correct and one wrong, then we mark this as four questions, with the student getting credit for three out of four.

Career Descriptions of Members of Famous Company Audit Committee

- Audit Committee Chairman. Named Professor of Management; PhD and BS from Big Time Famous University; Research Areas: Strategic use of information technology; leadership and organizational development

  *Famous Business School*: 199x-present (Dean, 199x-9y). *Previous appointment*: Other Famous University; President, XXX Consulting, 1989-90; Corporate Vice President, YYY [you've heard of it] Corporation, 1989-90; Chairman and CEO, Smaller Company., 1969-89. Rhodes Scholar, Oxford University, 196x-6y Fellow, World Economic Forum, Davos, Switzerland, 199x-present; Member, Committee for Economic Development, 199y-present Member of several corporate and not-for-profit boards. Also, chairman of audit committee of 2nd tier oil company.

- Audit Committee Member #2. *Founder of Private Equity Investment Firm XXX, Co-Chairman.* He oversees all aspects of XXX's activities, including strategy and investment policy, and will be Chairman of the Investment Committee. Prior to the formation of XXX in 199x, he served as President and Vice Chairman of Major Airlines from 198x to199y. He was Co-chairman of YYY 198x to 199y after leading the successful buyout of YYY in 198x. In 199z, he led the acquisition Famous Travel company with other Famous ZZZ Company as the lead equity partner.

  He joined ZZZ in 197x as a corporate Executive Vice President. Between 1980 and 1988, he was President of a major ZZZ division. Earlier in his career, he was a management consultant with Well Known Consulting Company, and in 196x he co-founded WWW a manufacturer. He currently serves as a Director of several publicly traded companies, including one famous and two I'd never heard of. He is the Chairman of a private equity investment firm focused on middle market buyouts with $1.4 billion under management.

  In addition to his work in the private sector, he has had a long career in public service, culminating as a Campaign Manager for a later president of the US…. He served as a Special Assistant to President XX and then as Deputy Director of the U.S. Office of Management and Budget from 1970 to 1974. He is a graduate of one of the Big 3 armed service academies and has an M.B.A. from Another Famous Business School.

- Audit Committee Member #3. He is chairman of the board and chief executive officer of XXX, a household name you might recognize as having been in a bit of SEC trouble before he took over. He began his XXX career as a field sales representative in 197x and assumed increasingly responsible sales and senior management positions. From 199x-199y, he was vice president for human resources, responsible for compensation, benefits, human resource strategy, labor relations, management development and employee training. He became chief staff officer in 199w and corporate senior vice president in 199z. Prior to that, he served as vice president and staff officer for Customer Operations, covering South America and Central America, Europe, Asia and Africa, and China. He is a member of the boards of directors of four companies—one is a well known financial institution and another is a famous retailer/discounter. He earned a bachelors degree in English and Journalism.

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**EXHIBIT 4.39**

**NORTHROP GRUMMAN CORPORATION**
**Data Taken from Consolidated Statements of Cash Flows**
**(Shaded Columns Showing Changes Do Not Appear in Original)**
**(all dollar amounts in millions)**
**(Problem 42)**

**Indirect Method**

| Years ended December 31 | Year 7 | | Year 8 | | Year 9 |
|---|---|---|---|---|---|
| **Cash Provided by Operating Activities** | | **Change** | | **Change** | |
| Net income | $ 467 | *141* | $ 608 | *(181)* | $ 427 |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operations: | | | | | |
| Depreciation | 193 | *(18)* | 175 | *91* | 266 |
| Amortization of Intangible Assets | 196 | *10* | 206 | *173* | 379 |
| Common Stock Issued to Employees | 2 | *6* | 8 | *38* | 46 |
| Loss on Disposal of Discontinued Operations | — | *56* | 56 | *(56)* | — |
| Loss (Gain) on Disposals of Property, Plant, and Equipment | 21 | *(8)* | 13 | *(20)* | (7) |
| Retiree Benefits Income | (249) | *(243)* | (492) | *223* | (269) |
| Decrease (Increase) in | | | | | |
| Accounts Receivable | 170 | *(849)* | (679) | *1,952* | 1,273 |
| Inventoried Costs | 172 | *(95)* | 77 | *(105)* | (28) |
| Prepaid Expenses and Other Current Assets | 45 | *(73)* | (28) | *45* | 17 |
| Increase (Decrease) in | | | | | |
| Advances from Customers on Long-Term Contracts | 21 | *645* | 666 | *(1,314)* | (648) |
| Accounts Payable and Accruals | (2) | *89* | 87 | *(783)* | (696) |
| Provisions for Contract Losses | (8) | *28* | 20 | *(85)* | (65) |
| Deferred income Taxes | 230 | *115* | 345 | *(171)* | 174 |
| Income Taxes Payable | 58 | *(30)* | 28 | *(41)* | (13) |
| Retiree Benefits | (129) | *37* | (92) | *17* | (75) |
| Other Noncash Transaction | 20 | *(8)* | 12 | *24* | 36 |
| **Net cash provided by operating activities** | $1,207 | *(197)* | $1,010 | *(193)* | $ 817 |

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**EXHIBIT 4.40**

**NORTHROP GRUMMAN CORPORATION**
**Data Taken from Consolidated Statements of Cash Flows**
**(Shaded Columns Showing Changes Do Not Appear in Original)**
**(all dollar amounts in millions)**
**(Problem 42)**

**Direct Method (without Reconciliation of Net Income to Cash Flow from Operations)**

| Years ended December 31 | Year 7 | Change | Year 8 | Change | Year 9 |
|---|---|---|---|---|---|
| **Cash Provided by Operating Activities** | | | | | |
| Sources of Cash | | | | | |
| Cash Received from Customers | | | | | |
| Collections from Customers on Long-Term Contracts | $ 1,691 | *(253)* | $ 1,438 | *1,664* | $ 3,102 |
| Other Collections | 7,450 | *(447)* | 7,003 | *4,145* | 11,148 |
| Less: Cash Paid to Suppliers and Employees | (7,715) | *465* | (7,250) | *(6,001)* | (13,251) |
| Net Cash Margin | $ 1,426 | *(235)* | $ 1,191 | *(192)* | $ 999 |
| *Cash Contribution Margin Percentage* | *15.6%* | | *14.1%* | | *7.0%* |
| Proceeds from Litigation Settlement | — | *—* | — | *220* | 220 |
| Interest Received | 18 | *(1)* | 17 | *—* | 17 |
| Income Tax Refunds Received | 75 | *(60)* | 15 | *8* | 23 |
| Other Cash Receipts | 7 | *3* | 10 | *14* | 24 |
| Cash Provided by Operating Activities | $ 1,526 | *(293)* | $ 1,233 | *50* | $ 1,283 |
| Other Operating Uses of Cash | | | | | |
| Interest Paid | $ 21 | *(51)* | $ 165 | *168* | $ 333 |
| Income Taxes Paid | 85 | *(28)* | 57 | *69* | 126 |
| Other Cash Payments | 18 | *(17)* | 1 | *6* | 7 |
| Cash Used in Operating Activities | $ 319 | *(96)* | $ 223 | *243* | $ 466 |
| **Net cash provided by operating activities** | $ 1,207 | *(197)* | $ 1,010 | *(193)* | $ 817 |

Table 8: Quarterly activity ratios

| | Fiscal Period | | | |
|---|---|---|---|---|
| | **2004Q3** | **2004Q2** | **2004Q1** | **2003Q4** |
| Inventory Turnover | nm | nm | nm | nm |
| Avg Days' Inventory on Hand | nm | nm | nm | nm |
| Accts Receivable Turnover | 3.38 | 3.53 | 2.94 | 2.36 |
| Avg Receivable Collection Period | 27.0 | 25.8 | 31.0 | 38.5 |

## 2. ANALYSIS OF ACCOUNTING POLICIES (Rating: Yellow)

- There were no material effects from changes in accounting principles, accounting estimates, or accounting classification.
- **Warning Sign 7: Related Party Transactions.** Prior to July 30, 2002, loans to executive officers were generally made in connection with their relocation and purchase of a new residence. Because of Sarbanes-Oxley legislation, no new loans have been made since July 30, 2002. The company's loans to executive officers and executives stood at $19.69 million and $21.27 million in fiscal 2003 and 2002 respectively. Of the total loans to executive officers still outstanding at 2003 fiscal year end, $9.4 million of loans were without interest for either the term of the note or for up to 4 years. In **2004Q2**, the Intuit Foundation contributed $2.5 million to a foundation directed by a member of the board of directors. The Intuit Foundation may contribute an additional $2.5 million to this foundation through November 2006.
- **Litigation:** Leonard Knable et al. v. Intuit Inc. was filed in Los Angeles County Superior Court on February 24, 2003. The lawsuit alleges various claims for unfair practices and deceptive and misleading advertising, fraud and deceit and product liability, on behalf of a purported class. The allegations are based on the design and operation of the product activation feature in Intuit's TurboTax 2002 for Windows desktop software and Intuit's representations and disclosures about product activation. The complaint seeks disgorgement of revenue from the sale of the product, compensatory and punitive damages, injunctive relief and attorneys' fees and costs.
- **Greg J. Santora, Senior Vice President and CFO**, retired and resigned as an officer of Intuit on January 5, 2003. Robert B. Henske has been appointed in his place from January 2003. Before joining Intuit, Robert B. Henske served as Senior Vice President and CFO of Synopsys, Inc., a supplier of electronic design automation software, from May 2000 until January 2003.
- **Seasonality:** The Company's tax businesses and small business products and services are highly seasonal and they generate higher total net revenue during second and third quarters ending January 31 and April 30. The company typically reports losses in its first and fourth quarters ending October 31 and July 31when revenue from tax businesses is minimal.
- **Acquisition:** In 2004Q1, the company acquired Innovative Merchant Solutions LLC ("IMS") for approximately $116.7 million in cash. The purchase price includes $98.4 million of Goodwill and $17.4 million to identified intangible assets, which was 84.3% and 14.8% respectively, of the entire purchase price.

## 3. ANALYSIS OF EARNINGS QUALITY (Rating: Yellow)

### CASH FLOW FROM OPERATIONS (CFFO)

- On an annual basis, unadjusted CFFO has been greater than net income the last three years (see Table 9). However, the growth rate of CFFO relative to net income growth has not been stable and declined in fiscal 2003 (Table 10). Nevertheless, Intuit has shown strong, and growing, CFFO – which consistently exceeds Net Income. In addition, Intuit's cash inflows come primarily from operations, not from investing or financing. These are all signs of higher quality earnings.

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