SEC Presses for Expanded MD&A Disclosure

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On January 22, 2002, the Securities and Exchange Commission issued a release entitled *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations* (SEC Release No. 34-45321) (the "Release"). The Release is part of a two-pronged initiative by the SEC in the aftermath of financial reporting and disclosure failures at Enron Corporation, Global Crossing Ltd. and other companies. On one front, the SEC is pursuing legislative and regulatory reforms to expand the rules governing public company disclosure. At the same time, it is warning public companies that existing regulations require disclosure of the factors that led to the rapid decline of seemingly viable public entities, including threats to liquidity posed by off-balance-sheet financing arrangements, trading in derivatives and transactions with related parties.

The Release is effective immediately, and is intended to affect disclosure for fiscal 2001 in upcoming Annual Reports on Form 10-K. As interpretive advice, the Release does not lay down new rules, but provides the SEC staff's position on complying with the existing MD&A rules. In light of the SEC's increased scrutiny of periodic filings, including a recently announced program to read every Annual Report on Form 10-K filed by Fortune 500 companies this year, public companies should carefully consider the Release.

Background

The purpose of MD&A is to allow the investor to "see through the eyes of management." The basic disclosure requirements are found in Item 303 of Regulation S-K, and include discussions of known material trends and uncertainties affecting liquidity, capital resources and results of operations, as well as an explanation of the causes of period-to-period changes in line items of the financial statements.

Further guidance is found in the SEC's 1989 Interpretive Release entitled *Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures* (SEC Release No. 34-26831) (the "1989 Release"). The 1989 Release includes a number of important SEC guidelines for companies preparing MD&A disclosure, including when prospective information must be disclosed (see"*Is disclosure required in MD&A?*" on the following page), requirements for segment reporting, and the scope of liquidity discussions in MD&A.

The most notable SEC enforcement action for inadequate MD&A disclosure took place in 1992 in *In the Matter of Caterpillar, Inc.* (SEC Release No. 34-30532). In that action, the SEC found that Caterpillar had failed to comply with the reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act") when it did not disclose the concerns of its board of directors that the dramatic increase in revenues experienced in the company's Brazilian unit in 1989, which significantly contributed to the company's earnings, resulted from the combined effects of Brazil's currency hyper-inflation and international exchange rates, and would not likely recur. The lesson of *Caterpillar* is that when management is aware of adverse trends and uncertainties, their

concerns must be disclosed. The SEC will have the benefit of twenty-twenty hindsight and access to corporate minutes in determining what was material, what management knew and when they knew it.

The requirements of MD&A were broadened further in 1999 by Staff Accounting Bulletin No. 99, 17 CFR 211 ("SAB 99"). In SAB 99, the SEC rejected numerical standards of materiality, eliminating the comfort many companies took when they withheld disclosure of matters when the amount of money involved fell below some standard threshold, such as 5% of earnings or assets.

The Release

Liquidity Disclosures

Item 303 of Regulation S-K has long required companies to disclose known trends and uncertainties affecting liquidity and capital resources. It has been a common practice, however, for companies to resort to conclusory language when describing financial resources and liquidity, such as "based on its cash and cash equivalents, borrowing capacity and funds from operations, the company believes it has sufficient resources for liquidity." In the Release, the SEC expressly disapproves of this practice and insists on further detail. For example, if operating cash flow is a source of liquidity, the company must also disclose known trends and uncertainties affecting that cash flow.

In particular, the Release instructs companies to include disclosure of any factors that are "reasonably likely" to affect liquidity. The SEC lists the following examples:

• Provisions in loans, guarantees or other commitments whereby a change in the company's earnings, credit rating, financial ratios, stock price, etc. can trigger acceleration of payment or additional obligations.

• Circumstances that could impair a critical or historically important activity of the company, or make it impracticable.

• Specific factors that could affect the company's credit rating or ability to raise capital.

• Guarantees of debt and commitments to third parties.

• Written options on non-financial assets (like real estate).

Off-Balance-Sheet Financing Arrangements

Taking special aim at the off-balance-sheet financing arrangements that prominently figured in the Enron collapse, the Release instructs registrants to include in MD&A an explanation of the risks and effects of off-balance sheet financing and to *consider* including a discussion of the following:

• Total amount of assets and obligations of each off-balance sheet entity, with a description of the nature of its assets and obligations, and identification of the class and amount of any debt or equity securities issued by the company.

• The effects of the entity's termination if it has a finite life or it is reasonably likely that the company's arrangements with the entity may be discontinued in the foreseeable future.

• Amounts receivable or payable, and revenues, expenses and cash flows resulting from the arrangements.

• Extended payment terms of receivables, loans, and debt securities resulting from the arrangements, and any uncertainties as to realization, including repayment that is contingent upon the future operations or performance of any party.

• The amounts and key terms and conditions of purchase and sale agreements between the company and the counterparties in any such arrangements.

• The amounts of any guarantees, lines of credit, standby letters of credit or commitments or take or pay contracts, through put contracts or other similar types of arrangements, including tolling, capacity, or leasing arrangements, that could require the company to provide funding of any obligations under the arrangements, including guarantees of repayment of obligors of parties to the arrangements, make whole agreements, or value guarantees.

Table of Contractual Obligations

The Release suggests that companies consider tabular disclosure of contractual obligations and third-party commitments, such as guarantees and letters of credit, and offers the following two examples:

Payments Due by Period   Contractual Obligations Total Less than 1 year 1-3 years 4-5 years After 5 years   Long-Term Debt   Capital Lease Obligations   Operating Leases   Unconditional Purchase Obligations   Other Long-Term Obligations   Total Contractual Cash Obligations

Payments Due by Period   Other Commercial Commitments Total Amounts Commitments Less than 1 year 1-3 years 4-5 years After 5 years   Lines of Credit   Standby Letters of Credit   Guarantees   Standby Repurchase Obligations   Other Commercial Commitments   Total Commercial Commitments

Footnotes to either table could be used to discuss provisions that could trigger increased liabilities or accelerated payment.

Disclosure of Non-Exchange Traded Derivative Positions

The Release also advises that expanded disclosure is appropriate when companies trade in commodities futures contracts that are not traded on an exchange, such as contracts to provide future electrical power or Internet bandwidth (also an issue for Enron). When companies account for these contracts at fair value, but no trading market exists to establish a market price, the fair value must be estimated. In the Release, the SEC advises companies to provide more detailed and more understandable disclosure of the methods used to estimate value. Again, a tabular presentation is suggested, along the following lines:

Fair Value of Contracts at Period-End   Source of Fair Value Maturity less than 1 year Maturity 103 years Maturity 4-5 years Maturity in excess of 5 years Total Fair Value   Prices actively quoted   Prices provided by Other external sources   Prices based on models and Other valuation methods

Related-Party Transactions

In disclosing related-party transactions, the Release instructs companies that it may be necessary to provide the following specific items of disclosure:

• The business purpose of the arrangement.

• The identity of the related parties.

• How transaction prices were determined.

• If disclosures represent that transactions have been evaluated for fairness, a description of how the evaluation was made.

• Any ongoing contractual or other commitments resulting from the arrangement.

The Release also advises that disclosure may be necessary in MD&A for transactions with parties who are not technically related to the company, but who are in a position to negotiate terms unavailable to others who must negotiate at arm's length. The SEC mentions former members of senior management or those with "some other current or former relationship" with the company as falling in this category, and expresses particular concern about transactions where an entity established by such parties will own an asset that will be used by the company. While stated in very broad terms, the examples show that this advice targets the type of entities used by Enron for off-balance-sheet financing of assets. According to the Release, companies must disclose such transactions in MD&A, even if the entities are not technically related parties.

Conclusion

The Release is the latest step in the SEC's growing emphasis on improving the quality of MD&A disclosure. While the specifics of the Release may seem most relevant to Enron and other recent failures of financial disclosure, there nevertheless is a general message: as management becomes aware of material threats to a company's liquidity and financial condition, the company must disclose the nature and extent of the problem in the MD&A. The MD&A is the place for disclosing trends and risks that may fall outside of specific line-item reporting requirements – not just the off-balance-sheet financing entities and off-market derivatives trading covered in the Release, but any material arrangements or events known to management that would conceal the company's true financial outlook from investors if not disclosed.

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