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Disclosure Practices in Light of Current Market Conditions

In current market conditions, two things are certain. First, the SEC will be reviewing periodic reports filed by the largest financial institutions in the United States[1] and potentially other companies viewed by the SEC as being particularly impacted by the credit crisis. Second, disclosures set forth in the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") section of such periodic reports will be closely scrutinized. To that list we can add a third element: there appears to be a strong correlation between companies in financial distress and companies singled out for enforcement action.

We highlight below recent SEC staff statements relating to staff review of periodic filings and observations of the SEC staff on disclosure practices, and also highlight the results of a recent study on SEC enforcement actions. In light of the greater scrutiny that public disclosure is likely to face and the potential difficult disclosure issues that reporting companies may well confront as they evaluate their levels of liquidity and access to capital, we use this opportunity to remind SEC reporting companies about disclosure practices that the SEC and the market will expect will be followed in light of the ongoing crisis.

For non-U.S. companies with SEC reporting obligations, we note that although the discussion below of disclosure of executive compensation and Form 8-K disclosures will not be applicable to such companies, the discussion of the MD&A, and best practices generally, will be applicable to the Operating and Financial Review and Prospects section of Form 20-F filings.

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1 John White, *Executive Compensation Disclosure: Observations on Year Two and a Look Forward to the Changing Landscape for 2009*, October 21, 2008: http://www.sec.gov/news/speech/2008/spch102108jww.htm

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Staff Review

By reason of the Sarbanes-Oxley Act, the SEC staff is required to review the periodic filings of all SEC reporting companies on a "regular and systematic basis," but in no event less than once every three years. In selecting filings for review, the staff is to consider companies that "experience significant volatility in their stock price," companies "with the largest market capitalization" and companies "whose operations affect any material sector of the economy." The director of the SEC's Division of Corporation Finance, John White, in a speech given in October, indicated that in 2009, the staff will review the annual reports of all of the "very largest financial institutions" in the United States that are SEC reporting companies. The review will focus on both the financial statements and executive compensation disclosures. The staff will also monitor Form 10-Q and Form 8-K filings of these companies.

Enforcement Trends

A recent study undertaken by Deloitte of large publicly-traded companies found a significant relationship between fraud, bankruptcy and SEC enforcement actions.[2] Deloitte's conclusions were based on a review of Accounting and Auditing Enforcement Releases ("AAERs") issued by the SEC. Deloitte found that bankrupt companies were three times more likely than non-bankrupt companies to face SEC enforcement action for financial statement fraud - 9% of bankrupt companies were issued AAERs as opposed to 3% of non-bankrupt companies. Companies issued an AAER were more than twice as likely to file for bankruptcy as those that were not issued one. Bankruptcy filings of large publicly-traded companies attract the SEC's attention and the SEC issues its greatest number of AAERs within three years of the bankruptcy filing (69%).

Best Practices for Disclosure

As management and boards of SEC reporting companies evaluate the impact of the current crisis on operations and results, communications with shareholders and the marketplace must adequately reflect the outcome of such evaluations. This in turn means that management, in the first instance, and those at the board who review public statements, must ensure that press releases, investor presentations, quarterly conference calls and, most importantly, SEC periodic reports convey the proper disclosures as to the impact of the crisis on the company.

As management teams consider their companies' disclosure obligations, they should evaluate the following:

MD&A

The MD&A has been required for many years (the origins date back to 1968 and the current framework dates back to 1980). Item 303 of Regulation S-K sets forth the key

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2 *Ten things about bankruptcy and fraud: A review of bankruptcy filings*, Deloitte Forensic Center, November 2008.

elements that should be covered in an MD&A. Since the revisions to the MD&A requirements in 1980, the SEC has issued various interpretive releases, including one in 1989 (Release no. 33-6835), a second in 2002 (Release no. 33-8056) (the "2002 Release") and a third in 2003 (Release no. 33-8350) (the "2003 Release"). The MD&A is to provide investors with the information "necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations." One of the key elements of the MD&A is the discussion and analysis of "known trends, demands, commitments, events and uncertainties."

A perennial challenge in drafting an MD&A is how to get behind the numbers and present an accurate picture of the company from a financial point of view. As the MD&A is the opportunity for investors to see the company through the eyes of management, boilerplate disclosures are not what either investors or the SEC expects to see. The disclosure of "known trends, demands, commitments, events and uncertainties" and the impact of any of the foregoing on the company's financial statements is required and will be especially scrutinized in these uncertain times.

We discuss below some of the key elements of the MD&A that warrant particular attention in this environment.

Revenue

In the overview of the MD&A, readers should be alerted to possible adverse impacts of the environment on the company's top line. Very few industries will be immune to macro-economic conditions and the current significant constraints on credit.

Note that the SEC does not recognize for disclosure purposes a concept equivalent to judicial notice. This means that a company cannot assume that investors are aware of publicly available market or industry information that might impact the company. As a result, the disclosure requirements applicable to known trends are not limited to company-specific disclosure; the trends may be industry-specific or broadly applicable (and still need to be discussed and analyzed). A company should also not hide behind macro-economic trends and uncertainties; the disclosure needs to be tailored to the company and its financial statements, and should address how the company and its financial statements are specifically affected by events occurring in, and pressures created by, the broader economy.

Liquidity and Capital Resources

With respect to liquidity and capital resources disclosure, the SEC notes that this information is "critical to an assessment of a company's prospects for the future and even the likelihood of its survival." A company is required to include in its MD&A, to the extent material (as outlined in the 2003 Release):

- historical information regarding sources of cash and capital expenditures;
- an evaluation of the amounts and certainty of cash flows;
- the existence and timing of commitments for capital expenditures and other known and reasonably likely cash requirements;

- a discussion and analysis of known trends and uncertainties;
- indications of which balance sheet, income statement or cash flow items should be considered in assessing liquidity; and
- a discussion of prospective information regarding a company's sources of and needs for capital.

A company should evaluate separately its ability to meet upcoming cash requirements over both the short-term and the long-term. Stating that a company has adequate cash resources generally is not sufficient, particularly if there are known material trends, or uncertainties, related to cash flow, capital resources, capital requirements or liquidity.

At the annual AICPA National Conference on SEC and PCAOB Developments held this week, the SEC staff again emphasized the importance of the liquidity discussion in the MD&A. It noted that the liquidity discussion must be user-friendly, display prominently the most critical information, be meaningful without resort to supplemental calculations by readers, include management's insights and exclude superfluous information. Readers should be able to review the disclosure as a stand-alone section.

We note below some of the factors management should consider as it assesses both the company's liquidity needs and its MD&A disclosure, followed by some of the staff's key observations in respect of disclosure they have reviewed:

- As for the company's liquidity needs and potential sources of capital:

  - When does the company need funding and what is the impact of the timing relative to the availability of the funding?

  - Is the company reliant on a single bank or a group of banks and is it possible that lenders may be unwilling or unable to lend under existing credit facilities or may have changed their lending practices?

  - Does the company access the commercial paper market or other short-term funding sources?

  - When do the company's term loans mature and when do the company's revolving credit arrangements terminate?

  - Does the company have "headroom" under a revolving credit facility, and does it make sense to draw down under the facility even if additional funds are not currently needed?

  - Has the company relied on the securitization markets and, if so, what are the funding implications of the current state of the market?

  - Is there a need for additional future pension funding to make-up any shortfall?

  - What is the impact of existing share repurchase programs and dividend payments?

- Are alternative sources of equity and debt capital available?

- Are there potential covenant compliance issues?

  - Is it possible that an amendment or waiver will be required from lenders under bank credit facilities?

  - For issuers with capital markets debt (e.g., high yield bonds), are there covenant issues that could require a consent solicitation?

  - Covenant issues could arise, for example, from changes in ratings or failure to meet maintenance covenants or from breaches of incurrence tests if the company were to take unexpected measures to relieve pressures associated with current market conditions.

  - Note the impact of accounting issues on debt covenant compliance.

- Do assets deemed to be liquid have the expected realizable value under current market conditions?

- What are the potential consequences of higher borrowing costs?

- If the company seeks amendments, waivers or consents, consider the possibility of the debt holders demanding new lender-friendly terms and conditions, and potentially expensive amendment or consent fees.

Other liquidity uncertainties will stem from the provisions in debt agreements that could trigger early payment, additional collateral support, more onerous terms or covenants, acceleration or additional financial obligations. These provisions could be tied to adverse changes in ratings, ratios, earnings, cash flow or stock price, or changes in underlying, linked or indexed reference assets.

Having considered the foregoing factors and questions, management should, in assessing the adequacy of disclosure, consider the following points, which are based on recent SEC staff observations:

- analyze and discuss the sources and uses of cash;

- discuss changes in cash received from all sources, and cash paid out; and discuss any known trends and uncertainties that are reasonably expected to have material effects on the separate uses and sources of cash;

- evaluate capital expenditures on a discretionary and non-discretionary basis (meaning expansion and maintenance of existing capacity) and discuss any anticipated funding sources (for example, the extent to which cash received from customers will be available);

- discuss the sufficiency of the unused availability under short-term funding arrangements (or the estimated utilization), the anticipated circumstances requiring its use, any uncertainty surrounding the ability to access funds when needed, and any implications of not being able to access the funds;

- discuss the factors that may materially influence credit ratings, the potential implications of known or reasonably likely changes in credit ratings or credit rating outlook, and management's expectations with respect to credit ratings;

- discuss any uncertainty or trends surrounding future compliance with financial covenants, and the material implications of a breach; and provide company-specific calculations when ratios under a debt agreement are provided in an SEC filing;

- discuss the capacity for additional borrowings under the most restrictive financial covenant, whether there is otherwise an ability to raise these funds, and whether this amount is sufficient or insufficient for current and long-term needs; and

- address current market conditions and any uncertainties relating to the commercial paper market, committed and uncommitted borrowings, cash and securities held at banks and other financial institutions, illiquid investments, future pension funding, share repurchase programs and dividend payments.

Finally, to the extent that any solutions involve related parties, management needs to consider the disclosure obligations under Regulation S-K Item 404 as well as the general disclosure obligations for the MD&A in respect of material related party transactions. (See the 2002 Release.)

Risk Factors

Management should consider whether the existing risk factors in the Form 10-K are adequate or need to be updated. To the extent that updates are appropriate, they should be updated in the next periodic report – either a Form 10-Q or Form 10-K. (Note that Part II, Item 1A of Form 10-Q requires disclosure of material changes to risk factors that were set forth in the Form 10-K.) Changes in the MD&A may well result in corresponding changes to the risk factors. More broadly, the effects of macro-economic changes are likely to have an impact on the business and should be adequately reflected in risk factor disclosure.

Forward-Looking Statements Safe Harbor Note

Management should consider whether specific factors cited in the note on forward-looking statements need to be updated with new or different factors, and whether the order of the factors listed should be modified based on changes in the probability of certain (previously remote) factors actually affecting results.

Form 8-K Current Reports

Risk factors. Management should consider whether Form 8-K risk factor disclosures may be warranted by reason of changes in the material risks faced by the company. Waiting until the next Form 10-Q may not be appropriate if the company has experienced a material change in its risk profile. There are an increasing number of examples of Item 8.01 updates of risk factors.

Events of default. Item 2.04 requires disclosure upon the occurrence of a triggering event causing an increase or acceleration of a direct financial obligation. A "direct financial obligation" may include any of the following: a long-term obligation, a capital lease obligation, an operating lease obligation, or a short-term debt obligation that arises other than in the ordinary course of business.

A "triggering event" is an event, including an event of default, event of acceleration or similar event, as a result of which a direct financial obligation of the company or an obligation of the company arising under an off-balance sheet arrangement is increased or becomes accelerated or as a result of which a contingent obligation of the company arising out of an off-balance sheet arrangement becomes a direct financial obligation of the company. A triggering event may relate to either the company or one of its subsidiaries.

Disclosure is required if a triggering event occurs in respect of the company's obligations under an off-balance sheet arrangement and the consequences are material to the company, whether or not the company is also a party to the transaction or agreement under which the triggering event occurs.

No disclosure is required unless and until a triggering event has occurred in accordance with the terms of the relevant agreement, transaction or arrangement, including, if required, the sending to the company of notice of the occurrence of a triggering event pursuant to the terms of the agreement, transaction or arrangement and the satisfaction of all conditions to such occurrence, except the passage of time. If declaration or notice is necessary prior to an increase or acceleration of the agreement, an Item 2.04 Form 8-K is not required until such declaration or notice is received. If no such declaration or notice is required and an increase or acceleration occurs automatically, disclosure is required under Item 2.04. No disclosure is required for a voluntary redemption of securities.

No disclosure is required if the company believes, in good faith, that no triggering event has occurred, unless the company has received a notice of the triggering event. To the extent that a company has disclosed a statement of its good faith belief as to any relevant matter, including, for example, that all conditions to occurrence of a triggering event have not been satisfied or that a triggering event otherwise has not occurred, disclosure may be required if the company's conclusion as to the triggering event changes due to a loss of, or change in, its good faith belief. The company would have to amend the Form 8-K to provide this updated disclosure within four business days from the date that its conclusion changes. Also, even if the company disputes the legitimacy of a notice of default and proceeds to arbitration, while the arbitration is pending, notwithstanding its good faith belief that no default has taken place, the notice of default is a triggering event and disclosure is required under Item 2.04.

Where a company is subject to an obligation arising out of an off-balance sheet arrangement, whether or not disclosed pursuant to Item 2.03 of Form 8-K, and a triggering event occurs as a result of which an accrual for a probable loss under that obligation is required under SFAS No. 5 ("Accounting for Contingencies"), the obligation arising out of the off-balance sheet arrangement becomes a direct financial obligation for purposes of Item 2.04. In this situation, if the consequences are material to the company, disclosure is required under Item 2.04.

Other. In addition, Form 8-K disclosure might be required under any one of the following items:

- Item 1.01, by reason of amendments to a material agreement;
- Item 1.02, by reason of the termination of a material agreement;
- Item 2.01, by reason of a disposition of a "significant amount" of assets (which might also trigger the need for pro forma financial information); and
- Item 2.06, by reason of a material impairment.

Compensation Discussion and Analysis ("CD&A")

In his October speech, the Director of the Division of Corporation Finance offered some thoughts on executive compensation disclosure for institutions participating in the Treasury Department's Capital Purchase Program under the Troubled Asset Relief Program as well as executive compensation disclosure for U.S. SEC reporting companies that are not participants.

Institutions participating in the Capital Purchase Program are subject to various limitations on executive compensation, and will need to consider carefully, and reflect, the new provisions and the consequences thereof in drafting their CD&A.

The financial crisis has focused considerable attention on the relationship between compensation and unnecessary and excessive risk-taking by senior executive officers that could threaten the value of an institution. While institutions participating in the Capital Purchase Program are required to review their compensation plans to ensure that they do not encourage excessive risk-taking by senior executive officers, the issue could be relevant to other reporting companies as well. In particular, the SEC staff has raised the question of whether it is prudent for compensation committees, when establishing targets and creating incentives, not only to discuss how difficult it is to meet the incentives, but also to consider the particular risks that an executive might be motivated to take to meet the target. To the extent that such considerations form a material part of a company's policies or decisions, the company would be required to discuss them as part of its CD&A.

In addition, the SEC staff has made clear that U.S. reporting companies should consider if, and to what extent, the current economic environment has affected their compensation programs. Simply marking up last year's disclosure is not an option. The staff notes that the following questions, among others, should be considered when preparing CD&A disclosures:

- whether the company has modified outstanding awards or plans, or implemented new ones;
- whether the structure of the compensation program and/or the relative weighting of various compensation elements has been reconsidered;
- whether certain performance conditions have been waived, or new conditions have been set using different standards; and
- whether the processes and procedures for determining executive and director pay have been changed.

Companies should also be mindful of some of the views expressed by the SEC staff as a result of staff review of disclosures during 2008. Some of the staff comments include:

The need for more analysis. The SEC recommends that the CD&A contain an analytical discussion of:

- the material elements of compensation;
- how the company arrived at the varying levels of compensation; and
- why it believes that its compensation practices and decisions fit within its overall objectives and philosophy.

The CD&A should also:

- explain each of the specific factors considered when approving each part of an executive officer's compensation package;
- analyze the reasons why the company believes the amounts it pays are appropriate; and
- describe how determinations with respect to one element impacted other compensation decisions.

Disclosure of performance targets. If performance targets are material in the context of a company's executive compensation policies, then the only basis for omission of its discussion is a reasonable showing that disclosure would cause substantial competitive harm. In such cases, disclosure regarding the degree of difficulty associated with achievement or non-achievement of the omitted performance objective is mandatory. This disclosure should clearly address the criteria for determining undisclosed target levels and must directly establish the connection between the achievement of the performance objective and the characteristics of the incentive payment to which the goal applies. In other words, if a company follows a pay-for-performance program, it should consider providing meaningful disclosure that describes the degree to which the performance goals were sufficiently challenging or appropriate in light of that program, and how achievement of the objectives actually rewarded performance.

Disclosure relating to benchmarking. If a company benchmarks a material element of compensation, it must:

- identify the companies that comprise the peer group used for benchmarking purposes; and
- disclose the basis for selecting the peer group, the relationship between actual compensation and the data utilized in benchmarking in a meaningful manner.

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In stable markets, informative disclosure that complies with both the letter and the spirit of the SEC's disclosure requirements should be a matter of best practice. In this environment, that informative disclosure (with particular sensitivity to trends and uncertainties) will be critical to help manage the expectations of shareholders and the market more generally, and reduce surprise public announcements. Informative disclosure should also reduce the strain on investor relations staff and the chief financial officer as they respond to the undoubtedly large (and increasing) volume of questions about a company's future, without violating Regulation FD. Informative disclosure can also help reduce the likelihood of the enforcement actions and securities class actions that invariably follow market downturns.
