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M E M O R A N D U M

**TO:** Clients and Friends of the Firm

**FROM:** Kramer Levin Naftalis & Frankel LLP Corporate Securities and Finance Department

**DATE:** August 1, 2002

**RE:** New Securities and Exchange Commission Guidance for Management's Discussion and Analysis of Financial Condition and Results of Operations

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On January 22, 2002, the U.S. Securities and Exchange Commission (the "Commission") issued a detailed release (the "Release") regarding the disclosure of Management's Discussion and Analysis of Financial Condition and Results of Operations in both filings made by public companies under the Securities Act of 1933 (the "Securities Act") and periodic reports under the Securities Exchange Act of 1934 (the "Exchange Act"). The Release applies to both U.S. companies and foreign private issuers that are U.S. reporting companies under the Exchange Act. Disclosure matters addressed by the Release are:

- liquidity and capital resources, including contractual obligations and commercial commitments and off-balance sheet arrangements;
- the effects of transactions with related and certain other parties; and
- trading activities that include non-exchange traded contracts accounted for at fair value.

The Commission's has indicated that the Release does not by itself create any new legal requirements regarding disclosure. However, the Release clearly indicates the Commission's view that the guidance provided in the Release will nonetheless need to be followed by public companies for such companies to be deemed in compliance with existing disclosure requirements. We also believe that compliance with the Commission's new guidance will require a substantially more detailed and thorough MD&A presentation than many public companies have customarily provided. Further, the Sarbines-Oxley Act of 2002 on Corporate Accounting Reform and Investor Protection that was adopted at the end of July 2002 requires the Commission to issue final rules within 180 days after the enactment of that Act that will require disclosure in annual and quarterly reports of all material off-balance sheet transactions and arrangements. We expect that compliance with the more detailed guidelines in the Release and the subsequent final rules to be issued by the Commission will require substantial time and attention of management and your financial advisors than in prior periods, as well as our ongoing guidance.

The Release provides, in relevant part, that "[w]e also want to remind registrants that disclosure must be both useful and understandable. That is, management should provide the most relevant information and provide it using language and formats that investors can

be expected to understand. Registrants should be aware also that investors will often find information relating to a particular matter more meaningful if it is disclosed in a single location, rather than presented in a fragmented manner throughout the filing.”

This general statement by the Commission can be taken to mean:

- There continues to be a strong emphasis on disclosure of complicated financial matters in "plain English";
- All aspects of a company's business, transactions and relationships involving the company that can be expected to impact that company's financial position or results of operations in a material manner needs to be included in the MD&A section, whether or not such business, transactions or relationships are reflected in its financial statements; and
- All disclosure relevant to a company's financial position and results of operations should be included in a single location--the MD&A section of a filing--and a company should not rely on disclosure contained in other sections of a filing, including the financial statements or notes thereto or those contained under the heading "Certain Transactions" (or a variant thereof).

The Commission staff will be monitoring periodic reports filed under the Exchange Act for disclosures that are inconsistent with Commission rules or GAAP or that are materially deficient in explanation or clarity. We have attempted to summarize the key points of the Release in this memorandum. Certain aspects of the Release, such as those dealing with trading activities involving commodity contracts, are not addressed in this memorandum. A copy of the Release can be viewed in its entirety by on the Commission's website at the following link: [www.sec.gov/rules/other/33-8056.htm](http://www.sec.gov/rules/other/33-8056.htm).

#### Liquidity and Capital Resources Disclosure

MD&A disclosure addressing liquidity should not be overly general. For example, the Commission stated that the following typical disclosures may not be sufficient without further explanation of the details and risks:

- our company has sufficient short-term funding to meet its needs for the next year; and
- our principal source of liquidity is operating cash flow

Instead, liquidity and capital resources disclosure must specifically inform investors about matters that could impact the company's liquidity on a short and/or long-term basis in greater detail than we may be accustomed to seeing. Companies should describe in sufficient detail their sources of funding and the circumstances that are likely to affect those sources. If a company's principal source of liquidity is operating cash flow, it may also need to disclose the risk that a decrease in demand for its products could adversely affect liquidity. Also, for companies having sales in non-US jurisdictions that are denominated in currency other than the US dollar, the risk that currency fluctuations will adversely impact operating cash flow (absent the implementation of a currency hedging program) should be disclosed. The company should describe in the MD&A section (and not rely on the fact that disclosures are elsewhere) the factors that could result in the decreased demand for its products, to the extent that such decreased demand could impact its liquidity and need for additional capital. Additionally, companies should disclose in MD&A how available or anticipated borrowings may be adversely affected by a deterioration in financial ratios or other factors that may cause additional funds under a credit facility to be no longer available. Accordingly, a general disclosure that "a company's debt facility is subject to customary financial covenants" is likely not sufficient in most circumstances. Rather a

company may need to disclose the specific ratio tests or other financial or non-financial covenants and their impact on borrowing capability, particularly if the ability to comply with a financial ratio or such covenants could come into question in the foreseeable future.

Identification of circumstances that would materially affect liquidity is necessary if these circumstances are "reasonably likely" to occur. Market price changes, economic downturns, defaults on credit facilities or guarantees, or contractions of operations that have material consequences for the company's financial position or operating results can be reasonably likely to occur under some conditions. Material effects on liquidity as a result of any reasonably likely changes should also be disclosed.

In 1989, the Commission identified two assessments management must make where a trend, demand, commitment, event or uncertainty is known. These assessments are set forth below, and should continue to be considered to determine whether disclosure is adequate.

1. Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
2. If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.

The Commission further reminded registrants that each final determination resulting from the assessments made by management must be objectively reasonable, as viewed at the time the determination is made.

To identify trends, demands, commitments, events and uncertainties relating to liquidity, the Commission advised that the following should be considered for disclosure:

- Provisions in financial guarantees or commitments, debt or lease agreements or other arrangements that could trigger an early payment requirement, additional collateral support, changes in terms, acceleration of maturity, or the creation of additional financial obligations, such as adverse changes in the company's credit rating, financial ratios, earnings, cash flows, or stock price, or changes in the value of underlying, linked or indexed assets;
- circumstances that could impair the ability to continue to engage in transactions or commercial activities, such as the inability to maintain investment grade status or satisfy financial ratios;
- factors specific to a company that are expected to be given significant weight in determining the company's credit rating or ability to raise short-term or long-term financing;
- guarantees of debt or other commitments to third parties; and

- written options in non-financial assets (e.g., real estate puts).

We do not interpret the Commission's guidance in the Release to impact a company's decision to include a description of the risks and factors that could impact liquidity and capital resources (and results of operations) in a separate "risk factors" section. Nor are we comfortable in suggesting that the disclosure that would normally be contained in such a section should in any way be mitigated because it has been disclosed in MD&A. Of course, this may appear to be inconsistent with the Commission's statement (indicated above) that information relating to a particular matter is more meaningful if disclosed in a single location. However, we believe that it continues to be appropriate to include this type of disclosure in both the risk factors and MD&A sections unless and until we receive specific guidance from the Commission to the contrary.

#### Disclosures about Contractual Obligations and Commercial Commitments

The Commission suggested that companies include in a single location a detailed description of the company's future financial obligations and commitments to make future payments under contracts, such as debt and lease agreements, and contingent commitments, such as debt guarantees. The Commission further suggested that this information could best be presented in a chart, in the form attached to this memorandum as Exhibit A. The chart could include, for example, anticipated term loan prepayment requirements, anticipated annual lease payments, contractual obligations to make future cash payments and other similar future liabilities. The chart could be accompanied by footnotes to describe provisions that create, increase or accelerate liabilities, and other pertinent information.

#### Off-Balance Sheet Arrangements

The Commission also advised companies (apparently, in direct response to the issues raised by Enron situation) to consider the need to provide additional disclosure in MD&A concerning transactions, arrangements and other relationships with unconsolidated entities or other persons that are reasonably likely to affect materially liquidity or the availability of or requirements for capital resources. Many companies have in the past described these transactions, arrangements and relationships, if at all, in the financial statement footnote regarding contingencies and not in the MD&A. The Release provides that material sources of off-balance sheet arrangements should be discussed fully and clearly, particularly to the extent a company is exposed to a potential liability that is not reflected on the face of its financial statements, as well as to the extent that there are uncertainties on the continued availability of these sources.

In particular, the Commission noted that disclosure should describe if a company is legally or, if not legally, economically required or reasonably likely to fund losses or provide additional capital to third parties or could be financially affected by the performance or non-performance of third parties to a particular transaction or arrangement. The Commission has indicated that other disclosures companies should consider in order to explain the effects and risks of off-balance sheet arrangements include:

- The total amount of assets and obligations of the 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;

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- The effects of an off-balance sheet entity's termination if it has a finite life or if it is reasonably likely that the company's arrangements with the entity may be discontinued in the foreseeable future;
- Accounts 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 any 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; and
- The amounts of guarantees, lines of credit, standby letters of credit or commitments or take or pay contracts, throughput 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 arrangements, or value guarantees.

Although disclosure regarding similar arrangements can be aggregated, important distinctions in terms and effects must not be lost in that process. Additionally, legal opinions regarding true sale or other issues relating to whether a company has contingent, residual or other liability do not obviate the need to consider whether disclosure is required.

#### Disclosures about Related Party Transactions

The Commission also stated that material related party transactions need to be discussed in MD&A to the extent necessary to understand the company's current and prospective financial results, even if the transaction is disclosed elsewhere in the report. For example, a material loan to a director or an officer of the company should be disclosed if the repayment obligations are dependent on continued employment or otherwise contain financial terms or conditions that are different than those that would be contained in an agreement with an unaffiliated party.

The Release provides that discussion of the following may be necessary:

- the business purpose of the arrangement;
- identification of the related parties transacting business with the company;
- how transaction prices were determined by the parties;
- if disclosures represent that the transaction has been evaluated for fairness, a description of how the evaluation was made; and

- any ongoing contractual or other commitments as a result of the arrangement.

The company must disclose the impact of the transactions on the financial statements and any special risks and contingencies.

The Commission stated that companies should also consider the need for disclosure about parties that may not fall within the definition of "related parties," but with whom the company has a relationship that entitles the company to negotiate terms of material transactions that might not be available from a more clearly independent party dealing with your company on an arm's length basis. For example, transactions with a person or entity with whom the company has a material relationship or through which a commercial relationship has been established may need to be disclosed in the MD&A section, even if not technically required to be disclosed pursuant to Item 404 of Regulation S-K ("Certain Relationships and Related Transactions").

Disclosures about Certain Activities that Include Non-Exchange Traded Contracts Accounted for at Fair Value

The Commission is also concerned that there may be a lack of clarity and transparency regarding disclosure of trading activities involving commodity contracts that are accounted at fair market value but for which a lack of market price information necessitates the use of fair value estimation techniques. This aspect of the Release appears to be directed to energy trading, telecommunications and other companies dealing with the ongoing valuation of commodities and similar items (e.g., use of bandwidth). We have not addressed this part of the Release in this memorandum. However, if you have particular questions about this portion of the Release, please do not hesitate to contact your attorney at Kramer Levin, who will be able to respond appropriately to your inquiry.

If you have any questions about this memorandum, please contact Andrew Hulsh in our New York office at (212) 715-9292.

**Exhibit A**

The following is a schedule suggested by the Commission for inclusion in the Liquidity and Capital Resources section regarding aggregate commitments.

Contractual Obligations	Payments Due by Period				
	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					

Other Commercial Commitments	Total Amounts Committed	Amount of Commitment Expiration Per Period			
		Less than 1 year	1-3 years	4-5 years	Over 5 years
Lines of Credit					
Standby Letters of Credit					
Guarantees					
Standby Repurchase Obligations					
Other Commercial Commitments					
Total Commercial Commitments					