

## SEC ISSUES STATEMENT REGARDING MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In an effort to address increasing investor concern about the sufficiency of registrants' financial disclosure, on January 22, 2002, the Securities and Exchange Commission (the "Commission") issued a statement of its views on certain aspects of the disclosure contained in Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). Specifically, the Commission addressed (1) liquidity and capital resources, including off-balance sheet arrangements, (2) certain trading activities that include non-exchange traded contracts accounted for at fair value, and (3) the effects of transactions with related and certain other parties.

The Commission's statement merely suggests steps that registrants should consider in meeting their disclosure obligations. It does not create new legal requirements or modify existing legal obligations, although the Commission has stated that it intends to consider rulemaking regarding the topics addressed in the statement and other topics covered by MD&A.

The Commission reminds registrants that the basis for MD&A disclosure is management's identification and evaluation of information, including the potential effects of known trends, commitments, events and uncertainties, that is important to providing investors with an accurate understanding of the registrant's current and prospective financial position and operating results.

### **1. Disclosure concerning Liquidity and Capital Resources, including "Off-Balance Sheet" Arrangements**

The Commission has previously expressed its view that a registrant's liquidity, capital resources and off-balance sheet financing arrangements are integrally related. It therefore recommends that all three items be considered both individually and together in MD&A.

#### *(a) Liquidity and Capital Resources*

Disclosure should be detailed and tailored to the registrant's individual circumstances, rather than overly general or "boilerplate." For example, stating that the registrant has sufficient short-term funding to meet its liquidity needs for the next year should be improved by describing those sources and the circumstances that are *reasonably likely* to affect them.

The Commission also suggests that management consider the following in identifying trends, demands, commitments, events and uncertainties that require disclosure:

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- provisions in financial guarantees or commitments, debt or lease agreements or other arrangements that could trigger a requirement for early payment, additional collateral, changes in terms, acceleration of maturity or the creation of an additional financial obligation, such as changes in credit rating, financial ratios, earnings or cash flows;
- circumstances that could negatively affect the registrant's ability to engage in transactions which are integral to its historical operations or which are financially or operationally essential, or that could render that activity commercially impracticable;
- factors specific to the registrant and its markets that could be given significant weight in determining its credit rating or that would otherwise affect its ability to raise capital;
- guarantees of debt or other commitments to third parties; and
- written options on non-financial assets.

### *(b) Off-Balance Sheet Arrangements*

Any transaction, arrangement or other relationship with an unconsolidated entity or other person that is reasonably likely to materially affect a registrant's liquidity or the availability of or requirements for capital resources should be disclosed. Furthermore, disclosure of the material sources of a registrant's liquidity and financing should include a description of off-balance sheet arrangements and transactions with unconsolidated, special purpose entities (particularly if those entities provide financing, liquidity or market or credit risk support, if they engage in leasing, hedging or research and development services for the registrant or if they expose the registrant to liability that is not reflected in its financial statements).

The Commission suggests that the disclosure include the business purposes and activities of the off-balance sheet arrangements, their economic substance, the key terms and conditions of any commitments, the initial and ongoing relationships with the registrant and its affiliates and the potential risk to the registrant of the contractual or other commitments of such arrangements.

Disclosure of these arrangements should be tailored to describe the registrant's risks. It should not merely present the transactions' legal terms or the relationships between the parties. The relative significance to the registrant's financial position should be made clear.

### *(c) Contractual Obligations and Commercial Commitments*

In order to give a complete picture to investors, the Commission recommends that disclosure of obligations and commitments to make future payments under contracts, such as debt and lease agreements, and under contingent commitments, such as debt guarantees, be presented in tabular format in a single location.

**2. Disclosure concerning Certain Activities that include Non-Exchange Traded Contracts accounted for at Fair Value**

The Commission is concerned about the present level of disclosure of commodity contracts that are accounted for at fair value but lack market price quotations, thereby necessitating the use of fair value estimation techniques. Registrants engaged in trading these contracts should consider providing additional disclosure beyond that required by accounting standards, including information regarding derivatives contracts involving the same commodities as those traded by the registrant.

MD&A disclosure is required to include a discussion of the material trends and uncertainties arising from a registrant's material commodity trading and risk management activities. Consideration should also be given to including a description of the effect on reported financial results of different outcomes reasonably likely under different circumstances or different measurement methods. The Commission notes that it has previously encouraged the inclusion of a full explanation, in plain English, of registrants' "critical accounting policies" and the judgments and uncertainties affecting the application of these policies.

**3. Disclosure concerning the Effects of Transactions with Related and Certain Other Parties**

MD&A should include a discussion of any material transactions involving related parties to the extent necessary to provide investors with an understanding of the registrant's current and prospective financial position and operating results. The elements of these transactions, their effects on the financial statements and the special risks or contingencies arising from these transactions should be described. Disclosure may also include the business purpose of the arrangement, identification of the related parties, how the transaction prices were determined, a description of any fairness evaluation of the transaction, and any ongoing contractual or other commitments as a result of the arrangement.

The Commission recommends that registrants also consider disclosing transactions with parties that fall outside the definition of "related parties." These include persons with whom the registrant has a relationship enabling it to negotiate the terms of material transactions that may not be available from other, more clearly independent, parties on an arm's-length basis.

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If you wish to obtain additional information regarding the Commission's statement, please contact the corporate partner with whom you regularly work.

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