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February 9, 2011

Alert

SEC Disclosure and Corporate Governance

Financial Reporting Challenges for 2011

Companies now focusing on preparation of the upcoming annual report have the benefit of wide-ranging disclosure guidance issued in 2010 and early 2011 by the SEC and its Staff. While many of the issues have been highlighted repeatedly since the financial crisis began to erupt in 2007, the significance of the latest round of guidance has been underscored by a far more aggressive SEC enforcement posture in the financial reporting area.[1]

The overarching theme of this guidance – whether formally outlined in binding SEC pronouncements or non-binding Staff interpretations, or informally expressed by Staff members in speeches – is the importance of providing "early-warning" disclosures of material risks and uncertainties that, if realized, could have a material adverse effect on a particular company's liquidity, capital resources or operating results. The SEC and its Staff increasingly are taking a holistic view of risk-related disclosures, with the focal point for regulatory scrutiny being the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") and Risk Factor sections of periodic reports filed under the Securities Exchange Act of 1934, as amended ("Exchange Act"). Staff in the Division of Corporation Finance routinely look outside the four corners of SEC filings and submissions in connection with SEC filing reviews, examining the content of various non-filed corporate communications – including company press releases and statements made by officials during company or third-party sponsored investor conferences conducted via telephone and/or the Internet – as well as analyst reports, news articles and blogs covering the company. The Staff's stated objective here is to assess the consistency of filed and non-filed communications being made by public companies, along with market perceptions of those communications, with a view toward determining whether all required material information has been disclosed in SEC-mandated documents.[2]

I. SEC Interpretive Guidance Published in 2010

We begin with the two most notable SEC interpretive pronouncements in 2010 regarding the need for "early warning" disclosures of material risks in periodic reports. In practical terms, they call for management to engage in an ongoing process of identifying, and reassessing the significance of, a multitude of business, financial and regulatory risks and uncertainties facing the company.

A. The February 2010 Climate Change Release

The first of these SEC interpretive releases, published in February 2010, is somewhat deceptively entitled *Commission Guidance Regarding Disclosure Related to Climate Change* (the "Climate Change Release").[3]

Notwithstanding its focus on disclosure of one category of risks – climate change – this release has much broader significance for companies regarding the duty to provide "early warning" to investors of all types of contingencies that, if realized, could have a material effect (whether negative or positive) on a company's financial condition and results of operations. The primary objective of this analysis is to shed light for investors on factors that are "reasonably likely to cause reported financial information not to be necessarily indicative of future operating performance or future financial condition."[4] These complex, future-oriented disclosure judgments require management to:

- consider financial, operational and other information **known** to the company, which means that management must have in place disclosure controls and procedures (as well as internal controls over financial reporting) that effectively and efficiently capture this information and bring it promptly to the attention of those within management who are charged with making key disclosure decisions on behalf of the company;
- based on the information thus collected, identify **known trends and uncertainties**; and
- evaluate whether these identified trends and uncertainties will have, or are **reasonably likely** to have, a **material** impact on a company's liquidity, capital resources or results of operations.

Under the Supreme Court's decision in *TSC v. Northway*, an item of information is considered "material" if there is a substantial likelihood that a reasonable investor would consider it important to an investment decision, or if it would significantly alter the "total mix" of available information about the company.[5]

The Two-Pronged MD&A Analysis

The SEC used the Climate Change Release to remind companies to apply the two-pronged analysis, first delineated in a 1989 interpretive release, in evaluating their obligation to disclose known trends, events or uncertainties.[6] Specifically, once management has identified a given trend, demand, commitment, event or uncertainty (and, as discussed below, management cannot bury its head in the sand to avoid such knowledge, particularly in the Internet era), it must make two assessments:

- is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that the contingency is **not reasonably likely to occur, no disclosure is required**.
- if management **cannot** make that determination, it must go on to evaluate objectively the consequences of the known trend, commitment, event or uncertainty, on the assumption that it will come to fruition. **Disclosure is then required, unless** management decides that **a material effect** on the company's financial condition or results of operation is **not reasonably likely to occur**.

The SEC expects management to cast a wide informational net and establish appropriate disclosure controls and procedures to process the information collected.[7] However, the SEC was careful to say that the breadth of the materiality analysis does not give management license to clutter the MD&A with "unnecessary detail or duplicative or uninformative disclosure that obscures the material information."[8]

Risk Factor Disclosure

Another, related topic covered in the Climate Change Release is effective risk factor disclosure. Consistent with recurring Staff criticisms of "boilerplate" risk factors appearing in the forepart of periodic reports, the SEC pointedly observed that "registrants should not present risks that could apply to any issuer or any offering."[9] Comments from the Staff likewise have made clear that risk factors must be re-evaluated on at least a quarterly basis to determine whether there has been any material change warranting disclosure – whether in the form of new or amended risk factors. Finally, the Staff continues to take the position that risk-mitigation measures should not be included in the Risk Factor section of periodic reports, although such measures appropriately may be discussed and analyzed in the MD&A.

Good risk factor disclosure is not just a matter of compliance with SEC line-item disclosure requirements – rather, if done well, it affords companies protections under one prong of the identical safe harbors added to each of the Securities Act of 1933, as amended ("Securities Act") (Section 27A), and the Exchange Act (Section 21E) by the Private Securities Litigation Reform Act of 1995 ("PSLRA"). To meet PSLRA standards, risk factor language must be "meaningful" and must "accompany" any forward-looking statements contained in the MD&A and/or other narrative sections of periodic reports. Note that the financial statements are not protected by the PSLRA safe harbors.

To ensure that risk factors qualify as "meaningful" in light of evolving facts and circumstances, companies should bear in mind the lessons of a May 2010 decision of the influential U.S. Court of Appeals for the Second Circuit, in *Slayton v. American Express Co*.[10] The Court ultimately ruled in favor of American Express and the other defendant-appellees on an appeal from the trial court's grant of a motion to dismiss in a securities fraud case, based on the "actual knowledge" prong of the PSLRA safe harbor.[11] However, the Court criticized the risk factor invoked by the company under the separate "meaningful cautionary statement" prong of the PSLRA to protect a specific forward-looking statement set forth in the MD&A contained in its Form 10-Q for the first quarter of 2001: that losses in a key subsidiary's high-yield debt investment portfolio, which had been large in the quarter being reported on, "are expected to be substantially lower for the remainder of 2001." The company's risk factor read as follows: "potential deterioration in the high yield sector … could result in further losses in … [the company's investment] portfolio." The Court found this language to be so "vague" as to "verge[] on the mere boilerplate, essentially warning [merely] that 'if our [investment] portfolio deteriorates, then there will be losses in our portfolio.'"[12] The Court's conclusion that this particular risk factor therefore was not "meaningful" was "bolstered by the fact that the defendants' cautionary language remained the same even while the problem changed."[13] The Deputy Chief Counsel of the SEC's Division of Corporation Finance highlighted the importance of this case during the Practising Law Institute's "SEC Speaks" conference held February 4-5, 2011.[14]

B. The September 2010 MD&A Liquidity Release

The second of the SEC's 2010 interpretive releases that we recommend you consider while preparing this year's annual report on Form 10-K reflects the SEC's serious concern about the adequacy of MD&A disclosure of liquidity and funding risks posed by short-term borrowing practices in which both financial and non-financial companies engage (the "MD&A Liquidity Release").[15] This release, which construes existing MD&A requirements, accompanied another SEC release proposing extensive new MD&A requirements for disclosure of intra-quarter fluctuations in short-term borrowings and the related risks and uncertainties.[16] The SEC has not acted to date on the proposing release.

Noting the proliferation of complicated short-term financing techniques on which many companies have come to rely in recent years, the SEC used the MD&A Liquidity Release to remind management of the importance of disclosure of "known trends or any known demands, commitments, events or uncertainties that will result in, or that are reasonably likely to result in, the registrant's liquidity increasing or decreasing in any material way." To illustrate, the SEC listed several potentially material trends and uncertainties relating to liquidity that should be considered, based on the experience of many companies during the financial crisis:

- Difficulties accessing the debt markets;
- Undue reliance on commercial paper or other short-term financing arrangements;
- Maturity mismatches between borrowing sources and the assets funded by those sources;
- Changes in borrowing terms requested by counterparties;
- Changes in collateral valuation; and
- Counterparty risk.

Intra-Period Fluctuations in Borrowings

The SEC also took this opportunity to highlight what it views as management's *current* duty – independent of the proposed disclosure requirements – to explain in the MD&A any instances in which period-end liabilities reflected in the company's financial statements do not communicate adequately the risks and uncertainties attendant to material intra-quarter fluctuations in amounts borrowed (due, for example, to the inaccessibility of previously liquid funds held in money-market accounts, the sharp decline in value of auction-rate securities, and the inability to tap the frozen commercial paper markets of a few years ago). Particular examples highlighted in the MD&A Liquidity Release include repurchase agreements (a technique flagged in a March 2010 "Dear CFO" Letter issued by the Division of Corporation Finance accounting staff),[17] share-lending transactions and other off-balance sheet arrangements or contractual repurchase obligations that may be accounted for as sales despite the seller's continuing involvement with the transferred assets. Regardless of the appropriate accounting treatment or the existence of an obligation to disclose these transactions as material off-balance sheet arrangements or contractual obligations in the MD&A, further discussion and analysis of these transactions may be necessary in the MD&A if management concludes that they are "reasonably likely to result in the use of a material amount of cash or other liquid assets."

Cash and Risk Management

Companies also should review the MD&A Liquidity Release for helpful tips on what the SEC and its Staff expect to see in the MD&A concerning disclosure of cash management and risk management policies relevant to an evaluation of their financial condition. This disclosure may be necessary, the SEC believes, to provide context for the material exposures identified in the MD&A.[18] A company that relies on a portfolio of cash and other investments as a material liquidity source, for example, should weigh whether to disclose the nature and composition (by asset type) of that portfolio, the existence of market, settlement or other risk exposure associated with the various asset types, and any limits or restrictions on access that might impair the company's ability to finance business operations. Banks could discuss policies and practices intended to satisfy banking agency guidance on managing liquidity and funding risk and, to the extent applicable, any internal policies and practices that might differ from such guidance.[19]

Table of Contractual Obligations

Focusing on the MD&A's contractual obligations table, the SEC stressed the purpose of what it sees as a sometimes-overlooked disclosure requirement: "to provide aggregated information about contractual obligations and [contractual] contingent liabilities and commitments in a single location so as to improve the transparency of a registrant's short-term and long-term liquidity and capital resources needs and to provide context for investors to assess the relative role of off-balance sheet arrangements."[20] Put more simply, the SEC wants a "meaningful snapshot of cash requirements arising from contractual payment obligations."[21] Despite calls for bright-line guidance with respect to the appropriate disclosure methodology for such diverse items as obligations under repurchase agreements, tax liabilities,[22] interest payments on debt, pension funding obligations,[23] synthetic leases, purchase obligations[24] and off-balance sheet obligations, the SEC reaffirmed its preference for a flexible, "facts-and-circumstances" approach. Each company "should develop a presentation method that is clear, understandable and appropriately reflects the categories of obligations that are meaningful in light of its capital structure and business[,]" and highlight any changes in that method to enable investors to make period-to-period comparisons. Where necessary to enhance investor understanding of the timing and amount of the specified contractual obligations, companies should add footnotes or additional narrative to explain the tabular data. The SEC suggested, for example, that a company might consider separating amounts in the table into "on" and "off" the balance sheet, particularly where such a distinction helps to tie the information to disclosure in the MD&A and financial statements.[25]

Back-to-Basics Approach

Finally, as management members prepare the MD&A for the upcoming annual report, they should pay careful attention to the SEC's "back-to-basics" approach. No matter how novel or complex a specific financing arrangement might be, or whether its disclosure is expressly mandated by rule, the longstanding "principles-based" analysis of materiality embodied in Exchange Act Rule 12b-20 should govern:

> "[I]n addition to the information expressly required to be included … [in the MD&A, the financial statements, or elsewhere in the annual report], there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading."[26]

II. Guidance from the SEC Staff in 2010 and Early 2011

Throughout 2010 and continuing into early 2011, the Staff reinforced the SEC's message on the necessity of "early-warning" risk disclosures by means of Compliance and Disclosure Interpretations ("C&DIs"), industry-wide "Dear CFO" Letters, staff comments and speeches. We discuss some of the most significant Staff guidance below.

A. Loss Contingencies

Although the FASB ultimately decided not to move forward last year with a controversial proposal to change the accounting treatment of loss contingencies,[27] that remains a possibility and companies should not breathe a sigh of relief. If anything, the FASB's decision to stay its hand, at least temporarily, has increased the pressure on both preparers and auditors of financial statements to demonstrate that they are complying with what FASB and the SEC staff have emphasized are existing GAAP requirements regarding loss contingencies (primarily ASC Subtopic 450-20, formerly known as FAS 5). Senior Staff members of both the SEC and FASB recently warned that they will be reviewing "FAS 5" compliance in upcoming annual reports with even greater rigor than before, after a year or more of intense SEC Staff focus on this issue in speeches and during the review and comment process.

Through the inspection process, the PCAOB Staff likewise will be evaluating whether the outside auditors are meeting their obligations when auditing loss contingencies, disclosures and related items. In a PCAOB Staff Audit Practice Alert published in December 2010,[28] the PCAOB cautioned registered public accounting firms that the audit risks that existed in late 2008 regarding loss contingencies and guarantees (among other areas) persist to this day,[29] and that auditors should drill down on management estimates and judgments and communicate their views on this and other matters to the audit committee. If the PCAOB Staff decides that a particular audit engagement selected for examination during the auditor inspection process is materially deficient – for example, if the Staff concludes that the auditor did not collect sufficient evidence to support management's estimates or assertion of an inability to make a reasonable estimate, or did not display the requisite professional skepticism in challenging management's judgment that a potentially material loss is not "reasonably possible" – the result can be an inspection report that outlines potentially material accounting errors that ultimately could lead to a restatement of the particular company's financial statements and, in the most serious cases, a referral to the SEC for further investigation.[30]

In a nutshell, companies are required under ASC Subtopic 450-20 to accrue an estimated loss for a litigation loss contingency if information available before the financial statements are issued indicates that it is *both* **probable** that a liability has been incurred as of the date of the financial statements, *and* the amount of loss (or a range) can be **reasonably estimated**. Even where no accrual is necessary because a loss is not considered "probable" and/or cannot be reasonably estimated, a company must disclose the loss contingency in the footnotes to its financial statements if there is at least a **"reasonable possibility"** – defined as "more than a remote" likelihood – that a loss or an additional loss (i.e., an amount above that previously accrued) may have been incurred. This disclosure must address the nature of the contingency and either give an estimate of the loss or range of losses, or state that such an estimate cannot be made. Since at least 2006, the SEC's Division

of Corporation Finance has emphasized the importance of an MD&A discussion of material pre-accrual loss contingencies as a "known trend or uncertainty."[31]

As reflected in speeches delivered by the SEC's senior accounting staff throughout 2010[32] and reaffirmed most recently during the 2011 "SEC Speaks" conference,[33] as well as a "Dear CFO" Letter issued in October 2010[34] and a flurry of comment letters, the SEC Staff is taking aim at such reportedly common practices as suddenly revealing an accrual in the financial statement footnotes without any advance warning at the "reasonably possible" stage in the MD&A and/or financial statements' loss contingencies footnote – whether in the form of an estimated loss or range of losses, or a representation that such losses are not reasonably estimable accompanied by a meaningful qualitative discussion.

Based on the SEC Staff's guidance, companies preparing periodic reports should take the following into account, recognizing that the Staff may insist on amendments to reports in the event of perceived non-compliance:

- If management cannot estimate the amount of loss or a range of losses for a material contingency deemed "reasonably possible" (or a group of similar contingencies that may be aggregated, as discussed below), it should so disclose and provide a qualitative explanation of the relevant facts and circumstances that go beyond the predominantly factual discussion required in the section of the annual report relating to litigation (Item 3 of Form 10-K, calling for disclosure of the information required by Item 103 of Regulation S-K). The Staff has been challenging statements that management cannot estimate a reasonably possible loss with "precision" or "confidence" – first, on the ground that qualifying terms of this nature are not permitted under ASC Subtopic 450-20; and second, requiring support for the assertion that management is unable to estimate the reasonably possible loss (or range of reasonably possible losses).
- The Staff expects to see a more analytical approach taken in the MD&A (and the loss contingencies footnote to the financial statements) than in the "factual" S-K 103 disclosure, and will be looking for inconsistencies between and among the MD&A, the litigation section, the risk factors and the financial statement footnotes. As discussed above, the reviewing staff also will be looking for material inconsistencies between the content of SEC-filed documents and less formal corporate communications, such as web-posted transcripts of earnings calls and earnings release.
- If management determines that reasonably possible losses in excess of amounts already accrued (as probable) are immaterial, it should disclose this fact and provide a basis for this determination. In this regard, the Staff has emphasized that materiality must be assessed in light of **all** of the issuer's financial statements; i.e., the balance sheet, the income statement and the cash flows statement.
- Potential recoveries from insurance or other indemnification arrangements should not be considered in estimating the magnitude of possible loss contingency.
- Management should re-evaluate the status of pending or threatened litigation (including governmental investigations that may lead to civil or criminal enforcement action) on a regular basis in light of the Staff's view that, as a given matter progresses, the available information on potential losses both expands and sharpens, and therefore may trigger one or more of an MD&A, financial statement footnote and/or risk factor disclosure obligation. Ultimately, a change in the pertinent facts and circumstances could allow quantification of an estimate of reasonably possible losses that previously could not be made, require an accrual because the "probable loss" threshold has been crossed, or require an increase in an accrued amount because the reasonable estimate of the probable loss has increased. In each instance, updated disclosure will be required and an explanation of the reason for the change may pre-empt likely Staff comments.
- Companies may aggregate estimated amounts for similar loss contingencies, but should be careful not to use aggregation to obscure material information relating to a particular contingency and avoid discussion and analysis of its implications for the particular company. This position has been taken by the Staff in response to concerns that case-specific disclosures may be prejudicial to the company's litigation defense and even potentially outcome-determinative.

B. Income Tax Disclosure Issues

In 2010, the Division of Corporation Finance issued comments addressing a number of tax-related disclosure issues, and delivered a broad message in an end-of-year update to the Division accounting staff's Financial Reporting Manual: "Registrants should consider discussing and analyzing the tax implications related to material transactions, trends, and other important items impacting their business as disclosed elsewhere in the MD&A."[35] Specific areas of focus, some of which were recently underscored by the Staff at the 2011 "SEC Speaks" conference, include:

- Companies should consider the need for MD&A and/or footnote disclosure in the event tax rate reconciling items result, for example, from a significant change in assumptions involving an unrecognized tax benefit or a different final resolution of any dispute related to that benefit. If uncertain tax positions are a critical accounting estimate, the MD&A should address why the assumptions were changed, or why the actual resolution differed from management's assumption.[36]
- In light of continued economic uncertainty within and outside the United States, companies with substantial international operations should evaluate, with a view to possible MD&A disclosure, the validity of the assumption often made that earnings of a foreign subsidiary will not be repatriated (meaning that they will not be subject to U.S. income tax, resulting in a tax rate reconciliation item). The Staff has suggested that in appropriate cases the MD&A should explain, as a material trend or uncertainty, that cash resources located offshore in a foreign subsidiary may not be available to the U.S. parent company in whole or in part in the event of a liquidity crunch.[37]
- Adjustment to valuation allowances for deferred tax assets remains a Staff "hot button" issue. The Staff continues to urge companies to consider including disclosure in the MD&A and financial statement footnotes if a material increase in the valuation allowance is reasonably likely to occur. Note also that the PCAOB considers this to be a high-risk area for outside auditors: "[E]stimates made by issuers regarding the recoverability of deferred tax assets as well as the outcome of uncertain tax positions might require significant management judgment, which increases the risk of material misstatement, particularly in times of economic distress."[38]

C. Goodwill Impairment

Goodwill impairment remained a favorite Staff candidate for critical accounting estimate treatment in 2010.[39] Even if the requirements for impairment testing are not triggered, the Staff expects companies to provide early warning in the MD&A – as a "known trend or uncertainty" – of the possibility that one or more reporting units are at risk of failing Step One of the impairment test if the actual impact of impairment would be material. (As defined in ASC Topic 350, a company fails Step One if the fair value of a reporting unit, which is tied to the definition of an accounting segment, was not **substantially** in excess of its carrying value.) In particular, the Staff has indicated that companies in this situation should disclose: (a) the percentage by which the fair value of the reporting unit exceeded the carrying value as of the latest impairment testing date; (b) the amount of goodwill allocated to the unit; (c) a description of the methods and key assumptions used by management, and how those assumptions were determined; (d) a discussion of the degree of uncertainty associated with the key assumptions; and (e) a description of the potential events and/or changes in circumstances that reasonably could be expected to affect negatively the key assumptions.[40]

A recent PCAOB report on audit risks and challenges identified by its Staff in conducting inspections of registered public accounting firms over the period of the economic crisis (2007-2009) found some audit firms to have applied insufficient skepticism to management judgments that goodwill and other intangible assets did not need to be tested more frequently than annually despite the presence of incipient impairment indicators.[41] Such indicators include "recent declines in issuer stock prices or reduced estimates of future revenue in situations where such declines or reductions appeared to be potentially significant to issuers' most recent impairment

analyses."[42] The PCAOB report also found failures by some accounting firms to evaluate, as required, the reasonableness of certain significant assumptions used by management in impairment assessments.

In light of this report's findings, the PCAOB recommended that audit committees of public companies consider discussing with management how management documents its decisions on impairment, and what type of information is available to the outside auditor on the support for these decisions. Audit committees also should consider discussing with the outside auditor: (a) the auditor's assessment of audit risk in this area; (b) what the auditor's strategy will be for dealing with this risk; and (c) the results of audit procedures performed in relation to this risk.[43] The PCAOB made the same recommendation with respect to other areas of deficiency listed in the report, such as fair value measurements, allowance for loan losses, impairment of intangible assets other than goodwill as well as tangible assets, off-balance sheet structures, revenue recognition, inventory valuation and income taxes.

D. Segments

Many companies have responded to volatile business and market conditions by restructuring their operations, leading in some cases to significant changes in how they manage their businesses. Alert to the possibility that some companies may not have reassessed their definition of GAAP segments in light of these developments under ASC Topic 280, the Division of Corporation Finance is checking during the review process for the consistency of a company's disclosures in the MD&A and the financial statement footnotes, with those made in webcast earnings calls and investor conferences. The Staff also may consider how the market views the company, examining analyst reports and other third-party sources of public information regarding that company. If the Staff spots apparent discrepancies, it may request access to the information furnished to the company's chief operating decisionmaker, board of directors or audit committee. Based on analysis of these materials, the Staff has observed a common tendency to aggregate operating segments improperly – although the Chief Accountant of the Division of Corporation Finance stated at the 2011 "SEC Speaks" conference that he has seen some improvement in this area.[44]

Improper aggregation of operating segments in turn raises Staff concerns regarding concealment of impairment risks because, as discussed above, appropriate definition of operating segments is critical to the allocation of goodwill to reporting segments, and therefore to impairment testing. Material errors in segment accounting thus can have significant negative consequences, resulting in a worst-case scenario in a restatement of the company's financial statements and a determination of material weakness in internal control over financial reporting.

E. Non-GAAP Financial Measures

To encourage disclosure of non-GAAP financial measures in SEC-filed documents, the Division of Corporation Finance published updated interpretive guidance in 2010[45] and generally has taken a more flexible approach in the review and comment process. However, the Staff continued to issue comments last year on perceived inconsistencies between filed and non-filed communications with investors. According to the Staff, these comments were not intended to force non-GAAP financial measures into SEC filings unless the company chooses to use them but, if the company does so choose, to ensure consistency between formal (i.e., in the MD&A and Risk Factors) and informal presentations of the company's financial condition and results of operations.

At the December 2010 AICPA conference and again at the 2011 "SEC Speaks," the Division's accounting staff indicated that companies seemed increasingly to be including non-GAAP financial measures in SEC-filed documents. Recent Staff comments on these filings have tended to identify such non-compliant practices as giving greater prominence (in a given periodic report) to non-GAAP financial measures than to the most directly comparable GAAP measure, and failing to explain why the non-GAAP measures provide useful information to investors. Despite the more flexible approach generally being taken in this area, the Staff repeatedly emphasized that cash flow per share measures are potentially misleading for purposes of Regulation G and Exchange Act

Rule 10b-5. As a result, such measures may not be included in informal communications subject only to the foregoing, or in SEC-filed documents subject to the additional requirements of Item 10(e) of Regulation S-K.

F. References to Credit Ratings in the MD&A and Elsewhere in Periodic Reports

Concerns arose in 2010 over the implications for company disclosure of the Dodd-Frank Act's repeal of Securities Act Rule 436(g),[46] which previously exempted credit rating agencies from the expert consent requirements applicable to Securities Act registration statements. Because the major rating agencies have indicated that they will not consent to the inclusion of ratings information in registration statements, companies that disclose such information in periodic reports that are incorporated by reference into registration statements sought and received guidance from the Division of Corporation Finance with respect to the circumstances in which ratings disclosure is appropriate without the consent of the agency that issued the rating.

A Staff interpretive position, C&DI No. 233.04,[47] outlines the circumstances in which companies may continue to disclose credit ratings in their periodic filings (usually in the MD&A liquidity discussion and Risk Factors section) without obtaining the consent of the rating agency to incorporation by reference of these filings into Securities Act registration statements. Companies may provide such information in discussing changes in credit ratings, liquidity, the cost of funds or the terms of material agreements that refer to credit ratings (e.g., indenture covenants). Such references also may be included in free-writing prospectuses (which are Securities Act Section 10(b) prospectuses) and Rule 134-compliant press releases and term sheets under the Securities Act, inasmuch as written expert consents are necessary only for Securities Act registration statements and Section 10(a) prospectuses.

G. Internal Control Over Financial Reporting

A key theme in the Staff's 2010 guidance, which was reiterated at the recent "SEC Speaks" conference,[48] was management's failure to consider the implications of continuing economic uncertainty for a company's internal control over financial reporting. In the Staff's view, reorganizations, reduced capital spending on information technology, cutbacks in staffing and other by-products of the recent recession should be causing (individually or collectively) more disclosable changes in internal control during a given quarterly reporting period than the Staff has observed in the review and comment process. Other Staff observations:

- Disclosures of material weakness could be improved. Rather than just identifying the accounting error that is the result of a material weakness, companies also should explain what problems in the underlying control or controls ultimately led to the failure to detect or prevent the material error.
- Once a material weakness has been disclosed, the Staff expects to see disclosure of changes in internal control *prior to completion of remediation* as the company works on correcting identified control deficiencies.
- The Staff remains highly skeptical in situations where disclosure of one or more material weaknesses in internal control is accompanied by disclosure of a management conclusion that the company's disclosure controls and procedures nevertheless are effective. While the Staff has acknowledged that this is not impossible, it will ask companies to justify the disparity in control-related disclosures, given the overlap between the two control systems in the area of financial reporting.
- In the event of a restatement due to material accounting error, the Staff may question the absence of prior, predictive disclosure, given that a material weakness exists if a particular control deficiency (or combination thereof) creates a reasonable possibility that a material error could occur in the future if not corrected.

- Both management and the outside auditors should "refresh" their respective approaches to evaluating internal control over financial reporting each year. According to the SEC's accounting staff, "the effort must go well beyond a rollforward of testing of the operating effectiveness of the same list of controls each year. The assessment must also include the consideration of the adequacy of the design of controls. The assessment should consider, for example, whether the design of controls has kept up with economic or business conditions or changes in financial reporting requirements."[49]

If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any member of the Firm's Public Company Advisory Group:

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ENDNOTES

1 *See*, *e.g.*, *SEC v. NutraCea, et al.*, SEC Lit. Rel. No. 21819 (Jan. 20, 2011)(charging company and former CEO, CFO and others with a fraudulent revenue recognition and inventory accounting scheme in federal district court in Arizona; settlement with company and three individual defendants announced), available at http://www.sec.gov/litigation/litreleases/2011/lr21819.htm; *SEC v. Vitesse Semiconductor Corp., et al.*, SEC Lit. Rel. No. 21769 (Dec. 10, 2010)(charging company and four former senior executives, in a New York federal district court, with fraudulent revenue recognition and option backdating; settled with all defendants), available at http://www.sec.gov/litigation/litreleases/2010/lr21769.htm; *In the Matter of Navistar International Corp., et al.*, SEC Lit. Rel. No. 21616 (Aug. 5, 2010)(announcing settled administrative cease-and-desist proceedings against the company and other respondents, based on charges of various "improper accounting practices" relating to (among other things) vendor rebates and tooling, accounts payable, inventory, deferred expenses, warranty reserve, and segments), available at http://www.sec.gov/litigation/litreleases/2010/lr21616.htm; *SEC v. Dell Inc., et al.*, SEC Lit. Rel. No. 21599 (Jul. 22, 2010)(announcing simultaneous filing and settlement of antifraud, reporting and books-and-records charges in a Washington, D.C. federal court, relating to fraudulent accounting practices designed to help the company meet analyst earnings estimates), available at http://www.sec.gov/litigation/litreleases/2010/lr21599.htm; *SEC v. Diebold, Inc.*, SEC Lit. Rel. No. 21543 (June 2, 2010)(announcing company's settlement of case brought in federal district court in Washington, D.C., charging fraudulent revenue recognition, manipulation of reserves and accruals, improper delay and capitalization of expenses, and inflating the value of used inventory), available at http://www.sec.gov/news/press/2010/2010-93.htm.

2 For example, company officials often use non-GAAP financial measures to present information on past and future corporate performance during earnings conference calls and investor conferences while excluding such measures from SEC filings. After reviewing this information, the Staff may issue a comment asking whether a particular annual or quarterly report should include any of this information for purposes of Exchange Act Rule 12b-20, which is discussed in the text at p. 4. (As discussed elsewhere above, at Section II.E., the Staff has observed a change in this area since more flexible Staff interpretations were published in January 2010.) The Staff also may note, during the comment process, that segment information may be presented differently within and outside the GAAP-compliant audited financial statements, which might suggest that companies are defining their businesses one way for GAAP purposes and another way for investors and analysts. *See* Section II.D of this Alert.

3 SEC Rel. No. 33-9106 (Feb. 2, 2010), 75 FR 6290, available at http://www.sec.gov/rules/interp/2010/33-9106.pdf.

4 *Id.* at 17.

5 426 U.S. 438 (1976). In the context of analyzing the materiality of contingent or speculative information or events, the Supreme Court later held, in *Basic v. Levinson*, 485 U.S. 224, 238 (1988)(citation omitted), that materiality will depend at any given time upon "'a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'" *See also* Climate Change Release at 18.

6 *See* SEC Rel. No. 33-6835 (May 18, 1989), 54 FR 22427, available at http://www.sec.gov/rules/interp/33-6835.htm.

7 Climate Change Release at 18.

8 *Id.*

9 *Id.* at 15 (footnote omitted).

10 604 F. 3d 758 (2d Cir. 2010), pet. for panel or en banc rehearing denied, 2010 U.S. App. LEXIS 18384 (2d Cir., Jul. 23, 2010).

11 The Court found that the disputed forward-looking statement was not made with actual knowledge of falsity and, therefore, was protected by a separate prong of the PSLRA safe harbor than the one discussed above in the text. *See id.* at 774-78.

12 *Id.* at 773. The Court stated that "the consistency of the defendants' [risk factor] language over time despite the new information they received in early May 2001 [indicating that the value of a subsidiary's high-yield bond portfolio actually would continue to deteriorate in the remainder of 2001] belies any contention that the cautionary language was 'tailored to the specific future projection'...." *Id.* (citation omitted).

13 *Id.*

14 Oral Remarks of Jonathan A. Ingram, Deputy Chief Counsel, Division of Corporation Finance, at PLI's "SEC Speaks in 2011" (Feb. 7, 2011, Wash. D.C.)(during Workshop C: Corporation Finance).

15 Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis, SEC Rel. No. 33-9144 (Sept. 17, 2010), 75 FR 59,984, available at http://www.sec.gov/rules/interp/2010/33-9144.pdf. Foreign private issuers should be aware that, while directed primarily to domestic companies, the MD&A Liquidity Release is also relevant to disclosure provided in the Operating and Financial Review and Prospects section required by Item 5 of Form 20-F.

16 Short-Term Borrowing Disclosure, SEC Rel. No. 33-9143 (Sept. 17, 2010), 75 FR 59,886, available at http://www.sec.gov/rules/proposed/2010/33-9143.pdf. For more information on this proposing release, see our client Alert dated Oct. 7, 2010, available at http://www.weil.com.

17 *See* Sample Letter Sent to Public Companies Asking for Information Related to Repurchase Agreements, Securities Lending Transactions, or Other Transactions Involving the Transfer of Financial Assets (March 2010), available at http://www.sec.gov/divisions/corpfin/guidance/cforepurchase0310.htm.

18 MD&A Liquidity Release at 7.

19 *Id*.

20 *Id*. at 9.

21 *Id*. at 10; *see also* Division of Corporation Finance, Financial Reporting Manual (last updated Dec. 6, 2010, for Staff positions taken as of Sept. 30, 2010)("FRM"), available at http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf, at Section 9240.1.

22 FRM at Section 9240.6.d.: "A registrant should include in the table liabilities related to unrecognized tax benefits, when a reasonable estimate of the amount and period of related future payments can be made. Similarly a registrant should include in the table interest and penalties when a reasonable estimate of the amount and period of related future payments can be made".

23 *Id*. at Section 9240.6.e.: "A registrant should include in the table pension and OPEB obligations when material contributions will be required".

24 *Id*. at Section 9240.3: "Purchase obligations are defined as agreements to purchase goods and services that are enforceable and legally binding, that specify all significant terms, including the quantities to be purchased, price provisions and the approximate timing of the transactions. Additional guidance has not been issued by the staff …. However, registrants should undertake reasonable effort and expense to assess and aggregate outstanding purchase obligations. Disclosures should accompany the table to clarify how the purchase obligations amount has been calculated".

25 MD&A Liquidity Release at 11 n. 17.

26 *See also* Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, SEC Rel. No. 33-8350 (Dec. 19, 2003), available at http://www.sec.gov/rules/interp/33-8350.htm; Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, SEC Rel. No. 33-8182 (Jan. 28, 2003), available at http://www.sec.gov/rules/final/33-8182.htm; FRM, *supra* note 21, at Sections 9230-9240.

27 *See* Summary of Board Decisions, November 10, 2010 FASB Board Meeting, at http://www.fasb.org, indicating that the FASB Board did not reach any decision at this meeting on whether to proceed with the July 2010 Exposure Draft, *Contingencies (Topic 450): Disclosure of Certain Loss Contingencies* or the major issues to be re-deliberated in light of public comment on the forgoing exposure draft, but directed its staff "to work with the staffs of the SEC and PCAOB to understand their efforts in addressing investor concerns about the disclosure of certain loss contingency [*sic*] through increased focus on compliance with existing rules. The Board also directed the staff to review filings for the 2010 calendar year-end reporting cycle to determine if those efforts have resulted in improved disclosures about loss contingencies."

28 PCAOB Staff Audit Practice Alert No. 7, *Auditor Considerations of Litigation and Other Contingencies Arising From Mortgage and Other Loan Activities* (Dec. 20, 2010)("PCAOB Audit Practice Alert No. 7"), available at http://www.pcaobus.org. This Alert is intended to supplement guidance given to preparers of financial statements in an October 2010 "Dear CFO" letter, discussed in the text accompanying footnote 34, below.

29 Auditors are reminded in PCAOB Audit Practice Alert No. 7 to consult PCAOB Staff Audit Practice Alert No. 3, A*udit Considerations in the Current Economic Environment* (Dec. 5, 2008), available at http://www.pcaobus.org/Standards/QandA/12-05-2008_APA_3.pdf.

30 Corporate audit committees should consider, whether in the context of engaging the outside auditor or otherwise, discussing the circumstances under which the PCAOB-registered independent accounting firm serving as outside auditor will divulge to the audit committee that: (a) the PCAOB staff has selected a particular company's audited financial statements for review (as part of the

process of inspecting the level of the outside auditor's compliance with PCAOB-prescribed auditing standards); and/or (b) in finding certain audit deficiencies, the PCAOB staff has called into question management's application of GAAP in preparing the audited financial statements. Clarification of these circumstances is very important, because the PCAOB staff may, in its discretion, refer the matter to the SEC's accounting staff since the PCAOB has no jurisdiction over the company itself. We understand that at least some such referrals have led to restatements.

31 Current Accounting and Disclosure Issues Outline (Nov. 30, 2006), not part of FRM but still posted, at http://www.sec.gov/divisions/corpfin/cfacctdisclosureissues.pdf.

32 *See* Wayne Carnall, Chief Accountant, Division of Corporation Finance, Slide Presentation (PDF): Remarks before the 2010 AICPA Conference on Current SEC and PCAOB Developments, Washington, D.C. (Dec. 7, 2010)("AICPA Slide Deck"), available at http://www.sec.gov/divisions/corpfinspeeches.shtml.

33 Oral Remarks of Wayne Carnall, Chief Accountant of the Division of Corporation Finance, at PLI's "The SEC Speaks in 2011" (Wash. D.C., Friday Feb. 4, 2011)("Carnall Remarks").

34 Division of Corporation Finance, Sample Letter Sent to Public Companies on Accounting and Disclosure Issues Related to Potential Risks and Costs Associated with Mortgage and Foreclosure-Related Activities or Exposures (Oct. 2010), available at http://www.sec.gov/divisions/corpfin/guidance/cfoforeclosure1010.htm. While focused primarily on an area that has been problematic primarily for companies such as banks, mortgage lenders and reinsurers, the guidance on disclosure of loss contingencies has broad applicability.

35 FRM, *supra* note 21, at Section 9220.4.

36 *Id*.

37 AICPA Slide Deck, *supra* note 32.

38 PCAOB Rel. No. 2010-006, *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis* (Sept. 29, 1010)("PCAOB Audit Risk Report"), at 20, available at http://www.pcaobus.org.

39 *See* AICPA Slide Deck, *supra* note 32.

40 FRM, *supra* note 21, at Sections 9510.2 and .3.

41 PCAOB Audit Risk Report, *supra* note 38.

42 *Id*. at 13-14.

43 *Id*. at 2-3.

44 Carnall Remarks, *supra* note 33.

45 *See* Non-GAAP Financial Measures, Compliance and Disclosure Interpretations (Jan. 15, 2010), available at http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm; FRM, *supra* note 21, at Topic 8.

46 Section 936G of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") repealed Securities Act Rule 436(g) effective July 22, 2010. The SEC Staff published relief for two classes of registrants affected somewhat differently by this repeal (given the refusal of the credit rating agencies to issue expert consents to either class of registrant), as follows: (a) for operating companies, in the form of the C&DIs discussed above in the text; and (b) for asset-backed issuers, a global no-action letter issued on July 22, 2010, to Ford Motor Credit Company LLC and Ford Credit Auto Receivables Two LLC, which was replaced by a subsequent letter issued to these entities on November 23, 2010 (available at http://www.sec.gov/divisions/corpfin/cf-noact/2010/ford072210-1120.htm).

47 Securities Act Rules, Compliance and Disclosure Interpretation ("C&DI"), available at http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm. *See also* C&DI Nos. 198.08, 233.04-.08.

48 Carnall Remarks, *supra* note 33.

49 Written Remarks of Brian T. Croteau, Deputy Chief Accountant, Office of the Chief Accountant, U.S. Securities Exchange Commission, Before the 2010 AICPA Natnal Conference on Current SEC and PCAOB Developments (Wash. D.C., Dec. 6, 2010), available at http://www.sec.gov/news/speech/2010/spch120610btc.htm.