Legal Backgrounder

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PUBLIC FINANCIAL DISCLOSURE IN THE POST-ENRON ERA

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Investor confidence in financial reporting may be declining as a result of a series of high profile scandals involving accounting frauds and misleading or inaccurate financial disclosures by public companies, particularly the Enron crisis. Racing to minimize this decline, the Securities and Exchange Commission (SEC) during the last two months has issued three releases intended to immediately improve financial disclosures. Issuers must consider these SEC releases in drafting their public disclosures, including earnings reports and the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), a standard section in all quarterly reports, Forms 10-K, and registration statements for public companies. In a move that should further heighten issuers' attention to the SEC's recent releases, the SEC announced on December 21, 2001 that it intends to review the annual report filings in 2002 of all Fortune 500 companies.

The most recent of the SEC releases is an interpretive statement issued on January 22, 2002 that specifies disclosures required in the MD&A (the "MD&A Release"). The SEC's MD&A Release: (a) clarifies the current MD&A rules; (b) reminds issuers of their disclosure obligations with respect to [i] liquidity and capital resources, including off-balance sheet arrangements, [ii] trading activities involving non-exchange-traded contracts accounted for at fair value, and [iii] related party relationships and transactions (i.e., the type of information that critics are arguing was omitted from Enron's public filings); and (c) suggests better ways of organizing such disclosures. While the SEC's interpretive statement does not itself create any new legal requirements, it effectively puts all issuers on notice of the type of information that the SEC will expect to see in this year's annual report and quarterly filings.

SEC also issued two "Cautionary Advice" releases in December 2001. The Cautionary Advice release on pro forma data (the "Pro Forma Release") warns issuers of the risks of presenting financial measurements that differ from the measurements appearing in an issuer's financial statements. Illustrating the SEC's concerns that such pro forma data can be confusing, and, worse yet, materially misleading, the SEC announced on January 16, 2002 the settlement of enforcement proceedings brought against Trump Hotels & Casino Resorts, Inc. on the basis of a misleading "pro forma" financial presentation. The second Cautionary Advice release on disclosures about critical accounting issues (the "Critical Accounting Policy Release") alerts issuers to the need for enhanced disclosure in the MD&A about the accounting principles that most critically affect their financial status and involve the most complex, subjective, or ambiguous decisions or assessments.

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Given the public's and the SEC's heightened sensitivity to financial disclosures, as well as the role played by audit committees in ensuring the quality and integrity of financial disclosures, an increased focus by issuers, their audit committees, and their entire boards of directors on such disclosures is recommended.

THE MD&A SHOULD INCLUDE APPROPRIATE DISCLOSURE ABOUT . . .

The Issuer's Critical Accounting Policies. The MD&A must include a plain-English discussion of those accounting policies that are most critical to the issuer's financial condition and results and that involve the most difficult, subjective, or complex judgments. Generally accepted accounting principles ("GAAP") require that the footnotes to financial statements describe the accounting principles and the methods of applying those principles that materially affect the determination of the financial position, cash flows, or results of operations reflected in those financial statements. The MD&A must identify among those accounting principles discussed in the footnotes the ones that are "both most important to the portrayal of the company's financial position and results, and . . . require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain." Such disclosures are designed to permit investors to evaluate an issuer's future financial prospects "through the eyes of management." Without an understanding of the risks and uncertainties that could affect future results, investors cannot evaluate an issuer's prospects.

Issuers should identify their "critical accounting policies" by considering which of the accounting principles they describe in the footnotes to the financial statements would have the most impact on the financial statements if the judgments, assumptions, or estimates applied in implementing those principles were different. Robert Herdman, the new SEC Chief Accountant, discussed the SEC's Critical Accounting Policy Release in a January 24, 2002 speech in San Diego. He identified the evaluation of the following areas as traditionally involving subjective decision-making by financial management: (a) the fair market value of non-exchange-traded, commodity-based contracts (such as energy trading contracts); (b) loan loss allowances; (c) impairment of assets; and (d) manufacturer's warranty reserves. The identification process should also involve consideration by the outside auditors, and the audit committee, of management's selection of the accounting principles and methods and, particularly, the propriety of the "critical accounting policies."

Mr. Herdman stated in his speech that the public disclosures about these "critical accounting policies" should include, at a minimum: "(a) the types of assumptions that underlie the most significant and subjective estimates; (b) the sensitivity of those estimates to deviations of actual results from management's assumptions; and (c) the circumstances that have resulted in revised assumptions in the past." Mr. Herdman also acknowledged that some companies may choose to provide "ranges" of possible alternative outcomes using different assumptions or estimates.

The Issuer's Liquidity. In addition to discussing all material sources of liquidity and financing, including any off-balance sheet arrangements, an issuer should describe the circumstances that are reasonably likely to affect those sources of liquidity and financing. The SEC will no longer accept overly general disclosures such as, "[s]hort-term funding is sufficient to meet our capital needs for the next year."

This evaluation of the circumstances which are reasonably likely to affect the sources of liquidity and financing is the same process that an issuer undertakes in determining whether known operational or environmental trends, circumstances, risks or uncertainties must be disclosed because they are reasonably likely to have a material effect on the issuer's financial condition or results of operations. Among the trends, demands, commitments, events, and uncertainties that management should evaluate to determine if they are reasonably likely to affect sources of liquidity and financing are: (a) provisions in financial arrangements that could trigger, among other things, the acceleration of maturity or additional financial obligations; (b) circumstances that could adversely affect the issuer's ability to continue to engage in important types of transactions, such as downgrades in the company's debt rating or deterioration of the issuer's financial position, financial ratios, or operating results; (c) other factors that the issuer expects can affect its credit rating or access to financing; and (d) guarantees and options on nonfinancial assets.

With respect to off-balance sheet arrangements, an issuer should consider the need to provide information about such an arrangement. This information includes an arrangement's business purposes and activities, its economic substance, the key terms and conditions of any commitments, the initial and ongoing relationships between the issuer and its affiliates, and the issuer's potential risk exposures.

In order to be absolutely certain that the accounting rules permit the issuer not to consolidate the entity, an issuer should review the accounting for any entity involved in an off-balance sheet arrangement. An issuer should also provide full and clear disclosure of the potential effects on the issuer's financial condition when the issuer uses an off-balance sheet entity in connection with financing, liquidity, market risk or credit support, leasing, hedging, or R&D. As with on-balance sheet arrangements, an issuer must disclose any contingencies inherent in the off-balance sheet arrangements that are reasonably likely to affect the issuer's liquidity or capital resources, with the effects of such contingencies quantified where practicable. This would include any commitments to provide funding to the entity, any guarantees of the entity's liabilities, and any other potential risk exposure arising out of the contractual relationship, including any uncertainties as to realization of expected receivables or repayments of loans contingent on the future performance of either of the parties.

Given the importance to investors of understanding an issuer's liquidity and capital resources, issuers should consider using a tabular presentation (the MD&A Release provides sample tables). Such presentation should set forth the payments required over particular future time periods by contractual and commercial commitments. These payments could include debt agreements, leases, purchase agreements, lines of credit, standby letters of credit, guarantees and standby repurchase obligations, and disclosing in footnotes to the table any contractual provisions that would have the effect of creating or increasing future payments under these contracts. While this type of information may now be disclosed in various parts of the Form 10-K and the audited financial statements, the presentation of this information as a part of the MD&A may provide more useful information to investors about the issuer's liquidity and capital resources.

The Issuer's Non-Exchange-Traded Contracts Accounted for at Fair Value. An issuer that is engaged in commodity-based trading activities involving contracts that are accounted for at fair value, and determined through fair value estimation techniques, should prepare additional coherent statistical and other information allowing investors to understand these complex contracts. Since no market price quotations exist for these contracts, which include contracts indexed to weather, commodity prices, and quoted prices of service capacity, such as energy storage and bandwidth capacity contracts, issuers should consider providing the additional information so that investors understand the subjectivity of the valuation and the uncertainties inherent in the estimation methodology.

In view of the required disclosures about the impact of material trends and uncertainties on an issuer's financial condition and results, additional information about trading activities may be necessary. The following additional disclosures about trading contracts should be considered:

1. Disclosure of both the realized and the unrealized changes in fair value;

2. Identification of the impact changes have in valuation techniques on the fair value;

3. Disclosure of the fair value of both contracts where those values are determined directly from quoted market prices and contracts where the fair values are estimated;

4. Disclosure of the maturities of the contracts outstanding at the latest balance sheet date;

5. Disclosure of the fair value of claims against counterparties that are in a net asset position at the most recent balance sheet date, based on the credit quality of the contract counterparty (e.g., investment grade, noninvestment grade, and no external ratings); and

6. Balanced disclosures regarding risk management in connection with the trading activities, including the management of risks related to changes in credit quality or market fluctuations of underlying,

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linked, or indexed assets or liabilities.

PRO FORMA MEASUREMENTS, WHICH DIFFER FROM GAAP MEASUREMENTS, SHOULD BE USED CAREFULLY

Readers of pro forma measurements included in an earnings release, Form 10-Q,10-K, or 20-F, should be able to understand clearly how those numbers differ from the firm financial measurements prepared in accordance with generally accepted accounting principles.

Any pro forma numbers should be prepared in an internally consistent way. If nonrecurring losses are excluded, so also should nonrecurring gains. In the Trump Hotels case, Trump Hotels touted in a press release that its "earnings before interest, taxes, depreciation, amortization, Trump World's Fair charge and corporate expenses" and net income "before a one-time Trump World's Fair charge" had improved as compared to the comparable quarter for the prior year. Trump Hotels also bragged that its earnings-per-share results for the third quarter had exceeded analysts' earnings per share estimates by $0.09 per share. However, the EBITDA, net income and earnings per share amounts disclosed in its press release excluded the $81 million one-time charge to earnings resulting from the Trump World's Fair charge and included a one-time gain in the amount of $17 million arising out of the premature termination of a lease during the quarter. The SEC stated that Trump Hotels' pro forma results created the misleading impressions that the one-time charge was the only nonrecurring financial event during the period, and that the Company had exceeded expectations primarily through operational improvements, when that was not true. Since the company's revenues actually declined and its results failed to meet analysts' expectations when the undisclosed one-time gain was excluded, the SEC concluded that the one-time gain was material.

Issuers should accompany all pro forma numbers with clear explanations of what items are being excluded and consider whether it is necessary to disclose the items that are reflected in the pro forma measurement. For example, if an issuer announces earnings "before unusual or nonrecurring transactions," it should identify, quantify, and describe, if appropriate, the unusual or nonrecurring transactions that are excluded and explain any items that are reflected but might seem to be similar to the excluded unusual or nonrecurring transactions.

The pro forma measurements should be prepared in a consistent manner for each period for which financial data is presented. They also must not create misleading perceptions such as in the Trump Hotels case. If the pro forma measurements, but not the measurements using generally accepted accounting principles, demonstrate an improvement over prior periods or results that exceed public performance expectations, such as analysts' estimates, the disclosure of the pro forma measurement should be accompanied by disclosure of the measurements using generally accepted accounting principles so that investors are not misled. The antifraud provisions of the securities laws apply to the use of pro forma information in public disclosures. The SEC found that Trump Hotels violated the antifraud provisions of the Securities Exchange Act by knowingly and recklessly issuing a materially misleading press release.

Foreign issuers are not immune from SEC scrutiny. Many foreign issuers that trade in the United States are accustomed to liberal home country disclosure rules that permit earnings-boosting presentations through pro forma presentations. To avoid the risk of liability under the SEC's antifraud rules, such issuers should also make sure that any pro forma data they present is accompanied by appropriate disclosures.

CONCLUSION

In the post-Enron era, SEC will be scrutinizing public companies' annual and quarterly reports more closely than ever for, among other things, misleading information, contradictions, and lack of clarity and specificity. Those responsible for financial disclosure at public companies must take very seriously the recent guidance documents SEC has offered and follow them to the letter.

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