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Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis

United States: Securities and Exchange Commission (SEC)

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SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 211, 231 and 241

Release Nos. 33-9144; 34-62934; FR-83

**Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures
in Management's Discussion and Analysis**

AGENCY: Securities and Exchange Commission.

ACTION: Interpretation.

SUMMARY: We are providing interpretive guidance that is intended to improve discussion of liquidity and capital resources in Management's Discussion and Analysis of Financial Condition and Results of Operations in order to facilitate understanding by investors of the liquidity and funding risks facing the registrant.

EFFECTIVE DATE: September 28, 2010

FOR FURTHER INFORMATION CONTACT: Questions about specific filings should be directed to staff members responsible for reviewing the documents the registrant files with the Commission. For general questions about this release, contact Christina L. Padden, Attorney Fellow in the Office of Rulemaking, at (202) 551-3430 or Stephanie L. Hunsaker, Associate Chief Accountant, at (202) 551-3400, in the Division of Corporation Finance; or Wesley R. Bricker, Professional Accounting Fellow, Office of the Chief Accountant at (202) 551-5300; U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

I. BACKGROUND

Over the past several years, we have provided guidance and have engaged in rulemaking initiatives to improve the presentation of information about funding and liquidity risk.¹ In a companion release, we are proposing amendments to enhance the disclosure that registrants present about short-term borrowings.² The proposals in that release would require a registrant to provide, in a separately captioned subsection of Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”), a comprehensive explanation of its short-term borrowings, including both quantitative and qualitative information. The proposed amendments to MD&A would be applicable to annual and quarterly reports, proxy or information statements that include financial statements, registration statements under the Securities Exchange Act of 1934, and registration statements under the Securities Act of 1933. We are also proposing conforming amendments to Form 8-K so that the Form would use the terminology contained in the proposed short-term borrowings disclosure requirement. To further improve the discussion of liquidity and

¹ See, e.g., Commission Statement About Management’s Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8056 (Jan. 22, 2002) [67 FR 3746]; Disclosure in Management’s Discussion and Analysis About Off Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, Release No. 33-8144 (Nov. 4, 2002) [67 FR 68054]; Disclosure in Management’s Discussion and Analysis About Off Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, Release No. 33-8182 (Jan. 28, 2003) [68 FR 5982] (adopting rules for disclosure in MD&A of off-balance sheet arrangements and aggregate contractual obligations); and Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8350 (Dec. 19, 2003) [68 FR 75056] (providing interpretive guidance on disclosure in MD&A, including liquidity and capital resources).

² See Short-Term Borrowings Disclosure, Release No. 33-9143 (the “Proposing Release”).

capital resources in MD&A in order to facilitate understanding by investors of the liquidity and funding risks facing the registrant, we are also providing the following guidance with respect to existing MD&A requirements.

II. GUIDANCE ON PRESENTATION OF LIQUIDITY AND CAPITAL RESOURCES DISCLOSURES IN MANAGEMENT’S DISCUSSION AND ANALYSIS

A. Liquidity Disclosure

As discussed in the Proposing Release, companies have expanded the types of funding methods and cash management tools they use. We remind registrants that Item 303(a)(1) of Regulation S-K requires them to “identify and separately describe internal and external sources of liquidity, and briefly discuss any material unused sources of liquidity.” Accordingly, as the financing activities undertaken by registrants become more diverse and complex, it is increasingly important that the discussion and analysis of liquidity and capital resources provided by registrants meet the objectives of MD&A disclosure.

In 2003, the Commission issued interpretive guidance relating to MD&A disclosures of liquidity and capital resources, as well as MD&A generally.³ We encourage registrants to review that guidance when preparing their MD&A, as it covers topics relating to the discussion of cash requirements, cash management, sources and uses of cash, as well as a registrant’s debt instruments, guarantees and related covenants, that continue to be relevant to investors.

³ See Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8350 (Dec. 19, 2003) [68 FR 75056] (the “2003 Interpretive Release”).

As we have stated in the past, MD&A requires companies to provide investors with disclosure that facilitates an appreciation of the known trends and uncertainties that have impacted historical results or are reasonably likely to shape future periods.⁴ This disclosure should both discuss and analyze the company’s business from the perspective of management.⁵ In the context of liquidity, Item 303(a)(1) of Regulation S-K requires 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.⁶ In past guidance, the Commission has highlighted a number of issues for management to consider when identifying trends, demands, commitments, events and uncertainties that require disclosure in MD&A.⁷ Some additional important trends and uncertainties relating to liquidity might include, for example, difficulties accessing the debt markets, reliance on commercial paper or other short-term

⁴ See Disclosure in Management’s Discussion and Analysis About Off Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, Release No. 33-8182 (Jan. 28, 2003) [68 FR 5982] (the “OBS Adopting Release”), at 5982 (“MD&A also provides a unique opportunity for management to provide investors with an understanding of its view of the financial performance and condition of the company, an appreciation of what the financial statements show and do not show, as well as important trends and risks that have shaped the past and are reasonably likely to shape the future.”).

⁵ “MD&A should be a discussion and analysis of a company’s business as seen through the eyes of those who manage that business. Management has a unique perspective on its business that only it can present. As such, MD&A should not be a recitation of financial statements in narrative form, or an otherwise uninformative series of technical responses to MD&A requirements, neither of which provides this important management perspective.” See 2003 Interpretive Release, supra note 3, at 75056.

⁶ “The scope of the discussion should thus address liquidity in the broadest sense, encompassing internal as well as external sources, current conditions as well as future commitments and known trends, changes in circumstances and uncertainties.” See Commission Statement About Management’s Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8056 (Jan. 22, 2002) [67 FR 3746] (the “2002 Interpretive Release”), at 3748 n.11.

⁷ See 2002 Interpretive Release, supra note 5, at 3748.

financing arrangements, maturity mismatches between borrowing sources and the assets funded by those sources, changes in terms requested by counterparties, changes in the valuation of collateral, and counterparty risk.

In addition, in the context of liquidity and capital resources, if the registrant's financial statements do not adequately convey the registrant's financing arrangements during the period, or the impact of those arrangements on liquidity, because of a known trend, demand, commitment, event or uncertainty, additional narrative disclosure should be considered and may be required to enable an understanding of the amounts depicted in the financial statements. For example, depending on the registrant's circumstances, if borrowings during the reporting period are materially different than the period-end amounts recorded in the financial statements, disclosure about the intra-period variations is required under current rules to facilitate investor understanding of the registrant's liquidity position.

Moreover, the Commission's staff has noted that there may be confusion on the part of registrants about how to address disclosure of certain repurchase agreements that are accounted for as sales, as well as other types of short-term financings that are not otherwise fully captured in period-end balance sheets.⁸ Again, disclosure is required in MD&A where

⁸ In its 2005 OBS Report, the Commission's staff identified transfers of assets with continuing involvement as one of the principal areas in need of improvement in disclosure of off-balance sheet arrangements. See Staff of the U.S. Securities and Exchange Commission, Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities and Transparency of Filings by Issuers (June 2005), available at <http://www.sec.gov/news/studies/soxoffbalancrpt.pdf>. See also, the Division of Corporation Finance, 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 (Mar. 2010), available at <http://www.sec.gov/divisions/corpfin/guidance/cforepurchase0310.htm>., and the Division of Corporation Finance, Sample Letter Sent to Public Companies That Have Identified Investments in

a known commitment, event or uncertainty will result in (or is reasonably likely to result in) the registrant's liquidity increasing or decreasing in a material way.⁹ The absence of specific references in existing disclosure requirements for off-balance sheet arrangements or contractual obligations to repurchase transactions that are accounted for as sales, or to any other transfers of financial assets that are accounted for as sales, does not relieve registrants from the disclosure requirements of Item 303(a)(1).¹⁰ Further, as stated in the 2002 Interpretive Release, legal opinions regarding "true sale" issues do not obviate the need for registrants to consider whether disclosure is required.¹¹ In evaluating whether disclosure in MD&A may be required in connection with a repurchase transaction, securities lending transaction, or any other transaction involving the transfer of financial assets with an obligation to repurchase financial assets, that has been accounted for as a sale under applicable accounting standards, the registrant should consider whether the transaction is reasonably likely to result in the use of a material amount of cash or other liquid assets. Disclosure may be required in the discussion of liquidity and capital resources, particularly

Structured Investment Vehicles, Conduits or Collateralized Debt Obligations (Off-balance Sheet Entities) (Dec. 2007) available at <http://www.sec.gov/divisions/corpfin/guidance/cfoffbalanceltr1207.htm>.

⁹ See Item 303(a)(1) [17 CFR 229.303(a)(1)].

¹⁰ We also note that, in 1986, the Commission adopted changes to Rule 4-08 of Regulation S-X to require financial statement footnote disclosure of the nature and extent of a registrant's repurchase and reverse repurchase transactions and the degree of risk involved. See Disclosure Amendments to Regulation S-X Regarding Repurchase and Reverse Repurchase Agreements, Release No. 33-6621 (Jan. 22, 1986) [51 FR 3765]. These requirements focus on disclosure of risk of loss due to counter-party default. See Rule 4-08(m) of Regulation S-X [17 CFR §210.4-08m]. However, the adopting release indicates that the requirements do not affect obligations under MD&A requirements to discuss "any material impact on liquidity or operations and risk resulting from involvement with repurchase and reverse repurchase agreements."

¹¹ See 2002 Interpretive Release, supra note 5, at 3749.

where the registrant does not otherwise include such information in its off-balance sheet arrangements or its contractual obligations table. A registrant may determine where in its MD&A this information would be most informative based on the type of obligation and potential exposure involved, with an emphasis on providing disclosure that is clear and not misleading.

To provide context for the exposures identified in MD&A, companies should also consider describing cash management and risk management policies that are relevant to an assessment of their financial condition. Banks, in particular, should consider discussing their policies and practices in meeting applicable banking agency guidance on funding and liquidity risk management, or any policies and practices that differ from applicable agency guidance. In addition, a company that maintains or has access to a portfolio of cash and other investments that is a material source of liquidity should consider providing information about the nature and composition of that portfolio, including a description of the assets held and any related market risk, settlement risk or other risk exposure. This could include information about the nature of any limits or restrictions and their effect on the company's ability to use or to access those assets to fund its business operations.

Transparent financial reporting that conveys a complete and understandable picture of a company's financial position reduces uncertainty in our markets. Surprises to investors can be reduced or avoided when a company provides clear and understandable information about known trends, events, demands, commitments and uncertainties, particularly where they are reasonably likely to have a current or future material impact on that company. The economic environment is not static. Circumstances and risks change and, as a result, disclosure about

those circumstances and risks must also evolve. As we stated in the 2003 Interpretive Release, if prior disclosure “does not adequately foreshadow subsequent events, or if new information that impacts known trends and uncertainties becomes apparent...additional disclosure should be considered and may be required.”¹² This principle is equally applicable in the context of liquidity and capital resources disclosure.

B. Leverage Ratio Disclosures

Where a registrant includes capital or leverage ratio disclosure in its filings with the Commission, and there are no regulatory requirements prescribing the calculation of that ratio, or where a registrant includes capital or leverage ratios that are calculated using a methodology that is modified from its prescribed form, we remind registrants of our long-standing approach to disclosure of financial measures and non-financial measures in MD&A. First, the registrant should determine whether the measure is a financial measure. If the measure is not a financial measure, registrants should refer to the guidance we provided in 2003 for disclosures relating to non-financial measures, such as industry metrics or value metrics.¹³ If the measure is a financial measure, the registrant should next determine whether the measure falls within the scope of our requirements for non-GAAP financial measures,

¹² See 2003 Interpretive Release, supra note 3, at 75061, and Management’s Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Release No. 33-6835 (May 18, 1989) [54 FR 22427] (the “1989 Interpretive Release”). The 1989 Interpretive Release clarifies that material changes to items disclosed in MD&A in annual reports should be discussed in the quarter in which they occur. The 2003 Interpretive Release states that “there may also be circumstances where an item may not be material in the context of a discussion of annual results of operations but is material in the context of interim results.”

¹³ See 2003 Interpretive Release, supra note 3, at 75060.

and if it is, the registrant would need to follow our rules and guidance governing the inclusion of non-GAAP financial measures in filings with the Commission.¹⁴

In any event, any ratio or measure included in a filing should be accompanied by a clear explanation of the calculation methodology. The explanation would need to clearly articulate the treatment of any inputs that are unusual, infrequent or non-recurring, or that are otherwise adjusted so that the ratio is calculated differently from directly comparable measures. Similar to our guidance for the disclosure of non-financial measures, if the financial measure presented differs from other measures commonly used in the registrant's industry, the registrant would need to consider whether a discussion of those differences or presentation of those measures would be necessary to make the disclosures not misleading. Finally, a registrant would need to consider its reasons for presenting the particular financial measure, and should include disclosure clearly stating why the measure is useful to understanding its financial condition. Where the ratio is being presented in connection with disclosure on debt instruments and related covenants, registrants should also consult our past guidance on disclosure of debt instruments, guarantees and related covenants.¹⁵

C. Contractual Obligations Table Disclosures

As an aid to understanding other liquidity and capital resources disclosures in MD&A, the contractual obligations tabular disclosure should be prepared with the goal of

¹⁴ See Conditions for Use of Non-GAAP Financial Measures, Release No. 33-8176 (Jan. 22, 2003) [68 FR 4820] and Item 10(e) of Regulation S-K [17 CFR 229.10(e)(5)]. We note that existing rules and guidance governing the inclusion of non-GAAP financial measures in filings with the Commission do not apply to financial measures that are "required to be disclosed by GAAP, Commission rules, or a system of regulation of a government or governmental authority or self-regulatory organization that is applicable to the registrant.

¹⁵ See 2003 Interpretive Release, supra note 3, at 75064.

presenting a meaningful snapshot of cash requirements arising from contractual payment obligations. The Commission's staff has observed that divergent practices have developed in connection with the contractual obligations table disclosure, with registrants drawing different conclusions about the information to be included and the manner of presentation. The requirement itself permits flexibility so that the presentation can reflect company-specific information in a way that is suitable to a registrant's business. Accordingly, registrants are encouraged to 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. Registrants should highlight any changes in presentation that are made, so that investors are able to use the information to make comparisons from period to period.

Since the adoption of Item 303(a)(5), registrants and industry groups have raised questions to our staff about how to treat a number of items under the contractual obligations requirement, including: interest payments, repurchase agreements, tax liabilities, synthetic leases, and obligations that arise under off-balance sheet arrangements. In addition, a variety of questions has been raised with our staff in the context of purchase obligations. Because the questions that arise tend to be fact-specific and closely related to a registrant's particular business and circumstances, we have not issued general guidance as to how to treat these items or other questions regarding the presentation of the contractual obligations table. The purpose of the contractual obligations table is to provide aggregated information about contractual obligations and contingent liabilities and commitments in a single location so as to improve 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;¹⁶ registrants should prepare the disclosure consistent with that objective. Uncertainties about what to include or how to allocate amounts over the periods required in the table should be resolved consistent with the purpose of the disclosure. To that end, footnotes should be used to provide information necessary for an understanding of the timing and amount of the specified contractual obligations, as indicated in the instructions contained in Item 303(a)(5)(i), or, where necessary to promote understanding of the tabular data, additional narrative discussion outside of the table should be considered. Registrants should determine how best to present the information that is relevant to their own business in a manner that is clear, consistent with the purpose of the disclosure and not misleading, and should provide additional disclosure where necessary to explain what the tabular data includes and does not include.¹⁷

¹⁶ See OBS Adopting Release, supra note 4, at 5990.

¹⁷ As an example, if useful to a clear understanding of the information presented, a registrant might consider separating amounts in the table into those that are reflected on the balance sheet and those arising from off-balance sheet arrangements, particularly where such a distinction helps to tie the information to financial statement disclosure and other MD&A discussion.

III. Codification Update

The “Codification of Financial Reporting Policies” announced in Financial Reporting Release 1 (April 15, 1982) [47 FR 21028] is updated by adding new Section 501.03.a.i, captioned “Additional Guidance on Presentation of Liquidity and Capital Resources Disclosures” to the Financial Reporting Codification and under that caption including the text in Section II of this release.

The Codification is a separate publication of the Commission. It will not be published in the Federal Register/Code of Federal Regulations.

List of Subjects

17 CFR Part 211, 231 and 241

Securities.

Amendments to the Code of Federal Regulations.

For the reasons set forth above, the Commission is amending title 17, chapter II of the Code of Federal Regulations as set forth below:

PART 211 — INTERPRETATIONS RELATING TO FINANCIAL REPORTING MATTERS

1. Part 211, Subpart A, is amended by adding Release No. FR-83 and the release date of September 17, 2010 to the list of interpretive releases.

PART 231 — INTERPRETATIVE RELEASES RELATING TO THE SECURITIES ACT OF 1933 AND GENERAL RULES AND REGULATIONS THEREUNDER

2. Part 231 is amended by adding Release No. 33-9144 and the release date of September 17, 2010 to the list of interpretive releases.

PART 241 — INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

3. Part 241 is amended by adding Release No. 34-62934 and the release date of September 17, 2010 to the list of interpretive releases.

By the Commission.

Elizabeth M. Murphy
Secretary

Dated: September 17, 2010