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Take Another Look at Funding and Liquidity Risk Disclosures

Companies preparing "Liquidity and Capital Resources" disclosure for Securities and Exchange Commission filings should make sure investors understand the funding and liquidity risks they face. This is not just a concern for financial companies. Recent SEC guidance stresses that every issuer should consider the need for disclosure of the impact of cash requirements, cash management, debt instruments and covenants on its liquidity.[1]

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A companion release proposes to require comprehensive new quantitative and qualitative explanations of short-term borrowings and is likely to apply to the next Form 10-K for calendar year companies.[2]

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) must identify and describe internal and external sources of liquidity and discuss known trends, demands, commitments, events or uncertainties that will, or are reasonably likely to, materially increase or decrease liquidity. A company is required to include in MD&A the following information where needed to provide a clear picture of the company's ability to generate cash and to meet existing and known or reasonably likely future cash requirements:

- historical information on sources of cash and capital expenditures;
- an evaluation of the amounts and certainty of cash flows;
- the existence and timing of commitments for capital expenditures and other known and reasonably likely cash requirements;
- a description of expected changes in the mix and relative cost of capital resources; and
- which balance sheet or income or cash flow items should be considered in assessing liquidity.

Analysis is required. "As with the discussion and analysis of the results of operations, a company's discussion and analysis of cash flows should not be a mere recitation of changes and other information evident to readers from the financial statements. Rather, MD&A should focus on the primary drivers of and other material factors necessary to an understanding of the company's cash flows and the indicative value of historical cash flows."[3]

Companies should evaluate separately their ability to meet upcoming cash requirements over both the short and long term.[4] The SEC emphasizes that merely stating that a company has adequate resources to meet its short and/or long-term cash requirements is generally insufficient, especially if there are any known material trends or uncertainties related to cash flow, capital

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[1] Rel. Nos. 33-9144, 34-62934 (Sep. 17, 2010), found at www.sec.gov/rules/interp.shtml. The guidance also discusses the need for clear, consistent definition of applicable leverage ratios and the importance of providing meaningful, comprehensive information in the Form 10-K contractual obligations table.

[2] Rel. Nos. 33-9143, 34-62932 (Sep. 17, 2010), found at www.sec.gov/rules/proposed.shtml.

[3] Rel. Nos. 33-8350, 34-48960 (Dec. 19, 2003)

[4] For this purpose, "short-term" refers to a period of twelve months or less. To determine what "long-term" disclosure is required, the company must "consider the duration of its known capital requirements and the periods over which cash flows are managed. . . ." Rel. Nos. 33-9106, 34-61469 (Feb. 2, 2010).

resources, capital requirements, or liquidity. Instead, registrants should describe the sources of funding and the circumstances that are reasonably likely to affect them materially.

Specific matters the SEC has identified for disclosure include:

- the risk that reduced demand for the company's products would limit available funds;
- potential adverse impact on a credit facility of a debt rating downgrade or deterioration in financial ratios;
- factors limiting the company's ability to continue using important off-balance sheet financing arrangements;
- circumstances, including but not limited to defaults, that could trigger an early payment, additional collateral support, modification, acceleration, or additional financial obligation under financial guarantees or commitments or debt or lease agreements;
- circumstances that could impair the ability to continue to engage in historically important transactions;
- options on non-financial assets (e.g., real estate puts); and
- other company or industry-specific factors that would affect the company's credit rating or its ability to raise short-term or long-term financing.

If it is difficult to assess the impact of uncertain events, such as potentially material loss contingencies, on cash requirements and liquidity, the company should explain why.

The SEC's recent guidance reminds companies of those matters and addresses new topics related to contemporary types of funding methods and approaches to cash management.

Consistency and Transparency

Some of the SEC's recent guidance stems from recent headlines, e.g., Lehman's use of repurchase transactions for "window dressing." The SEC emphasizes that, "if the registrant's financial statements [i.e., at the end of a fiscal period] do not adequately convey the registrant's financing arrangements during the period, or the impact of those arrangements on liquidity, . . . additional narrative disclosure should be considered and may be required to enable an understanding of the amounts depicted in the financial statements." The guidance goes into some detail about disclosure of repurchase transactions.

Cash Management

The SEC has previously noted that MD&A should describe known material trends or uncertainties relating to management's determinations when and how to use cash resources to satisfy obligations and make other capital expenditures. The new guidance advises companies to consider describing:

- cash management and risk management policies that are relevant to an assessment of the company's financial condition;
- the nature and composition of any portfolio of short-term assets; and
- any related market, settlement or other risk exposure.

The latter "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." For example, an international company that maintains cash balances or other short-term assets in different jurisdictions should consider whether regulatory or tax considerations, debt covenants or other factors limit its ability to use those assets to satisfy its requirements. (This has been the subject of frequent SEC comments on filings.)

Other Trends and Uncertainties

The SEC guidance adds the following to its prior laundry lists of circumstances that may require disclosure and analysis:

- difficulties accessing the debt markets;
- reliance on commercial paper or other short-term 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.

The bottom line is that "transparent financial reporting that conveys a complete and understandable picture of a company's financial position reduces uncertainty in our markets. . . . The economic environment is not static. Circumstances and risks change and, as a result, disclosure about those circumstances and risks must also evolve."

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