

DAVIS POLK & WARDWELL

Date: December 19, 2008
To: Interested Persons
Re: Disclosure Considerations for Your 2008 Form 10-K

Many companies are beginning preparations for their 2008 Form 10-K. While there are no new Form 10-K requirements this year, in light of the extraordinary financial market conditions which continue to define 2008, the drafting of this year's disclosures may prove particularly challenging. We therefore discuss below some considerations and suggestions that may be helpful as you embark on this task.¹ Please do not hesitate to contact us for help throughout this process.

Risk Factors. Many companies will need to modify and improve upon their risk factors to reflect new risks facing their company as a result of the financial market crisis. The SEC staff has recently emphasized, however, that they do not want to see a lot of "boilerplate" disclosures about general economic risks that are not company specific and have cautioned against "kitchen sink" risk factors that distract from the real risks facing a company. As a result, companies should keep their risk factors focused on the implications of current economic conditions for their company specifically.

MD&A Disclosures. It should come as no surprise that SEC staff members have suggested that companies will need to draft their MD&A disclosures anew this year to reflect the exceptional events of the past year and the current state of the financial markets and economy. As part of this effort, SEC staff members have suggested that companies review the SEC's past MD&A guidance, in particular the 2003 MD&A guidance,² which the staff still views as very relevant.

Liquidity and Capital Resources. One of the focus points of the 2003 MD&A guidance is Liquidity and Capital Resources disclosure. This is an area that many companies may find needs significant revisions due to economic conditions and the state of the credit markets. For example, a company may find the need to adjust its disclosure to discuss:

¹ This memorandum does not address items that are typically found in a company's proxy statement and incorporated by reference into the Form 10-K. We plan to distribute a separate memorandum addressing considerations for this year's proxy statement.

² The 2003 guidance is available at <http://www.sec.gov/rules/interp/33-8350.htm>. The SEC also issued MD&A guidance in 2002 which is available at <http://www.sec.gov/rules/other/33-8056.htm> and in 1989 which is available at <http://www.sec.gov/rules/interp/33-6835.htm>.

- any material reduction in cash flows from operations and how it plans to meet its operating and other cash requirements in light of this reduction in cash flows;
- its ability to satisfy the covenants in its existing debt instruments as well as its ability and/or intent to refinance existing debt or obtain additional financing in light of restrictions in its existing debt instruments;
- any consequences or risks resulting from transactions with Lehman Brothers or its role as a lender, administrative agent or syndication agent in the company's loan facilities;
- any changes in the company's credit ratings;
- any other changes in the company's ability to obtain financing from external sources; and/or
- any changes in the company's capital expenditure plans.

Known Trends and Uncertainties. Disclosure of any known trends or uncertainties will require significant focus this year and top level management should be involved early in this process. MD&A disclosure of a trend, demand commitment, event or uncertainty is required unless a company is able to conclude either that it is not reasonably likely that the trend, uncertainty or other event will occur or come to fruition, or that a material effect on the company's liquidity, capital resources or results of operations is not reasonably likely to occur. SEC guidance also calls for an analysis of "factors which are expected to make reported historical results and trends either indicative or not indicative of future operating results and related financial condition" and "matters which have had an impact on past operations but are not expected to continue to do so, as well as any matters expected to impact future operations even though they have not had an impact in the past." In light of these requirements, MD&A should provide management's view on how they expect recent events and the current economic climate to impact their operations, if material. Any material changes in the company's business plan made to account for the current economic uncertainties should be discussed in MD&A and appropriate changes should also be made in the Business section.

Fair Value Disclosures. In 2008, the SEC sent two "Dear CFO" letters about fair value disclosures in MD&A as part of an effort to help focus senior management and audit committees on fair value disclosures.³ Companies should review these letters as they prepare their Form 10-K disclosures about their fair value measurements, especially with respect to financial instruments that are not currently actively traded. In particular, the SEC staff is looking for more disclosure about the judgments and assumptions underlying a company's fair

³ The September 2008 letter is available at <http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm>. The March 2008 letter is available at <http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm>.

value measurements, the sensitivity of the company's measurements to those assumptions and details about the methodology and inputs the company used to help investors better understand their accounting and disclosure.

Item 5 Disclosure of Unregistered Sales of Equity Securities or Share Repurchases. Entities that have recently issued unregistered equity securities, such as preferred stock issued under the Troubled Asset Relief Program (TARP) or otherwise, should remember that these unregistered issuances are required to be disclosed under Item 5 of Form 10-K (which refers to the requirements of Item 701 of Regulation S-K) unless the information has been previously included in a Form 10-Q or Form 8-K. Issuers that have recently repurchased any equity securities should also remember that these repurchases are required to be disclosed under Item 5 of Form 10-K.

Internal Control Reports under Section 404 of the Sarbanes-Oxley Act. While not general in applicability, certain filers may need to keep the following in mind with respect to their internal control reports this year:

Material weakness disclosures. An SEC staff accountant noted in a recent speech that the staff finds many material weakness disclosures are deficient. According to the staff, the goal underlying material weakness disclosure is to go beyond describing the existence of a material weakness and allow investors to understand the cause of the control deficiency and to assess its potential impact. In light of this, the staff requests that management consider the following:

- Material weakness disclosure should not be a description of the financial statement adjustment but rather the control deficiency that resulted in the material weakness.
- Material weakness disclosures should discuss any pervasive impact on internal control over financial reporting rather than being limited to specific areas where the error was discovered.
- When previously issued financial statements are reissued to correct a material misstatement, management is not required to reassess or revise its conclusions related to the effectiveness of internal control over financial reporting. Management should, however, consider whether its original disclosures are still appropriate in light of the restatement. Management should discuss its judgment as to whether the material weakness does not exist, existed but has been remediated or still exists as of the current year-end.
- Companies should make sure that the disclosure of a remediation plan is consistent with, and appropriate in light of, the material weakness disclosed. For example, if a company discloses a material weakness in a discrete financial statement account but then goes on to describe much broader remediation plans, such as “adopt new policies and procedures related to review process for all accounts” or “hire additional resources,”

the staff may become concerned that the full extent of the material weakness has not been disclosed.

Non-accelerated filers. Due to an extension passed earlier this year, non-accelerated filers (*i.e.*, generally those companies that have a market capitalization of less than \$75 million and/or have not been filing Exchange Act reports for at least a year) may continue to file a management's report on internal controls without an accompanying auditor attestation report on internal controls. Non-accelerated filers will be required to begin filing an auditors' attestation report on their internal controls beginning in their first fiscal year ending on or after December 15, 2009.

Companies filing their first or second annual report. Companies that are filing their first Form 10-K with the SEC may omit both the management report on internal controls and the auditor attestation report on internal control. Until they are required to file their first internal control report, these companies may also omit the reference to internal controls in the introductory language in paragraph 4 of the Section 302 certification as well as paragraph 4(b) of the certification.

Companies filing their second Form 10-K will need to remember that in addition to including their first management report on internal controls over financial reporting and the related auditor attestation report, they must also update their Section 302 certifications accompanying the Form 10-K. The certifications must now include a reference to internal controls in the introductory language of paragraph 4 of the certification as well as paragraph 4(b). The exact form of the certification can be found in Item 601(b)(31) of Regulation S-K.

If you have any questions regarding this memorandum, please call your regular Davis Polk contact.