December 29, 2003

SEC Issues Comprehensive Guidance Regarding MD&A Preparation

The Securities and Exchange Commission has issued comprehensive guidance about the preparation of Management’s Discussion and Analysis of Financial Condition and Results of Operations. The latest interpretive release contains the first comprehensive guidance by the SEC staff on MD&A disclosure since 1989. The new release is effective for all filings made after December 29, 2003, including the upcoming annual reporting cycle for calendar year-end public companies. See SEC Release No. 33-8350 (December 19, 2003), which is available at http://www.sec.gov/rules/interp/33-8350.htm.

The new release does not change existing MD&A requirements or alter previous SEC guidance. Instead, it consolidates (and provides additional guidance with respect to) previous staff notices and releases directed at improving the quality of MD&A disclosure. The release emphasizes four primary areas of concern:

- format and clarity of presentation;
- need for focus on key information and analysis;
- improvement of liquidity and capital resources section; and
- disclosure of critical accounting estimates and assumptions made by management.

The release reaffirms prior guidance that the MD&A should (i) enable investors to view the company “through the eyes of management,” (ii) provide context for analysis of the company’s financial information and (iii) inform readers about the quality and potential variability of a company’s earnings and cash flows. The release identifies the essentials for composing a straightforward and meaningful MD&A for investors and warns companies that the staff “will continue to review MD&A submitted after this guidance is released and take action as appropriate.”

Presentation of MD&A

The SEC recommends that companies begin their MD&A with an introduction or overview that discusses the “most important matters on which a company’s executives focus in evaluating financial condition and operating results.” Depending on materiality and each company’s circumstances, this introduction or overview might cover:

- economic or industry-wide factors affecting the company’s operations;
• how the company earns revenues and income and generates cash;
• lines of business and principal products and services (without duplicating the “Description of Business” section); and
• material opportunities, challenges and risks, for both the short and long term.

The release also advocates using an introduction to period-to-period comparisons which would lay out the principal factors or trends that affected performance in the covered fiscal periods. The staff believes that introductions and overviews present the most important information most prominently and avoid unnecessary duplicative disclosure. For example, disclosure regarding a material trend in an overview would not need to be repeated in later sections of the MD&A. In addition, the release recommends using tables of relevant financial information and additional headings to assist readers “in following the flow” of the MD&A. Finally, the staff emphasizes that it expects the introduction to change over time to remain current, noting that “boilerplate disclosures and other generic language generally are not helpful . . . and would detract from the purpose of the introduction or overview.”

Focus on Key Information and Analysis

Key Indicators. The release urges companies to identify the “key variables and other factors that management uses to manage the business.” These key variables and other factors may include traditional financial measurements and non-financial information that may encompass external or macro-economic factors, such as interest rates or economic growth rates, as well as industry metrics and “value drivers.” Companies should disclose their methods for calculating any non-financial performance measures for which there is no commonly accepted calculation method. The release specifically recommends that companies review earnings releases, publicly available presentations to analysts and investors and website postings to evaluate whether these sources identify key variables that should be disclosed in a company’s MD&A. Companies should anticipate that, in the future, SEC comments may ask about company statements in these sources. Additionally, the release states that companies should balance their MD&A by disclosing both a company’s successes and those “instances when it failed to realize its goals.”

The staff has anticipated, in part, a question regarding the effect of using management’s key variables in the MD&A, by noting that many measures critical to understanding a company’s business are non-financial and therefore do not implicate rules for the use of non-GAAP financial measures contained in Regulation S-K Item 10(e) or Regulation S-B Item 10(b). Other key variables, such as pro forma calculations, will implicate those rules, and companies therefore must consider how the identification, verification and control of non-GAAP financial information would be addressed in their MD&A.

Materiality. The release primarily addresses materiality in the context of a request that companies eliminate duplicative or stale information from the MD&A. Companies are directed to “focus on an analysis of the consolidated financial position and operating results” and to avoid unnecessary duplication when discussing segments or line items. The release promotes the elimination of line item discussions “where the information that would be disclosed is not material and would not promote understanding of the MD&A.” Similarly, the release states that quarterly reports are not required to include disclosure that was adequately made in a prior
annual or quarterly reports, and which has not materially changed since those earlier reports were filed.

**Material Trends and Uncertainties/Analysis.** The staff emphasizes that one of the principal objectives of MD&A is to provide “information about the quality and potential variability of a company’s earnings and cash flow, so that the reader can ascertain the likelihood that past performance is indicative of future performance.” To meet this objective, a company’s MD&A must adequately disclose known material trends and uncertainties. Disclosure of a known trend or uncertainty without providing context or analysis of the underlying reasons for the trend or uncertainty may not be adequate. A company should consider discussing the underlying reasons for the trend or uncertainty and analyzing the implications of the trend or uncertainty for the future performance of the company. In addition, disclosures of material unusual or non-recurring items should be followed by an analysis of the factors leading to those items, the likelihood of similar events occurring in the future and the impact these factors may have on performance in future periods.

**Liquidity and Capital Resources**

The release states that information regarding liquidity and capital resources is “critical to an assessment of a company’s prospects for the future and even the likelihood of its survival.” The purpose of the disclosure is “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.”

Companies should avoid a “mere recitation” of changes in the statement of cash flows. Companies should, instead, identify material cash requirements to maintain current operations, complete projects underway and achieve stated plans, including capital expenditures. The release identifies the table of contractual obligations as a starting point for this discussion, which should also address known uncertainties for cash requirements such as loss contingencies. Companies also should discuss their ability to meet cash requirements in both the short run and long run, including a discussion of sources of cash available to meet these requirements.

Disclosure of the sources of cash should discuss the underlying reasons for any changes in cash flow rather than focusing on the caption for the line item. As an example, the release notes that how a reader evaluates an increase in accounts receivable depends on whether the increase is due to higher sales or an extension of more generous payment terms to a company’s customers.

The release provides guidance on disclosures related to financing sources. A company should discuss and analyze, to the extent material, its:

- external debt financing;
- off-balance sheet financing arrangements;
- issuance or purchase of derivative instruments linked to its stock;
- use of stock as a form of liquidity; and
known or reasonably likely changes in credit ratings or ratings outlook (or inability to achieve changes).

Material debt covenants must be disclosed if a company has breached, or is reasonably likely to breach, such covenants, or these covenants materially restrict a company’s ability to incur additional debt or equity financing. In addition, companies should disclose how debt financing “fits into the overall business plan.”

Critical Accounting Estimates

The release repeats current guidance on the disclosure of critical accounting estimates, noting that the proposed new rules on this subject remain under consideration by the SEC. MD&A should disclose accounting estimates or assumptions that require subjective judgments to account for uncertain matters, or matters subject to change, which have a material impact on a company’s financial condition or operating performance. Disclosure of critical accounting estimates should not duplicate the footnotes to the financial statements. The disclosure should focus on the uncertainties associated with an estimate or assumption or explain why the estimate or assumption is difficult to measure. The release asks companies to consider disclosure of how accurate its estimates have been in the past and how likely the estimates are to change in the future. The release also recommends that companies consider including a sensitivity analysis for the critical accounting estimates, if appropriate.

Conclusion

The latest MD&A interpretive release creates no new rules or regulations. It provides, however, an essential roadmap of what the staff expects to see in the MD&A going forward. It also clearly encourages companies to use the issuance of the release as an opportunity to rethink their MD&A sections to provide more meaningful and succinct disclosure enabling investors to assess whether past operations will be indicative of future performance.

Companies should start now to review and reconsider their MD&A disclosures by:

- involving top-level management early to identify key disclosure themes and items for inclusion;
- preparing an overview section;
- identifying the most important information for prominent disclosure and eliminating duplicative, immaterial or “boilerplate” information;
- increasing the use of tabular presentations, where appropriate, and using clear, understandable language;
- identifying key performance indicators used by management;
- considering sufficiency of liquidity and capital resources disclosures; and
• evaluating whether all material known trends and uncertainties have been addressed and critical accounting estimates and assumptions have been disclosed.

Even with this improved guidance from the staff, producing a clear, complete and comprehensible MD&A will continue to be the most crucial disclosure challenge for most companies subject to SEC reporting. The new release makes it clear that MD&A disclosure will also continue to be a focus for staff scrutiny and enforcement.

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