SEC Issues MD&A Interpretive Guidance

As we announced in our client publication dated December 22, 2003,¹ the Securities and Exchange Commission (the “SEC”) has issued interpretive guidance regarding Management’s Discussion & Analysis of Financial Condition and Results of Operations, or MD&A (the “Release”).² The Release is the fourth in a series of MD&A interpretive releases that the SEC has published since December 2001, all of which elaborate on the SEC’s landmark MD&A interpretive release published in 1989.³

The Release strongly reiterates a simple message—one that the SEC and its staff have delivered in public remarks and numerous staff comment letters; namely, that MD&A disclosure is becoming “unnecessarily lengthy, difficult to understand and confusing” and that companies should step back and “take a fresh look at MD&A with a view to enhancing its quality.”

The SEC’s broadest review of annual report disclosure—the review of Fortune 500 companies—revealed that MD&A accounted for the largest source of staff comments issued.⁴ Responding in large part to that review, the SEC seeks to elicit more meaningful MD&A disclosure in areas long regarded by the staff as deficient, especially:

- the overall presentation of MD&A;
- its focus and content, including materiality, analysis, key performance measures and known material trends, demands, commitments, events and uncertainties;
- disclosures about liquidity and capital resources; and
- disclosures about critical accounting estimates.

The SEC stresses that the Release is not intended to modify existing disclosure requirements or create new ones, but to assist companies in preparing a clearer, more transparent MD&A. The Release, therefore, is required reading for anyone involved in the preparation or drafting of MD&A.

However, because the Release is not a comprehensive review of MD&A interpretive guidance, it is imperative that it be read in conjunction with the Fortune 500 Summary and the MD&A releases that came before it (which are mentioned below).

The SEC has instructed the staff of the Division of Corporation Finance to keep it apprised of whether the new interpretive guidance is producing improved disclosure. Because the staff will be scrutinizing MD&A disclosure, companies are advised to revisit their MD&A with renewed focus and energy and ensure that it is responsive to the new guidance.

The Release became effective on December 29, 2003 and applies to all SEC filings that include an MD&A, including those relating to 2003 financial periods.

POST-ENRON MD&A INITIATIVES

The MD&A has become the linchpin of the SEC’s post-Enron disclosure reform. Since December 2001, the disclosure initiatives and guidance of the SEC and its staff have focused principally on improving the quality and transparency of companies’ financial reporting and MD&A.

The initial guidance, set out in two SEC statements, focused on the need for enhanced MD&A discussion of critical accounting policies and discussion and analysis about liquidity and capital resources, transactions with non-independent parties and trading activities involving non-exchange traded contracts:

- “Cautionary Advice Regarding Disclosure About Critical Accounting Policies,” Release No. 33-8040; FR-60 (Dec. 12, 2001)⁵ and
- “Commission Statement about Management’s Discussion and Analysis of Financial Condition

⁵ Available at http://www.sec.gov/rules/other/33-8040.htm.
In each of these statements, the SEC stated its intention to codify its views. In May 2002, the SEC began the codification process by proposing to expand upon and codify the earlier guidance concerning MD&A disclosure of critical accounting policies:


In addition, as directed by Section 401 of the Sarbanes-Oxley Act of 2002, the SEC adopted amendments to the MD&A requirements mandating specific disclosure concerning off-balance sheet arrangements:


**Remainder of MD&A Objectives**

The Release reminds companies of the SEC’s long-standing objectives for MD&A:

- to provide a narrative explanation of a company’s financial statements that enables investors to see the company through the eyes of management;
- to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
- to provide information about the quality of, and potential variability of, a company’s earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

To meet these objectives, companies are expected to provide not only disclosure of information responsive to MD&A requirements, but also an analysis that explains management’s view of the implications and the significance of that information. Notably, the Release states that companies are expected to consider all relevant information that promotes understanding, even if that information is not required to be disclosed.

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**MD&A Presentation**

**Focus on Material Information**

While acknowledging the increasingly complex nature of the operations of companies, the SEC emphasizes that MD&A should be presented in a clear and understandable manner, focusing on the most important material information and de-emphasizing or eliminating immaterial information that is not required and does not promote understanding.

**Use of an Overview**

The SEC suggests including an executive-level introduction or overview that (i) highlights the key matters that management considers most important in evaluating the company’s financial condition and operating results and (ii) provides the context for the detailed discussion and analysis of the financial statements that follows, without duplicating it.

A good introduction should be revised on an ongoing basis to remain current, and might include discussion of:

- economic or industry-wide factors;
- how the company earns revenues and income and generates cash;
- the company’s lines of business, locations of operations, and principal products and services; and
- material opportunities, challenges and risks for the short- and long-term, and the actions management is taking to address such matters.

Anticipating companies' concerns that filtering out details or highlighting particular themes may increase the risk of antifraud litigation, the SEC states:

[T]he failure to include disclosure of every material item in an introduction or overview should not trigger automatically the application of the “buried facts” doctrine, in which a court would consider disclosure to be false and misleading if its overall significance is obscured because material is “buried,” such as in a footnote or an appendix.

**Use of Headings, Tables and a “Layered Approach”**

The Release suggests various formats that it believes will enhance the readability and clarity of MD&A:

- use of headings to assist readers in following the flow of the MD&A;
- use of tables, such as tabular comparisons of results in different periods or tabular summaries of material interest and discount rate assumptions;

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• use of a “layered” approach that emphasizes the most important material information and analyses (e.g., beginning a section containing a detailed analysis of period-to-period information with a statement of the principal factors, trends or other drivers).

**MD&A CONTENT AND FOCUS**

**Early Involvement of Senior Management**

The touchstone of MD&A disclosure—allowing investors to see the company through the eyes of management—points to one of the major recommendations in the Release; namely, that senior management should become involved early in the drafting process to identify key items and themes that should be discussed and analyzed in MD&A. As expressed by the SEC:

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.

**Information in Earnings Releases, Analysts’ Calls and Corporate Websites**

Another key recommendation that emerges from the Release is the need to consider whether to include in MD&A information presented by the company in its informal communications—not only for the purpose of avoiding an omission that may make the MD&A materially misleading, but to meet one of MD&A’s principal objectives and provide disclosure that allows investors to see the company’s financial condition through the eyes of management.

Such informal communications as the CEO’s annual letter to shareholders, earnings releases, investor calls, analysts’ calls and corporate websites are a valuable source of information for investors, both for the information they contain as well as the succinct, bottom-line style in which the information is presented. The Release states that these communications should be evaluated to determine whether any of the information presented, historical or forward-looking, is required to be included in MD&A.

In addition, companies’ should note that the SEC staff routinely reviews these types of informal communications for consistency with the disclosure in formal SEC filings and will continue to do so as part of its ongoing MD&A review.

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**Key Performance Indicators**

Starting from the premise that companies should “identify and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the individual company,” the Release states that companies should consider disclosing key performance indicators used by management to manage the business of the company—information that is typically readily available.

Examples given in the Release of key performance indicators include:

- manufacturing plant capacity and utilization;
- backlog;
- trends in bookings;
- employee turnover rates;
- the description, nature and number of patents;
- technology licensing information;
- those based on units or volume, customer satisfaction, time to market, interest rates, product development, service offerings, throughput capacity, affiliations/joint undertakings, market demand, customer/vendor relations, employee retention, business strategy, changes in the managerial approach or structure, regulatory actions; and
- any other pertinent macroeconomic measures, such as interest rates or economic growth.\(^9\)

**Focus on Materiality**

Excess disclosure of information that is immaterial and uninformative dampens the effectiveness and understanding of MD&A. The Release emphasizes the need for companies to review information in their MD&A with a view to distilling information that is material and important and eliminating information that is duplicative, immaterial or stale.

One area identified in the Release as prone to excessive disclosure is the disclosure of line-item comparisons. The Release advises companies to avoid disclosing changes to line items that are not material and do not aid investor understanding and to group those that are material to avoid duplication.

Also, companies should consider whether it is appropriate to discuss material changes to items disclosed in an annual report MD&A in the quarter in

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\(^9\) The SEC notes that, because these measures are “non-financial in nature” (i.e., are not “non-GAAP financial measures”), their disclosure should not raise issues under Regulation G or Item 10(c) of Regulation S-K.
which they occur. According to the Release, disclosure in a quarterly report may not be necessary, particularly if no new information that impacts known trends and uncertainties becomes apparent during the quarter, and the earlier MD&A adequately foreshadowed subsequent events.

Quantification of Material Trends and Uncertainties
Critical to an understanding of the company’s performance and to whether investors can ascertain the likelihood that past performance is indicative of future performance is the discussion and analysis of known trends and uncertainties. The SEC suggests that quantification of the material effects of known trends and uncertainties may be required to the extent material, if it is reasonably available.

Need for Analysis
Rather than merely restate financial statement information in narrative form, management should provide an analysis explaining the underlying material causes and the relative significance of trends and uncertainties. Analysis is especially important to an investor’s understanding in instances where material restructuring, impairment charges or declines in profitability or business activity are reflected in a company’s financial statements. The Release also suggests that companies consider MD&A analysis:

- where there is a reasonable likelihood that reported financial information is not indicative of the company’s future financial condition or operating performance;
- if events and transactions reported in the company’s financial statements reflect material unusual or non-recurring items, aberrations, or other significant fluctuations; or
- where the economic characteristics of a company’s business arrangements, or the methods used to account for them, materially impact its results of operations or liquidity in a structured or unusual fashion.

LIQUIDITY AND CAPITAL RESOURCES
The Release emphasizes the importance of providing a clear picture of a company’s ability to generate cash and to meet existing and known or reasonably likely future cash requirements.

Merely stating that a company has adequate resources to meet its short-term and/or long-term cash requirements is insufficient unless no additional more detailed or nuanced information is material. In particular, such a statement would be insufficient if there are any known material trends or uncertainties related to cash flow, capital resources, capital requirements, or liquidity.

Basic Liquidity Requirements
The SEC has traditionally required companies to include the following information in MD&A, to the extent material:

- historical information regarding 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;
- discussion and analysis of known trends and uncertainties;
- a description of expected changes in the mix and relative cost of capital resources;
- indications of which balance sheet or income or cash flow items should be considered in assessing liquidity; and
- a discussion of prospective information regarding sources of and needs for capital, except where otherwise clear from the discussion.

Effect of Uncertainties on Liquidity
The discussion should address the difficulties involved in assessing the effect uncertain events, such as loss contingencies, have on cash requirements and liquidity.

Sources and Uses of Cash
With respect to sources and uses of cash, mere repetition of information from the financial statements is insufficient. Rather, MD&A should focus on the primary drivers necessary to an understanding of a company’s cash flows and the indicative value of its historical cash flows.

Analysis and discussion should explain how a company’s cash requirements tie into its business plan and the resources that are available to satisfy those requirements. Also, discussion and analysis should be provided where there has been material variability in cash flows.

Companies that use the indirect method of presenting operating cash flows consistent with SFAS No. 95 should highlight the underlying cause of any material changes in operating cash flows, which may not be readily apparent from the cash flow statement.
Cash Requirements of Reportable Segments and Foreign Subsidiaries

The Release suggests additional disclosure concerning the cash requirements of, and the cash provided to, a company’s reportable segments or its foreign subsidiaries, and other circumstances such as the inability of a company to access the cash flow or assets of a consolidated entity.

Historical Financing Arrangements

Where appropriate and material, a company must disclose and analyze its historical financing arrangements and their significance to its cash flows, including:

- external debt financings;
- off-balance sheet arrangements;
- uses of stock as a form of liquidity;
- issuances or purchases of derivative instruments linked to its stock; and
- the potential impact of known or reasonably likely changes in credit ratings.

Available Sources of Financing

Discussion and analysis should also be considered for the types of financing that are, or are reasonably likely to be, available (or unavailable) to a company and the corresponding impact on its liquidity and cash flow.

Breaches in Debt Covenants

With respect to material covenants relating to outstanding debt, guarantees or other contingent obligations, the Release suggests that companies provide enhanced disclosure where such companies are, or are reasonably likely to be, in breach or where the impact of such covenants may limit their ability to incur additional debt or equity financing. Disclosure should include the steps that the company is taking or intends to take to avoid the breach, cure it or obtain a waiver, an analysis of the impact of cross-default or cross-acceleration provisions and alternate sources of funding.

Use of Cash Resources

Where companies have flexibility in determining the use of their cash resources, disclosure should be provided describing any known material trends or uncertainties with respect to such determinations.

Critical Accounting Estimates

The Fortune 500 Summary noted that a substantial number of companies did not provide the required disclosures or failed to adequately follow the guidance in the SEC’s December 2001 “Cautionary Advice” about critical accounting policies. The Release reiterates the importance of that guidance.

The Release emphasizes that disclosure about critical accounting estimates and assumptions should supplement, not duplicate, the description of accounting policies disclosed in the notes to the financial statements. Companies should provide an analysis of the uncertainties involved in applying an accounting policy at a given time or the variability that is reasonably likely to result from its application over time. Companies should also address why such estimates or assumptions are susceptible to the risk of change—whether due to their inherent uncertainty or to difficulties in measurement.

Once critical accounting estimates or assumptions are identified, companies should discuss:

- how they arrived at the estimate;
- how accurate the estimate or assumption has been in the past;
- how much the estimate or assumption has changed in the past; and
- whether the estimate or assumption is reasonably likely to change in the future.

Notably, in what is the first reference to sensitivity analysis of critical accounting estimates outside the SEC’s still pending rule proposal, the Release recommends that companies perform an analysis of the sensitivity of their critical accounting estimates and assumptions’ to change based on other outcomes and scenarios that are reasonably likely to occur and have a material effect. As appropriate, companies should provide both quantitative and qualitative disclosure of the sensitivity analysis.
This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

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