

## Client Alert

# SEC Issues Interpretive Guidance on MD&A Disclosure

### A. Introduction

On December 19, 2003, the SEC issued an interpretive release providing guidance to companies on the preparation of Management's Discussion and Analysis of Financial Condition and Results of Operations, or MD&A.<sup>1</sup> The release does not modify existing legal requirements or create new legal requirements.

The release emphasizes that "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". The SEC encourages companies to take a fresh look at their MD&A disclosure with the involvement of senior management, and believes that when companies follow the guidance outlined in the release the overall quality of MD&A will improve. The release also notes that the Division of Corporation Finance will continue to review MD&A and take action where appropriate.

### B. Objectives of MD&A

The release reminds companies of the three basic objectives of MD&A:

- to provide a narrative explanation of a company's financial statements enabling investors to see the company through the eyes of management;
- to enhance overall financial disclosure and provide a context for the analysis of financial information by investors; and
- to provide information about the quality and potential variability of a company's earnings and cash flow, so that investors can assess whether past performance is indicative of future performance.

The SEC believes there are a number of ways companies can improve their MD&A disclosure consistent with the objectives outlined above, and in the release focused its guidance in the following areas: overall presentation; focus and content (including

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<sup>1</sup> Securities and Exchange Commission Release Nos. 33-8350, 34-48960. A copy of the release is available on the SEC website at [www.sec.gov/rules/interp/33-8350.htm](http://www.sec.gov/rules/interp/33-8350.htm).

materiality, analysis, key performance measures and known material trends and uncertainties); liquidity and capital resources; and critical accounting policies.

### C. Overall Presentation

The SEC believes that MD&A, like other disclosures, should be presented in clear and understandable language and with an organized presentation of information.

Companies should organize their disclosure so that the most important information is most prominent and should avoid unnecessary and duplicative disclosure that can impede a reader's ability to understand and identify material matters. The SEC guidance offers several suggestions to make MD&A clearer and more effective, including:

- *Executive-Level Overview.* The SEC believes that many companies would benefit from including at the beginning of MD&A an executive-level overview that includes the most important matters on which a company's executives focus in evaluating financial condition and operating performance. The overview should provide the context for MD&A, and should not merely repeat the discussion and analysis that follows. A good overview would:
  - include economic or industry-wide factors relevant to the company;
  - discuss how the company earns revenues and income and generates cash flow;
  - to the extent necessary or useful, discuss the company's business, locations of operations and principal products (without duplicating the Description of Business section); and
  - highlight material opportunities, challenges and risks, such as those presented by known material trends and uncertainties, on which management is most focused, as well as the actions being taken to address them.

The SEC expects that a company's overview would need to change over time to remain current, and acknowledges that an overview cannot be complete and comprehensive and should not by itself be determinative of whether a company has made full disclosure.

- *Tabular Presentation of Information.* Companies should consider whether a tabular presentation of financial or other information would be more useful to a reader than a verbal explanation in understanding certain MD&A disclosures, such as comparisons of results from different periods.

- *Use of Headings.* Companies should consider whether the headings they use assist readers in following the flow of MD&A and whether additional headings would be helpful.
- *“Layered” Approach to Disclosure of Information.* The SEC suggests presenting MD&A so as to emphasize the most important information and analysis and assist readers in readily identifying that information within the universe of material information. Examples would include the executive-level overview and beginning each section containing detailed analysis with a brief discussion of principal factors or trends that will be covered in more detail in the section.

#### D. Focus and Content of MD&A

In addition to overall presentation, the SEC guidance addresses the focus and content of MD&A, suggesting that MD&A can be improved by focusing on important information and de-emphasizing (or deleting if appropriate) immaterial information.

- *Key Indicators of Financial Condition and Operating Performance.* In addition to financial measures, the guidance suggests that companies identify and discuss factors that may be non-financial in nature, including business and operational data that management uses to manage the business and that would be material to investors. Such information may relate to external or macroeconomic factors such as interest rates or economic growth rates or matters specific to a company or industry, such as those based on units or volume, customer satisfaction, product development, service offerings, affiliations/joint undertakings, market demand, strategy and regulatory matters. In addition, companies should evaluate whether information disclosed other than in their filed documents (such as in earnings releases, analysts’ calls or on websites) is material and would be required in, or would promote understanding of, MD&A. Finally, in order to provide a balanced view of the underlying dynamics of a business, the SEC suggests that MD&A include not only a description of a company's successes, but also of instances when it failed to realize goals.
- *Materiality.* The SEC wants companies to focus their MD&A on material information and de-emphasize unnecessary detail or duplicative or uninformative disclosures that obscure material information, suggesting that companies use the guidance as an opportunity to evaluate whether their MD&A disclosure contains immaterial information that should be eliminated. The SEC notes that current MD&A of some companies that discusses changes in financial statement line items includes an excessive amount of disclosure, as well as disclosure of immaterial items that do not promote understanding.

- *Material Trends and Uncertainties.* One of the most important elements to understanding a company's performance and the extent to which reported financial information is an indicator of future results is the discussion and analysis of known trends, demands, commitments, events and uncertainties. Disclosure decisions concerning material trends and uncertainties should involve:
  - the consideration of financial, operational and other information known to the company;
  - identification, based on this information, of known trends and uncertainties; and
  - the assessment of whether these trends and uncertainties will have, or are reasonably likely to have, a material impact on the company's liquidity, capital resources or results of operations.

The SEC has in the past stated that disclosure of a material trend or uncertainty is required unless the company can conclude either that it is not reasonably likely to occur, or that a material effect on the company's liquidity, capital resources or results of operations is not reasonably likely to occur. Companies should consider both financial and non-financial information and whether or not such information itself is required to be disclosed when identifying material trends and uncertainties. MD&A should also include, if available, quantitative disclosure of the material effects of known trends and uncertainties because such quantification provides information about the quality and potential variability of a company's earnings and cash flow.

- *Analysis.* The release stresses that MD&A should not be merely a restatement of financial statement information in a narrative form. MD&A must also include a thorough analysis of known material trends, events, demands, commitments and uncertainties, their intermediate effects and the reasons underlying those effects. For example, it may not be enough to say that lower revenues reflect a decline in volume of products sold; MD&A should analyze the reasons underlying the decline in sales volume if the reasons are material and determinable. Similarly, MD&A should analyze the reasons underlying material restructuring or impairment charges in a company's financial statements, not simply report their existence in narrative form. Appropriate disclosure should be considered and may be required if there is a reasonable likelihood that a company's reported financial information is not indicative of its future performance, such as where results reflect material unusual or non-recurring items.

## E. Liquidity and Capital Resources

To the extent material, a company is required to include in its MD&A information concerning liquidity and capital resources, including:

- historical information regarding sources and uses of cash and capital expenditures;
- an evaluation of the amounts and certainty of cash flow;
- the existence and timing of commitments for capital expenditures and other known or reasonably likely cash requirements;
- a 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 need for capital.

Companies should assess and separately disclose their ability to meet cash requirements over both the short and long term. A statement that the company has adequate resources to meet its cash requirements is not sufficient without a discussion of known material trends or uncertainties relating to cash flow, capital resources, capital requirements or liquidity.

- *Identify Known Cash Requirements.* Known cash requirements may include (1) funds necessary to maintain current operations, complete ongoing projects and achieve stated objectives and (2) commitments for capital or other expenditures. Companies should discuss the reasonably likely exposure to future cash requirements associated with known trends. Companies should also address, if material, the difficulties involved in assessing the effect of uncertain events, such as loss contingencies, on cash requirements and liquidity. The SEC suggests that one starting point for a discussion and analysis of cash requirements is the now required tabular disclosure of contractual obligations supplemented by additional material information as necessary.
- *Sources and Uses of Cash.* A company's discussion of its cash flows should not merely be a recitation of information evident in the financial statements, but rather should focus on the primary drivers and other material factors necessary to an understanding of a company's cash flows. Such a discussion should include:

- an analysis of material variabilities in cash flow, if any, focusing on material changes in operating, investing and financing cash flows;
  - the cash requirements of reportable segments or other subdivisions of the business, such as foreign subsidiaries, if necessary;
  - the inability to access the cash flow and financial assets of consolidated entities;
  - historical financial arrangements (such as external debt financing, off-balance sheet financing arrangements and issuance or purchase of derivatives), if material, and their importance to cash flows, including information not included in the financial statements; and
  - additional types of financings that are, or are reasonably likely to be, available in the future and the impact of such financings on a company's cash position and liquidity.
- *Debt Instruments, Guarantees and Related Covenants.* Companies should consider discussing the material covenants relating to their outstanding debt (or any guarantees of third party debt) when (1) a company is, or is reasonably likely to be, in breach of such covenants, in which case the company should disclose material information about the breach, analyze its impact if material and discuss steps the company is taking to cure or otherwise address the breach; or (2) the covenants limit a company's ability to take on additional debt or equity financing, in which case the company should discuss those covenants and any consequences of the limitations to the company's financial condition and operating performance.

#### F. Critical Accounting Estimates

The SEC had previously issued guidance reminding companies to include in MD&A a discussion of the material implications of uncertainties associated with the assumptions and estimates underlying a company's critical accounting measurements. In addition, in May 2002 the SEC proposed rules that are still under consideration to expand disclosure in this area. The new release recommends that disclosure about critical accounting estimates or assumptions supplement, not duplicate, the description of accounting policies already disclosed in the notes to the financial statements. The financial statement notes generally describe the method used to apply an accounting principle, whereas MD&A should analyze the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time.

The SEC suggests that MD&A should address factors such as how each critical accounting estimate or assumption was arrived at, how accurate it has been in the past, how much it has changed in the past and whether it is reasonably likely to change in the future. Since critical accounting estimates and assumptions are often highly uncertain, companies should analyze their specific sensitivity to change, based on other outcomes that are reasonably likely to occur and would have a material effect. Companies should also provide quantitative as well as qualitative disclosure when quantitative information is reasonably available and will provide material information for investors.

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For Additional Information

This client alert can be found, together with other recent Chadbourne & Parke LLP client alerts, at [www.chadbourne.com/publications/sub\\_Publications.html](http://www.chadbourne.com/publications/sub_Publications.html). If you have any questions regarding MD&A disclosure requirements, please contact any of the following:

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