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SEC Issues Further Guidance on MD&A

The Staff of the SEC had for the past few months been stating that the SEC was working on an interpretive release to provide additional guidance on the preparation of Management's Discussion and Analysis of Financial Condition and Results of Operations contained in periodic reports and registration statements filed with the SEC. The SEC has issued that guidance in the form of a release.

The guidance, which the SEC stresses neither modifies existing legal requirements nor creates new legal requirements, is effective and, therefore, will need to be reflected in Form 10-K and Form 20-F annual reports filed in respect of the 2003 fiscal year. Technically, it applies to any MD&A disclosure, including the MD&A in a quarterly report.

The Division of Corporation Finance will continue to review MD&A and will take action, presumably through the comment process, to push for better compliance with the principles set out in the guidelines. The SEC also called upon the Division to suggest whether additional action related to MD&A is warranted. One area where further action may be taken, but not in the foreseeable future, concerns critical accounting estimates; in spite of the proposed rules on critical accounting estimates, the guidance falls short of the disclosure contemplated by the proposed rules and, instead, merely provides additional general guidance.

The guidance applies to disclosure provided by domestic SEC registrants as well as foreign private issuers. Although reference is made throughout to MD&A, the principles addressed in the guidance apply with equal force to Item 5 of Form 20-F (applicable to foreign private issuers). In addition, foreign private issuers should be mindful that Item 5 also requires a discussion of any aspect of the difference between U.S. GAAP and foreign GAAP (to the extent the primary financial statements are presented in accordance with foreign GAAP) that management believes are necessary to an understanding of the financial statements as a whole.

This memorandum summarizes the guidance and provides some examples of possible disclosure based on statements of the Staff since the issuance of the guidance in late December.

Summary

The guidance focuses on:

- the overall presentation of MD&A;
- the focus and content of MD&A (including materiality, analysis, key performance measures and known material trends and uncertainties);
- disclosure regarding liquidity and capital resources; and
- disclosure regarding critical accounting estimates.

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The key elements of the guidance include:

Overall:

- each company and its management should take a fresh look at MD&A with a view to enhancing its quality; and
- top-level management should be involved early in identifying the key disclosure themes and items that should be included in the MD&A.

As to presentation:

- present disclosure so that the most important information is most prominent – this might best be accomplished through tabular presentation and more informative headings;
- avoid unnecessary duplicative disclosure that can overwhelm readers and obscure material matters; and
- start the MD&A with an executive-level overview (for example, the type of overview often included in IPO registration statements) that provides context for the remainder of the discussion.

As to focus and content:

- focus on material information and eliminate immaterial information that does not promote understanding of companies' financial condition, liquidity and capital resources, changes in financial condition and results of operations (both in the context of profit and loss and cash flows);
- identify and discuss key performance indicators, including non-financial performance indicators, that management uses to manage the business and that would be material to investors (for example, if revenues increased due to increases in volume, explain why the volume increased – was it better pricing, improved quality of product, disappearance of a competitor; if line items were impacted by a plant closure, why was the plant closed?);
- identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance (for example, impairments and covenant defaults do not occur overnight; contributing factors will be known ahead of time and should be addressed when they become known, and not when the consequence becomes apparent); and
- provide not only disclosure of information responsive to the MD&A's requirements, but also an analysis responsive to those requirements that explains management's view of the implications and significance of that information and that satisfies the objectives of the MD&A.

In effect, management should

- step back and consider how informative current disclosure is;
- highlight, by moving forward, material information;
- craft disclosure so as to avoid surprises; and
- drill down so as to give full explanations of significant elements that contribute to performance.

Background

The MD&A requirements are intended to:

- provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management;

- enhance overall financial disclosure and provide the context within which financial information should be analyzed; and

- 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 will be indicative of future performance.

The SEC views the MD&A as a discussion and analysis of a company's business as seen through the eyes of those who manage that business. Management has a unique perspective on its business that only it can present. MD&A should therefore not be a recitation of financial statements in narrative form or an otherwise uninformative series of technical responses to MD&A requirements.

The starting point for drafting MD&A is Item 303 of Regulation S-K (for domestic issuers and registrants) and the instructions to Item 5 of Form 20-F (for foreign private issuers). The SEC has, over the years, through interpretive releases, cautionary statements, the comment process and enforcement action, conveyed its views as to the scope and content of MD&A. The most notable of these include the 1989 interpretive release, the Fortune 500 review process, the cautionary statement and proposed rules on critical accounting policies and the release announcing the off-balance sheet disclosure rules,

Based on recent experience, the SEC concluded that further guidance was warranted.

Presentation of MD&A

In order to engender better understanding, companies should prepare MD&A with a strong focus on the most important information, provided in a manner intended to address the objectives of MD&A. In particular:

- Companies should consider whether a tabular presentation of relevant financial or other information may help a reader's understanding of MD&A. For example, a company's MD&A might be clearer and more concise if it provides a tabular comparison of its results in different periods, which could include line items and percentage changes as well as other information determined to be useful, followed by a narrative discussion and analysis of known changes, events, trends, uncertainties and other matters.

- Companies should consider whether the headings they use assist readers in following the flow of, or otherwise assist in understanding, MD&A, and whether additional headings would be helpful in this regard.

- MD&A could benefit from adding an introductory section or overview. An introduction or overview should include the most important matters on which management focuses in evaluating financial condition and operating performance and should provide the context for the discussion and analysis of the financial statements. The introduction or overview should not be a duplicative layer of disclosure that merely repeats the more detailed discussion and analysis that follows. This section is often found in IPO registration statements as a means of introducing an issuer’s financial information to the market, but these sections often are not carried over to periodic reports. The guidance provides the following examples of matters that would be addressed in an introduction or overview:

    - economic or industry-wide factors relevant to the company;

    - a brief discussion of how the company earns revenues and income and generates cash;

  - a brief discussion of the company's lines of business, location or locations of operations, and principal products and services (but an introduction should not merely duplicate disclosure in the description of business section); and

  - an insight into material opportunities, challenges and risks, such as those presented by known material trends and uncertainties, on which the company's executives are most focused for both the short and long term, as well as the actions they are taking to address these opportunities, challenges and risks.

- Companies should consider using a "layered" approach. Such an approach would present information in a manner that emphasizes, within the universe of material information that is disclosed, the information and analysis that is most important. Important information should be placed up front. This presentation would assist readers in identifying more readily the most important information. Using an overview or introduction is one example of a layered approach. Another is to begin a section containing detailed analysis, such as an analysis of period-to-period information, with a statement of the principal factors, trends or other matters that are the principal subjects covered in more detail in the section.

Content and Focus of the MD&A

Companies are to focus on important information and de-emphasize (or eliminate) immaterial information.

Key Indicators of Financial Condition and Operating Performance

Companies are expected to identify and address those key variables and other quantitative and qualitative factors that are peculiar to, and necessary for an understanding and evaluation of, the company. These key variables and other factors may be financial or non-financial. Non-financial information may relate to external or macro-economic matters as well as matters specific to a company or industry.

Key variables may be peripheral to the accounting function, but integral to the business or operating activity. Examples of such measures can include 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 or regulatory environment, and any other pertinent macroeconomic measures. Because these measures are generally non-financial in nature, they should not raise issues under Item 10(e) of Regulation S-K (the non-GAAP financial measure rules).

The guidance notes that if companies disclose material information (historical or forward-looking) other than in their registration statements and periodic reports (such as in earnings releases or publicly accessible analysts' calls or companion website postings) they should also evaluate that material information to determine whether it is required to be included in the MD&A, either because it falls within a specific disclosure requirement or because its omission would render misleading the filed document in which the MD&A appears. This aspect of the guidance has two consequences: it may require companies to include more in its filed reports from its other public statements, and to the extent that the latter contain non-GAAP financial measures that are prohibited from being included in an SEC filing under Item 10(e), such measures may need to be removed from the public statements as well.

Companies should provide a balanced view of the underlying dynamics of the business, including not only a description of the company’s successes, but also a description of the company’s failures to realize goals, where material.

Materiality

Companies must provide specified material information in their MD&A, and they also must provide other material information that is necessary to make the required statements, in light of the circumstances in which they are made, not misleading. MD&A must specifically focus on known material events and uncertainties that would cause reported financial information not to be necessarily indicative of future operating performance or of future financial condition. Companies must determine, based on their own particular facts and circumstances, whether disclosure of a particular matter is required in the MD&A. Companies should

- evaluate whether there is information in their MD&A that is no longer material or useful, and therefore should be deleted, for example where there has been a change in their business or the information has become stale;

- evaluate issues presented in previous periods and consider reducing or omitting discussion of those that may no longer be material or helpful, or revise discussions where a revision would make the continuing relevance of an issue more apparent;

- provide segment data where material to an understanding of consolidated information and should avoid unnecessary duplication and immaterial detail in segment discussions that is not required and does not promote understanding of a company's overall financial condition and operating performance;

- a avoid a discussion of a line item and its changes where the information that would be disclosed is not material; and

- assess the materiality of items in preparing disclosure in their quarterly reports. There may be different quantitative and qualitative factors to consider when deciding whether to include certain information in a specific quarterly or annual report. Material changes to items disclosed in the MD&A in annual reports should be discussed in the quarter in which they occur. There may also be circumstances where an item may not be material in the context of a discussion of annual results of operations but is material in the context of interim results. There may be cases, particularly where adequate disclosure is included in the MD&A in those earlier reports, where further disclosure in a quarterly report is not necessary. If, however, disclosure in those earlier reports does not adequately foreshadow subsequent events, or if new information that impacts known trends and uncertainties becomes apparent in a quarterly period, additional disclosure should be considered and may be required.

Material Trends and Uncertainties

One of the most important elements necessary to an understanding of a company's performance, and the extent to which reported financial information is indicative of future results, is the discussion and analysis of known trends, demands, commitments, events and uncertainties. Disclosure decisions concerning trends, demands, commitments, events, and uncertainties generally should involve:

- consideration of financial, operational and other information known to the company;

- identification, based on this information, of known trends and uncertainties; and

- 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.

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. Companies should consider financial and non-financial information in identifying the known material trends and uncertainties.

Analysis

When a description of known material trends, events, demands, commitments and uncertainties is set forth, companies should consider including, and may be required to include, an analysis explaining the underlying reasons or implications, interrelationships between constituent elements, or the relative significance of these matters.

Identifying the intermediate effects of trends, events, demands, commitments and uncertainties alone, without describing the reasons underlying these effects, may not provide sufficient insight for a reader to see the business through the eyes of management. A thorough analysis often will involve discussing both the intermediate effects of those matters and the reasons underlying those intermediate effects. For example, if a company's financial statements reflect materially lower revenues resulting from a decline in the volume of products sold when compared to a prior period, the MD&A should not only identify the decline in sales volume, but also should analyze the reasons underlying the decline in sales when the reasons are also material and determinable. The analysis should reveal underlying material causes of the matters described, including for example, if applicable, difficulties in the manufacturing process, a decline in the quality of a product, loss in competitive position and market share, or a combination of conditions.

Similarly, where a company's financial statements reflect material restructuring or impairment charges, or a decline in the profitability of a plant or other business activity, the MD&A should also, where material, analyze the reasons underlying these matters, such as an inability to realize previously projected economies of scale, a failure to renew or secure key customer contracts, or a failure to keep downtime at acceptable levels due to aging equipment.

If there is a reasonable likelihood that reported financial information is not indicative of a company's future financial condition or future operating performance due, for example, to the levels of subjectivity and judgment necessary to account for highly uncertain matters and the susceptibility of such matters to change, appropriate disclosure in the MD&A should be considered and may be required. For example, if a change in an estimate has a material favorable impact on earnings, the change and the underlying reasons should be disclosed so that readers do not incorrectly attribute the effect to operational improvements. In addition, if events and transactions reported in the financial statements reflect material unusual or non-recurring items, aberrations, or other significant fluctuations, companies should consider the extent of variability in earnings and cash flow, and provide disclosure where necessary for investors to ascertain the likelihood that past performance is indicative of future performance.

Liquidity and Capital Resources

The MD&A should include the following information, 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;
- 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 needs for capital, except where otherwise clear from the discussion.

Companies should evaluate separately their ability to meet upcoming cash requirements over both the short and long term. Merely stating that the 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.

Cash Requirements

To identify known material cash requirements, companies should consider whether the following information would have a material impact on liquidity (discussion of immaterial matters, and especially generic disclosure or boilerplate, should be avoided):

- funds necessary to maintain current operations, complete projects underway and achieve stated objectives or plans;
- commitments for capital or other expenditures; and
- the reasonably likely exposure to future cash requirements associated with known trends or uncertainties, and an indication of the time periods in which resolution of the uncertainties is anticipated.

A useful starting point for a company's discussion and analysis of cash requirements is the tabular disclosure of contractual obligations, supplemented with additional information that is material to an understanding of the company's cash requirements. For example, the cash requirements for items such as interest, taxes or amounts to be funded to cover post-employment (including retirement) benefits may not be included in the tabular disclosure, but should be discussed, if material.

If a company has incurred debt in material amounts, it should explain the reasons for incurring that debt and the use of the proceeds, and analyze how the incurrence of that debt fits into the overall business plan, in each case to the extent material. Debt may have been issued to fund the construction of a new plant, which will allow the company to expand its operations into a specific geographic area. Understanding that relationship and the expected commencement date of plant operations puts the cash requirement for the debt into an appropriate context to understand liquidity.

Where debt has been incurred for general working capital purposes, the anticipated amount and timing of working capital needs should be discussed, to the extent material.

Companies should address, where material, the difficulties involved in assessing the effect of the amount and timing of uncertain events, such as loss contingencies, on cash requirements and liquidity. Any such discussion should be specific to the circumstances and informative, and companies should avoid generic or boilerplate disclosure. In addition, because of these difficulties and uncertainties, companies should consider whether they need to make or change disclosure in connection with quarterly as well as annual reports.

Sources and Uses of Cash

The 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. In addition to explaining how the cash requirements identified in the MD&A fit into a company's overall business plan, the company should focus on the resources available to satisfy those cash requirements. Where there has been material variability in historical cash flows, the MD&A should focus on the underlying reasons for the changes, as well as on their reasonably likely impact on future cash flows and cash management decisions.

Even where reported amounts of cash provided and used by operations, investing activities or financing have been consistent, if the underlying sources of those cash flows have materially varied, analysis of that variability should be provided. The discussion should focus on material changes in operating, investing and financing cash flows, as depicted in the statement of cash flows, and the reasons underlying those changes.

Operations. The discussion of operating cash flows should not be limited by the manner of presentation in the statement of cash flows. Alternate accounting methods of deriving and presenting cash flows exist, and while they generally yield the same numeric result in the major captions, they involve the disclosure of different types of information. Companies should address material changes in the underlying drivers (*e.g.* cash receipts from the sale of goods and services and cash payments to acquire materials for manufacture or goods for resale), rather than merely describe items identified on the face of the statement of cash flows, such as the reconciling items used in the indirect method of presenting cash flows.

A company may report an overall increase in the components of its working capital other than cash with the effect of having a material decrease in net cash provided by operations in the current period. If the increase in working capital was driven principally by an increase in accounts receivable that is attributable not to an increase in sales, but rather to a revised credit policy resulting in an extended payment period for customers, these facts would need to be addressed, along with the resulting decrease in cash provided by operations, if not otherwise apparent.

While a cash flow statement prepared using the indirect method would report that various individual components of working capital increased or decreased during the period by a specified amount, it would not provide a sufficient basis for a reader to analyze the change. If the company reports negative cash flows from operations, the disclosure provided should identify clearly this condition, discuss the operational reasons for the condition if material, and explain how the company intends to meet its cash requirements and maintain operations. If the company relies on external financing in these situations, disclosure of that fact and the company's assessment of whether this financing will continue to be available, and on what terms, should be considered and may be required.

A company should consider whether, in order to make required disclosures, it is necessary to expand the MD&A to address the cash requirements of and the cash provided by its reportable segments or other subdivisions of the business, including issues related to foreign subsidiaries, as well as the indicative nature of those results. A company also should discuss the effect of an inability to access the cash flow and financial assets of any consolidated entities. For example, an entity may be consolidated but, because the company lacks sufficient voting interests or the assets are legally isolated, the company may be unable to utilize the entity's cash flow, cash on hand, or other assets to satisfy its own liquidity needs.

Financing. To the extent material, a company must provide disclosure regarding its historical financing arrangements and their importance to cash flows, including, to the extent material, information that is not included in the financial statements. A company should discuss and analyze, to the extent material:

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

Discussion and analysis of the types of financing that are, or that are reasonably likely to be, available (or of the types of financing that a company would want to use but that are, or are reasonably likely to be, unavailable) and the impact on the company's cash position and liquidity, should be considered and may be required. Where a company has decided to raise or seeks to raise material external equity or debt financing, or if it is reasonably likely to do so in the future, discussion and analysis of the amounts or ranges involved, the nature and the terms of the financing, other features of the financing and plans, and the impact on the company's cash position and liquidity (as well as results of operations in the case of items such as interest payments) should be considered and may be required. In effect, if a company has various options, it should address them.

Debt Instruments, Guarantees and Related Covenants

Companies that are, or are reasonably likely to be, in breach of material debt covenants must disclose material information about that breach and analyze the impact on the company, if material. That analysis should include, as applicable and to the extent material:

- the steps that the company is taking to avoid the breach;
- the steps that the company intends to take to cure, obtain a waiver of or otherwise address the breach;
- the impact or reasonably likely impact of the breach (including the effects of any cross-default or cross-acceleration or similar provisions) on financial condition or operating performance; and
- alternate sources of funding to pay off resulting obligations or replace funding.

As with many other areas of the MD&A, the key is to avoid surprises. The first the market hears of a liquidity issue should not be disclosure of a covenant breach, if it was at all anticipated.

Companies should also consider the impact of debt covenants on their ability to undertake additional debt or equity financing. Examples of these covenants include: debt incurrence restrictions, limitations on interest payments, restrictions on dividend payments and various debt ratio limits. If these covenants limit, or are reasonably likely to limit, a company's ability to undertake financing to a material extent, the company is required to discuss the covenants in question and the consequences of the limitation on the company's financial condition and operating performance. Disclosure of alternate sources of funding and, to the extent material, the consequences (including but not limited to the cost) of accessing them should also be considered and may be required. In the case of high yield issuers, much of this disclosure can be found in its risk factors.

Cash Management

Companies should describe known material trends or uncertainties relating to material determinations as to how they use cash resources and make other capital expenditures. A decision by a company in a highly capital-intensive business to spend significantly less on plant and equipment than it has historically may result in long-term effects that should be disclosed if material. Material effects could include more cash, less interest expense and lower depreciation, but higher future repair and maintenance expenses or a higher cost base than the company would otherwise have.

Critical Accounting Estimates

In December 2001, the SEC reminded companies that, under the existing MD&A disclosure requirements, a company should address material implications of uncertainties associated with the methods, assumptions and estimates underlying the company's critical accounting measurements. In May 2002, the SEC proposed rules, which remain under consideration, that would broaden the scope of disclosures beyond those currently required.

Companies should consider whether they have made accounting estimates or assumptions where:

- the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and

- the impact of the estimates and assumptions on financial condition or operating performance is material.

If so, companies should provide disclosure about those critical accounting estimates or assumptions.

The disclosure should supplement, not duplicate, the descriptions of accounting policies that are already disclosed in the notes to the financial statements. The disclosure should provide greater insight into the quality and variability of information regarding financial condition and operating performance. The discussion should present an analysis of 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.

Disclosure should address specifically why a company's accounting estimates or assumptions bear the risk of change. There may be an uncertainty attached to the estimate or assumption, or it simply may be difficult to measure or value. Equally important, disclosure should address the questions that arise once the critical accounting estimate or assumption has been identified, by analyzing, to the extent material, such factors as

- how management arrived at the estimate;

- how accurate the estimate/assumption has been in the past;

- how much the estimate/assumption has changed in the past; and

- whether the estimate/assumption is reasonably likely to change in the future.

Since critical accounting estimates and assumptions are based on matters that are highly uncertain, a company 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 provide quantitative as well as qualitative disclosure when quantitative information is reasonably available and will provide material information for investors. For example, if reasonably likely changes in the long-term rate of return used in accounting for a company's pension plan would have a material effect on financial condition or operating performance, the impact that could result given the range of reasonably likely outcomes should be disclosed and, because of the nature of estimates of long-term rates of return, quantified.

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This memorandum provides only a general overview of the SEC's views on MD&A and is not intended to provide or constitute legal advice, and no legal or business decision should be based on its contents. Any questions concerning the foregoing should be addressed to members of the Paul Weiss Securities Group (see below). In addition, memoranda on related topics may be accessed under Securities Group publications on our web site (www.paulweiss.com).

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