FENWICK & WEST LLP

CORPORATE & SECURITIES LAW UPDATE

SEC Focus on MD&A Disclosure

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The SEC has clearly signaled a heightened interest this year in Management's Discussion and Analysis disclosures by public companies. This focus is due in part to the scrutiny on Enron and its perceived inadequate financial disclosures. As a result, we expect the SEC to review and comment on MD&A disclosures of many public companies, and that these reviews will be more rigorous than in past years. To make sure that your disclosures are adequate, you should take a fresh look at your MD&A drafting procedures and objectives. This memo provides some reminders about MD&A requirements, including summaries of two recent releases issued by the SEC, that must be considered when drafting future MD&A disclosures.[1] The following is a summary of the topics discussed in this memo, with links to each.

MD&A Disclosure In General

In general, MD&A disclosure requirements seek to elicit disclosures that will allow investors to understand the current and expected future operating results and financial condition of a company, including the potential effects of known trends, commitments, events and uncertainties. According to the SEC, "MD&A is intended to give investors an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company."

[1] The SEC has indicated that these releases do not create new legal requirements but are instead intended to improve companies' compliance with existing disclosure requirements.

MD&A disclosure must be both useful and understandable.[2] Descriptions should be in plain English and should provide "transparent" disclosures of the company's financial situation. It may help to group disclosures together, rather than spreading them throughout a filing, and to use charts and tables where possible. The SEC has reminded companies not to be overly general in their MD&A disclosure. Each company must evaluate its particular circumstances and describe relevant details and risks related to material aspects of its operating results and financial condition.

The primary focus of a company's MD&A should be its GAAP financial statements. The SEC has conceded that it is acceptable to discuss pro forma results, but it should be secondary to the analysis of the company's GAAP results.

With respect to trend information, a company must disclose circumstances that could materially affect its operating results and financial condition if they are "reasonably likely" to occur. This is lower disclosure threshold than a "more likely than not" probability test. If a company cannot make a determination that a known trend, demand, commitment, event or uncertainty is not likely to occur, then it must evaluate objectively the potential consequences of the trend, demand, commitment, event or uncertainty if it were to occur. If the company cannot conclude that these consequences are not reasonably likely to have a material effect on the company's financial condition or results of operations, then the company must provide disclosure of the potential consequences.

Each company analyzes different matters to determine whether to include MD&A disclosure about them. The following list suggests some of the matters to consider when evaluating your MD&A disclosure obligations:

- the details regarding the company's liquidity situation and material off-balance sheet arrangements, trading activities and related party transactions;
- the impact on the company of its key accounting policies and changes in accounting estimates;
- the impact of changes in company sales policies (for example, the level of sales discounts given to customers or the length of customer payment periods);
- the effect of acquisitions and dispositions on revenues and earnings, including how the company will evaluate the impairment of recorded goodwill and what effect this could have on the company's future operating results;
- the impact of declines in the values of security holdings that may be other than temporary and the impact of derivative financial instruments;

[2] For example, with respect to revenue disclosures, investors should be able to understand, among other things, what the company does to generate revenue, what terms and conditions govern when it's entitled to receive revenue, when it recognizes revenue and when it realizes the revenue in cash.

- the potential impact of environmental and contingent liabilities;
- how the company is affected by current economic conditions;
- the impact of the loss of a significant customer or supplier;
- the impact of business restructurings;
- the potential impact of any debt terms or covenants that are binding on the company;
- how the company is affected by changes in credit risk, including changes in its own credit rating and the creditworthiness of its customers;
- what trends are affecting the company's recognition of revenue (such as an increase in period end shipments, changes in the mix of sales by distribution channel or type of customer and changes in the mix of products and services);
- seasonality effects;
- the effects of reserves;
- the impact of items that are not likely to be recurring;
- the effects of deferred revenue; and
- segments of the company's business that have a disproportionate impact on the company's revenue and results of operations.

As companies discuss future trends and uncertainties in MD&A, they should also strive to take advantage of the safe harbor for forward-looking statements. To do that, they must identify statements that are forward looking and accompany the forward-looking statements with meaningful cautionary language about the risks and uncertainties associated with these future expectations.

MD&A Drafting Suggestions

To ensure that your MD&A is prepared with enough thought and analysis, you should review your drafting procedures and build into them the following process suggestions:

- start the analysis and drafting process early;
- start this year's draft from a clean slate and with a fresh perspective, rather than simply updating last year's or last quarter's disclosures;
- consult your senior executives, independent auditors, audit committee and legal advisors about key MD&A disclosure issues before drafting begins and then involve them in the drafting and review process;
- evaluate the need to address the industry and company trends discussed at meetings of senior management and the Board of Directors, as well as in public announcements regarding the company's business and operating results (such as press releases, conference calls, industry and financial conferences and on the company's web site);

- carefully read the reports of analysts that follow the company and its industry and address the important trends and issues that are identified; and
- evaluate MD&A and other disclosures by your competitors in their SEC filings, public statements and releases for trends that might apply to your company as well.

Summary of December 2001 Release - Disclosure of Key Accounting Principles

On December 12, 2001, the SEC released cautionary advice to remind companies that investors need "full transparency" of their accounting policies. The text of the release can be found at: http://www.sec.gov/rules/other/33-8040.htm.

A company's financial statements, even when prepared in accordance with GAAP, may indicate on their surface a higher degree of accuracy and certainty than is warranted. Many investors do not realize that elements of reported financial statements may rely on subjective management assumptions and estimates of future events that are outside management control. As a result, the SEC believes that companies need to include in their MD&A disclosures plain English descriptions of:

- their critical accounting policies;[3]
- the judgments and uncertainties affecting the application of those policies; and
- the likelihood that materially different amounts would be reported under different conditions or using different assumptions.

The SEC suggests the following procedures in drafting MD&A disclosures:

- company management and its auditors should bring particular focus to the evaluation of the critical accounting policies affecting the financial statements;
- the disclosure in MD&A regarding the company's critical accounting policies should be balanced and fully responsive to the requirements described above;
- prior to finalizing and filing the annual report, audit committees should review the selection, application and disclosure of critical accounting policies; and
- if there is uncertainty about the application of specific GAAP principles, companies should consult with the SEC's accounting staff.

[3] In the release, the SEC referred to accounting policies as "critical" where they are both most important to the portrayal of the company's financial condition and results of operations and where they require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

We strongly suggest that company management meet with the company's independent auditors, the company's legal advisors and the audit committee to identify the three to five critical accounting policies that affect the company's financial statements. The parties should discuss the accounting principles employed, and the source and reasonableness of any management judgments used in applying those principles, in order to craft appropriate disclosure for inclusion in the company's MD&A.

Summary of January 2002 Release - Disclosure Relating to Liquidity and Capital Resources, Off-Balance Sheet Arrangements, Trading Activities and Related Party Transactions

On January 22, 2002, the SEC issued a statement with its views regarding the MD&A disclosure obligations of companies with respect to: (i) liquidity and capital resources generally; (ii) off-balance sheet arrangements and their potential impact on liquidity and capital resources; (iii) contractual obligations and commercial commitments; (iv) certain trading activities that include non-exchange traded contracts accounted for at fair value; and (v) the effects of transactions with related and certain other parties. The text of the release can be found at: http://www.sec.gov/rules/other/33-8056.htm. The SEC's statement refers to recommendations contained in a petition for interpretive guidance from the five largest accounting firms, which was endorsed by the American Institute of Certified Public Accountants. That petition can be found at: http://www.sec.gov/rules/petitions/petndiscl-12312001.htm.

Liquidity and Capital Resources

In the release, the SEC reminded companies that they should not be overly general in their MD&A liquidity disclosures. For example, companies should consider describing the sources of their short-term funding and the circumstances likely to affect these sources, rather than simply disclosing that the company expects to have sufficient short-term funding to meet its liquidity needs for the next year. In describing the circumstances that are likely to affect these sources of liquidity, companies should consider material risks that could reduce the availability of funds and describe these risks in a manner that is tailored to the particular circumstances of the company.

The SEC provided the following list of trends, demands, commitments, events and uncertainties that companies should consider when preparing their MD&A liquidity disclosures:

- provisions in financial guarantees or commitments, debt or lease agreements or other arrangements that could trigger a requirement for an early payment, additional collateral support, changes in terms, acceleration of maturity or the creation of an additional financial obligation, such as adverse changes in the company's credit rating, financial ratios, earnings, cash flows or stock prices, or changes in the value of underlying, linked or indexed assets;

- circumstances that could impair the company's ability to continue to engage in transactions that have been integral to historical operations or are financially or operationally essential, or that could render that activity commercially impracticable, such as the inability to maintain specified investment grade credit ratings, levels of earnings, earnings per share, financial ratios or collateral;
- factors specific to the company and its markets that the company expects to be given significant weight in the determination of the company's credit rating or that will otherwise affect the company's ability to raise short-term and long-term financing;
- guarantees of debt or other commitments to third parties; and
- written options on non-financial assets (for example, real estate puts).

Off-Balance Sheet Arrangements

Companies must also disclose material sources of liquidity and financing that are provided by off-balance sheet arrangements and transactions with unconsolidated, limited purpose entities, as well as contingencies associated with these arrangements or entities that are reasonably likely to affect in a material way the company's liquidity or the availability of or requirements for capital resources.[4] The SEC indicated that disclosures regarding similar arrangements can be aggregated as long as the company provides important distinctions in the terms and effects of the arrangements. Disclosures of these matters must be clear and individually tailored to describe the risks to the company.

Companies should consider whether the following areas should be addressed when providing MD&A disclosure about off-balance sheet arrangements:

- the business purpose and activities of the arrangement;
- the economic substance of the arrangement;
- the key terms and conditions of any commitments;
- the initial and ongoing relationships with the company and its affiliates; and
- the company's potential risk exposures.

In addition, companies should consider the following additional disclosures in explaining the effects and risks of off-balance sheet arrangements:

[4] These entities often provide financing, liquidity or credit risk support to the company or engage in leasing, hedging, or research and development services with the company. In some circumstances, these entities can expose the company to liability that is not reflected on the face of the financial statements.

- the total amount of assets and obligations of the off-balance sheet entity, including their nature, and identification of the class and amount of any debt or equity securities issued by the company;
- the effects of the termination of the off-balance sheet entity if it has a finite life or if it is reasonably likely that the company's relationship with the entity may be discontinued in the foreseeable future;
- amounts receivable or payable, and revenues, expenses and cash flows, resulting from the arrangements;
- extended payment terms of receivables, loans and debt securities resulting from the arrangements and any uncertainties as to realization, including repayment that is contingent upon the future operations or performance of any party;
- the amounts and key terms and conditions of purchase and sale agreements between the company and the counter parties in any such arrangements; and
- the amounts of any guarantees, lines of credit, standby letters of credit or commitments or take or pay contracts, throughput contracts or other similar types of arrangements, including tolling, capacity or leasing arrangements, that could require the company to provide funding of any obligations under the arrangements, including guarantees of repayment of obligors of parties to the arrangements, make whole agreements or value guarantees.

Contractual Obligations and Commercial Commitments

The SEC suggested that companies aggregate disclosure about their obligations and commitments to make future payments under contracts and provide this disclosure in a single location so that a total picture of obligations will be readily available to investors. The SEC suggested that this information be presented in tabular form. For example, companies could provide a table relating to contractual obligations that includes aggregated disclosures in separate classifications for long-term debt, capital lease obligations, operating leases, unconditional purchase obligations and other contractual obligations, with disclosure of total payments due and information about the timing of these payments.[5] In addition, companies could provide a separate table relating to other commercial commitments that includes aggregated disclosures in separate classifications for lines of credit, standby letters of credit, guarantees, standby repurchase obligations and other commercial commitments, with disclosure of total amounts committed and information about the timing of the expiration of these commitments.[6]

5 For example, disclosure of payments due less than one year and thereafter at other intervals (such as between one and three years, between three and five years and after five years).

6 For example, commitments expiring in less than one year and thereafter at other intervals (such as between one and three years, between three and five years and after five years).

Trading Activities that Include Non-Exchange Traded Contracts Accounted for at Fair Value
The SEC expressed concern about the adequacy of MD&A disclosures regarding trading activities involving commodity contracts that are accounted for at fair value but for which a lack of market price quotations necessitates the use of fair value estimation techniques,[7] as well as material energy trading and risk management activities. MD&A should include a discussion of material trends and uncertainties arising from these activities, including an explanation of the different outcomes reasonably likely under different circumstances or measurement methods, and how these activities affected reported results for the latest annual period and subsequent interim period and how the company's financial position is affected as of the latest balance sheet date.

The SEC suggested that companies consider whether they should furnish the following information in connection with these activities:

- disaggregated disclosures of realized and unrealized changes in fair value;
- changes in fair value attributable to changes in valuation techniques;
- estimated fair values at the latest balance sheet date, classified according to whether fair values are determined directly from quoted market prices or are estimated; and
- the timing of maturities of contracts at the latest balance sheet date (for example, within one year, within years one through three, within years four and five and after five years).

In addition, the SEC advised companies to consider the need to disclose the fair value of net claims against counter parties that are reported as assets at the most recent balance sheet date, based on the credit quality of the contract counter party.

With respect to risk management disclosures, the SEC advised companies to consider whether they should provide fuller disclosure regarding the management of risks related to changes in credit quality or market fluctuations of underlying, linked or indexed assets or liabilities, especially where such assets are illiquid or susceptible to material uncertainties in valuations.

Effects of Transactions with Related and Certain Other Parties
The SEC indicated that where related party transactions are material,[8] MD&A should include discussion of those transactions to the extent necessary for an understanding of the

[7] For example, contracts that are indexed to measures of weather, commodities prices or quoted prices of service capacity, such as energy storage and bandwidth capacity contracts.

[8] Materiality is discussed in Staff Accounting Bulletin No. 99 (SAB 99), Materiality.

company's current and prospective financial position and operating results.[9] Companies should consider describing the elements of the transactions that are necessary for an understanding of the transactions' business purpose and economic substance, their effects on the financial statements and the special risks or contingencies arising from these transactions, including the following:

- identification of the related parties transacting business with the company;
- how transaction prices were determined by the parties;
- a description of how the fairness of the transaction was evaluated, if the company is representing that the transaction has been evaluated for fairness; and
- any ongoing contractual or other commitments as a result of the arrangement.

In addition, the SEC suggested that, prior to making a recommendation that the financial statements be included in the company's Form 10-K, audit committees may want to include a review of these relationships and transactions in their discussions with management and the company's auditors, including a review of their terms and internal corporate and Board actions involving the transactions.

The SEC also advised companies that they should consider the need to provide disclosures about parties that fall outside the definition of "related parties" in FAS 57, if those parties have a relationship that enables them to negotiate terms of material transactions that may not be available from other, more clearly independent, parties on an arm's-length basis.[10]

Should you have any questions about preparing your MD&A, or about the SEC's new MD&A advice, please do not hesitate to contact us.

9 "Related parties" are defined in Statement of Financial Accounting Standards No. 57 (FAS 57), Related Party Disclosures.

10 Examples of these entities include those that are established and operated by individuals that were former senior management of, or have some other current or former relationship with, the company.