FENWICK & WEST LLP

Corporate and Securities Law Updates

Interpretive Release Regarding MD&A

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The Securities and Exchange Commission recently issued an interpretive release providing important reminders and specific new guidance regarding Management's Discussion and Analysis of Financial Condition and Results of Operations. The text of the release can be reviewed at http://www.sec.gov/rules/interp/33-8350.htm.

Summary

This important release reminds companies of the fundamental purposes of the MD&A disclosure requirements. The release does not alter any existing disclosure requirement, but it does identify areas in which the SEC believes that MD&A disclosures have been deficient, and it provides specific suggestions about how to improve those disclosures. The SEC staff has expressed the view that MD&A is critical disclosure for every public company, and it will be reviewing all companies' disclosures on a regular basis, so we recommend that this interpretive guidance be taken into consideration in preparing MD&A disclosures, effective immediately.

Objectives of MD&A

The SEC uses this release to remind companies that MD&A disclosure is intended to satisfy three principal objectives:

- 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.

Focus Areas

Based on its experience reviewing MD&A disclosures, particularly its recent systematic review of the Fortune 500 periodic reports, the SEC provides guidance on four topics:

- 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.

Common Problems

The SEC is concerned that most MD&A disclosures simply restate in narrative paragraph form the company's period-to-period changes in operating results and financial condition as reflected in the financial statements, without the analysis necessary to allow investors to understand the extent to which the company's historical financial performance is indicative of future results. In addition, MD&A is often unnecessarily duplicative, too long, and presented in a manner that obscures the most relevant information.

Introduction and Layered Disclosure

The SEC's most significant presentation idea is the suggestion that companies should consider using an overview or introductory section to the MD&A section. This overview would not merely provide company background information, but rather would address the most important information focused on by management and provide context for the ensuing analysis of the financial results. Similarly, the SEC suggests what it calls a "layering" approach that presents the most significant information first in each section. For example, at the beginning of the comparison of the current year to the prior year, the most significant factors that affected the year-over-year comparison would be identified, rather than simply calling those factors out in relation to the specific income statement line items.

Key Performance Information

In order to give readers of MD&A a view of the company "through the eyes of management," companies should address the key performance indicators that are essential to an understanding of the company's performance in particular. All important financial measures are required, and non-financial measures should be considered as appropriate. The information may relate to external or macroeconomic matters as well as to a specific company or industry. In addition, the SEC notes that if a company discloses material financial or non-financial information to analysts and others in its earnings calls, this information may be sufficiently significant that it is required to be included in the MD&A.

Table Format

The SEC advocates that companies use tables to present financial information, such as period-over-period dollar and percentage changes, and avoid repeating that information in the text. The SEC also reminds companies that Regulation S-K Item 303 does not require a discussion of every line item, and that line item discussions should be avoided where the particular information would not be material. Companies might also consider addressing two or more line items together where discussion of the individual items is not merited.

Liquidity and Capital Resources

Underscoring the importance of liquidity and capital resources disclosure to MD&A, the SEC devotes a separate section of its release to detailed guidance on this topic. In keeping with the themes of the release generally, the SEC emphasizes the need for attention to evaluation and enhanced analysis of the sources and uses of cash. The SEC warns against merely reproducing the statement of cash flows in narrative form, and recommends that companies 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. Merely stating that the company has adequate resources to meet its cash requirements is insufficient, unless no additional more detailed or nuanced information is material. The SEC also recommends that companies consider additional disclosure about material debt instruments, guarantees and related covenants.

Critical Accounting Estimates

In May 2002, the SEC proposed a rule requiring substantially greater disclosure of critical accounting policies. This controversial proposed rule has not yet been adopted, but the SEC is interested in improving the quality of critical accounting policies disclosure. The release advises companies to refer to the SEC's December 2001 cautionary advice on this topic, and in particular to present the company's 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. Distinguishing the MD&A treatment of critical accounting policies from the financial statement disclosures of those policies, the SEC advises:

> "While accounting policy notes in the financial statements generally describe the method used to apply an accounting principle, the discussion in MD&A should present a company's 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."

In the SEC's Own Words

In providing its guidance, the SEC provides several examples to illustrate the depth and quality of disclosure it expects. Here are some of the more instructive of these illustrative examples:

- "When preparing MD&A, companies should consider whether disclosure of all key variables and other factors that management uses to manage the business would be material to investors, and therefore required.... Examples of such measures, depending on the circumstances of a particular company, 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."
- Reminding companies that MD&A should analyze, not simply discuss, financial results, the SEC provided this example: "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, 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."
- "If there is a reasonable likelihood that reported financial information is not indicative of a company's future operating performance... appropriate disclosure in MD&A... 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 discussing the need for a fuller analysis of liquidity, the SEC uses this example: "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."
- Also addressing liquidity analysis, the SEC provides the following: "For example, consider a company that reports 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 in MD&A to the extent material, along with the resulting decrease in cash provided by operations, if not otherwise apparent. In addition, if there is a material trend or uncertainty, the impact of the new credit policy on cash flows from operations should be disclosed."
- "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 the financial condition or operating performance of the company, 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."

Additional Questions

Should you have additional questions about this interpretive release, please contact any member of your Fenwick & West team. You may also contact Dan Winnike and Horace Nash, who contributed to this update.

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