KIRKLAND & ELLIS LLP

Alert

Corporate Practice Area

February 2004

SEC Issues Additional Guidance Regarding MD&A

Overview

The Securities and Exchange Commission recently issued additional interpretive guidance regarding the disclosure contemplated by Management's Discussion and Analysis of Financial Condition and Results of Operations (commonly referred to as MD&A).[1] MD&A is required to be included in most periodic reports filed with the SEC under the Securities Exchange Act of 1934 and many registration statements filed with the SEC under the Securities Act of 1933. The SEC's guidance is intended to improve the quality of the disclosure in MD&A to make MD&A easier to follow and understand.

The SEC's guidance and recommendations, which are summarized below, do not include any new definitive rules or modifications to existing disclosure requirements. However, the release indicates that the SEC is beginning to focus additional attention on the quality of the disclosure in MD&A, which according to the SEC is too often a recitation of the financial statements included in the filing without any meaningful description of the company.

Accordingly, management should reexamine the disclosure contemplated by past MD&A in light of the guidance provided by the SEC and take steps to improve MD&A in the company's future filings. The SEC specifically recommends that "each company and its management . . . take a fresh look at MD&A with a view to enhancing its quality," which should include early top-level involvement by a company's management in identifying the key disclosure themes and items that should be included in MD&A. This exercise should limit the number of comments received by a company upon the SEC's review of its filings and improve the quality of its disclosure.

However, we also caution that while the SEC's guidance encourages deletion from MD&A of information that may be less important, the release does not provide any "safe harbor" for companies that have oversimplified the disclosure in MD&A. Therefore, as management undertakes this exercise, it should nevertheless continue to provide full and accurate disclosure of information that it believes to be relevant to investors. Despite the SEC's guidance, a company should err on the side of too much information in MD&A rather than too little.

The SEC's guidance primarily recommends three areas for change in MD&A, which we will address in order. First, the SEC has provided guidance on the form and style of presentation in MD&A. Second, the SEC has suggested methods by which the content of disclosure in MD&A generally can be improved. Third, the SEC has provided specific guidance on two topics required in MD&A, liquidity and capital resources and critical accounting estimates.

Form of Presentation

According to the SEC, companies should provide clearer and better organized presentations of MD&A. In the SEC's view, MD&A has become unnecessarily lengthy, difficult to understand and confusing. The SEC believes that clearer and better organized presentation in MD&A will result in more understandable disclosure that does not sacrifice the appropriate level of complexity or nuance. The SEC has made the following recommendations of methods by which disclosure in MD&A can be presented in a more meaningful manner:

Use Clear and Understandable Language. The SEC has stated that it believes companies too often use language and sentence structure that is unclear and convoluted.

Use Tabular Presentations. The SEC suggested that a tabular presentation of relevant financial or other information may help a reader's understanding of MD&A. In particular, the SEC suggested that tabular presentations may be a cleaner and simpler way for comparing a company's results across different periods and for explaining a company's material interest and discount rate assumptions used for estimating fair value or determining discounted cash flow figures.

Improve the Use of Headings. Companies should consider whether the headings in its MD&A assist readers in understanding or following the flow of MD&A. The SEC suggested that additional headings may be helpful in this regard.

Add an Introduction. Many companies' MD&A could benefit from adding an introductory section or overview that would facilitate a reader's understanding of MD&A. The SEC cautioned that the introduction should not be a duplicative layer of disclosure that merely repeats the more detailed discussion and analysis that follows.[2]

An introduction should provide a balanced, executive-level discussion of the most important themes or other significant matters with which management is concerned in evaluating the company's financial condition and operating results. Thus, an introduction should:

- include economic or industry-wide factors relevant to the company;
- inform the reader about how the company earns revenues and income and generates cash;
- discuss the company's lines of business, location of operations and principal products and services;
- provide insight into material opportunities, challenges and risks (such as those presented by known material trends and uncertainties) on which management is most focused and actions management is taking to address these opportunities, challenges and risks; and
- avoid the use of boilerplate disclaimers and other generic language that would detract from the purpose of the introduction or overview.

Use a "Layered" Approach. Consistent with the recommended use of an introduction to MD&A, a company should consider using a "layered" approach to disclosure in MD&A, which presents information in a manner that emphasizes the information and analysis that is most important. In addition to the use of an introduction to MD&A generally, the SEC suggested beginning sections containing detailed analysis with a statement of the principal factors, trends or other matters that are covered in more detail in the section.

Content and Focus

The SEC stated that many companies could improve their MD&A by focusing on the most important information disclosed in MD&A. The SEC intends for MD&A to be a discussion and analysis of a company's business as seen through the eyes of management. The SEC would prefer that disclosure emphasize material information that is required or promotes understanding and de-emphasize (or, if appropriate, delete) immaterial information that is not required and does not promote understanding. Accordingly, the specific content of MD&A should vary based on the circumstances of each particular company. The SEC recommended the following methods to better explain the company's financial condition, operating performance and prospects:

Focus on Key Indicators of Financial Condition and Operating Performance. A company 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." In particular, while financial measures are helpful and necessary, a company should also focus the reader's attention on other key variables used by management to manage the business, including non-financial criteria, macro-economic matters (such as interest rates or economic growth rates) and industry-specific measures.

MD&A should provide a frame of reference that allows readers to understand the effects of material changes and events and known material trends and uncertainties arising during the periods being discussed. The SEC believes that this should include a balanced view of the underlying dynamics of the business. The SEC acknowledges, however, that selecting this information may be difficult given the amount of information available to management to monitor the performance of a company.

Focus on Materiality. The SEC suggests that MD&A too often includes the accumulation of unnecessary detail and duplicative disclosures and warns that the effectiveness of MD&A decreases when such information obscures material information. 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 future financial condition. In the SEC's view, some instances where deletion of excess information would be particularly appropriate are when there has been a change in a company's business, when the information has become stale, or if segment discussion and analysis does not promote understanding of a company's overall financial condition. In addition, the SEC has found that the disclosure of changes in line items is particularly prone to duplicative and immaterial disclosure.

Focus on Material Trends and Uncertainties. The release focuses considerable attention on the discussion and analysis of known trends, demands, commitments, events and uncertainties (which the SEC refers to throughout the release as "known material trends and uncertainties"). Known material trends and uncertainties are among 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. Disclosure regarding known material trends and uncertainties is particularly important because it provides information about the quality and potential variability of a company's earnings and cash flow so that readers can ascertain the likelihood that past performance is indicative of future performance.

Each known material trend or uncertainty must be disclosed unless a company is able to conclude that it is either not reasonably likely to occur or not reasonably likely to have a material effect on the company's liquidity, capital resources or results of operations. The SEC distinguished disclosures required to address known material trends and uncertainties (which are likely to have an effect on future performance) from optional disclosures of forward-looking information.

Disclosure decisions concerning known material trends and uncertainties generally should involve:

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

Focus on Analysis. The SEC reminds companies that MD&A includes both "discussion" and "analysis" of known material trends and uncertainties. Rather than restating the financial statement information, MD&A should include an analysis of the underlying reasons or implications, interrelationships between constituent elements and relative significance of those matters. Thorough analysis frequently involves discussing the intermediate effects of those matters and the reasons underlying those intermediate effects. For example, if a company's financial statements reflect material decreases in revenues when compared to a prior period and the decreases are a result of a decline in the volume of products sold, MD&A should analyze the reasons underlying the decrease in sales volume.

If there is a reasonable likelihood that reported financial information is not indicative of future financial condition or future operating performance, appropriate disclosure should be considered and may be required. In particular, this disclosure may be necessary if a change in an estimate underlying the reported financial information would have a material impact on earnings, if events and transactions reported in the financial statements reflect material unusual or non-recurring items or if the economic characteristics of any of a company's business arrangements materially impact their results of operations or liquidity in a structured or unusual fashion.

Topic-Specific Guidance

The SEC provided the following specific guidance on disclosure in MD&A relating to liquidity and capital resources and critical accounting estimates:

Liquidity and Capital Resources. A company is required to include in MD&A various information regarding its liquidity and capital resources, to the extent material, including:

- historical information regarding sources of cash and capital expenditures;
- the existence and timing of commitments for capital expenditures and other known and reasonably likely cash requirements; and
- a discussion of prospective information regarding companies' sources of and needs for capital.

A company's disclosure regarding its liquidity and capital resources should discuss and analyze known material trends and uncertainties relating to its cash flow, capital resources, capital requirements and liquidity.

More specifically, the SEC addresses four topics which management should consider in preparation of the liquidity and capital resources section in MD&A:

Cash requirements. Companies should consider whether the following information would have a material impact on liquidity:

- 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.

Companies should supplement their existing tabular disclosure of contractual obligations with other information helpful to understanding the company's cash requirements.

Sources and uses of cash. MD&A should focus on the primary factors necessary to understand the company's cash flows, the indicative value of historical cash flows and the resources available to satisfy cash requirements. The discussion and analysis of liquidity should focus on material changes in operating cash flows and financing cash flows and the reasons underlying those changes.

With respect to a company's operating cash flows, MD&A should address material changes in the underlying drivers, rather than merely describing items identified on the face of the statement of cash flows. In some cases, it may be necessary to expand 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. In addition, a company should also discuss the effect of an inability to access the cash flow and financial assets of any consolidated entities.

MD&A should also include disclosure regarding the company's historical financing arrangements and their importance to cash flows. A company should discuss and analyze:

- its external debt financing;
- its use of off-balance sheet financing arrangements;
- its issuance or purchase of derivative instruments;
- 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.

MD&A should also address likely prospective financing availability, the types of financing that a company would want to use but that are unavailable and the nature and terms of expected future financing.

Debt instruments, guarantees and related covenants. If a company is or is reasonably likely to be in breach of covenants in its outstanding debt obligations, it must disclose material information about that breach and analyze the impact on the company. This disclosure should include:

- the steps that the company is taking to avoid the breach;

- the steps that the company intends to take to cure the breach or obtain a waiver for the breach;
- the impact of the breach on financial condition or operating performance; and
- alternate sources of funding to satisfy resulting obligations or replace funding.

In addition, a company should assess the impact of debt covenants on its ability to undertake additional debt or equity financing.

Cash management. MD&A should describe known material trends and uncertainties relating to determining when and how to use a company's cash resources to satisfy obligations and make other capital expenditures.

Critical Accounting Estimates

MD&A should address material implications of uncertainties associated with the methods, assumptions and estimates underlying the company's critical accounting measurements.[3] These estimates and assumptions involved in the application of GAAP have a material impact on reported financial condition and operating performance and on the comparability of such reported information over different reporting periods. In particular, MD&A should address the estimates and assumptions when (i) the nature of the estimates or assumptions is material due to the level of subjectivity or judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change or (ii) they are likely to have a material impact on the company's financial condition or operating performance. According to the SEC, disclosure regarding critical accounting estimates should supplement and not duplicate the description of accounting policies that are disclosed in the notes to the financial statements by analyzing 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. A company should address specifically why its accounting estimates or assumptions bear the risk of change and factors, such as the uncertainty associated with the estimate or assumption or the difficulty in determining the estimate.

Should you have any questions about the matters addressed in this Kirkland & Ellis LLP Alert, please contact the following Kirkland & Ellis authors or the Kirkland & Ellis partner you normally contact.

Thomas Christopher
(212) 446-4790

William Sorabella
(212) 446-4932

[1] SEC Release No. 33-8350 (Dec. 19, 2003), which can be found on the Internet at: http://www.sec.gov/rules/interp/33-8350.htm.

[2] The SEC believes that the failure to include disclosure of every material item in an introduction or overview should not automatically trigger 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.

[3] In May 2002, the SEC proposed rules on the disclosure of the application of critical accounting policies in MD&A. The proposed rules are SEC Release No. 33-8098 (May 10, 2002). The release discussed in this summary does not modify the proposed rules.