SEC Issues MD&A Interpretive Guidance

Late last year, the SEC issued an interpretive release providing guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). Although the release does not create any new legal requirements, it does provide the SEC's current view of MD&A and guidance on MD&A disclosures. As a company prepares MD&A for its next SEC report - the annual report on Form 10-K for many clients - it is relevant to focus on the most important concepts emphasized in the release:

- Start with a clean slate. Companies should "take a fresh look" at MD&A rather than simply repeating prior years' format with updated numbers and explanations. Senior management should consider whether a new format and/or approach to the MD&A is desirable this year and have early involvement in identifying key disclosure themes.
- Emphasize the most important information. Give more important information greater prominence and avoid duplicative disclosures.
- Include an executive summary. Consider beginning the MD&A with an overview providing context for the disclosure that follows.
- Use tables. Consider formatting certain disclosures in tabular format to help the reader.
- Pay particular attention to liquidity and capital resources. If appropriate, include an enhanced analysis of sources and uses of cash, and of covenants and the ability to obtain alternative funding sources if the company is out of compliance with covenants.
- Discuss critical accounting estimates. Explain critical accounting estimates. Don't just summarize the accounting policies already discussed in the financial statements.

We describe the SEC's interpretive release in more detail below. The full text of the interpretive release can be found at the SEC's website at http://www.sec.gov/rules/interp/33-8350.htm.

Presentation of MD&A

The release emphasizes that MD&A should be presented in a clear and understandable manner, with "a strong focus on the most important information". Specifically, the SEC encourages companies to consider the following suggestions:

- *Tables*. Use tables to present relevant information. For example, a tabular comparison of results for different periods followed by a narrative discussion and analysis of known changes, events, trends, uncertainties, and other matters may be preferable to a narrative comparison (e.g., "sales increased __%, from __ to __").
- *Headings*. Consider whether headings actually assist readers, and whether different or additional headings would be helpful.
- *Overview*. Consider including an introduction or overview - an "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. For example, the introduction might include a discussion of:
  - economic or industry-wide factors;
  - information on how the company earns revenues and income and generates cash;

  - the company's lines of business, locations, and principal products and services; and
  - insight into material opportunities, challenges and risks, both short- and long-term, as well as actions being taken to address them.
- *"Layered" approach.* Consider using a "layered" approach to emphasize the most important material information. For example, consider beginning a section containing detailed analysis with a "statement of principal factors, trends or other matters that are principal subjects" covered.
- *Prospective information.* The discussion throughout should include both past performance and financial condition information, and prospective information which would promote investor understanding.

Content and Focus of MD&A

As discussed above, one of the most important improvements to MD&A suggested by the release is to emphasize material information and de-emphasize (or delete, where appropriate) immaterial information that is not required or does not further an investor's understanding of the company. In particular, the SEC provided the following guidance:

- *Focus on key financial and non-financial indicators.* Companies should identify and discuss the key variables and other factors that are particularly necessary for an understanding and evaluation of the company, including:
  - Financial measures that management uses to manage the business; and
  - Non-financial variables and information beyond financial statement measures, including macroeconomic, industry-specific, and company-specific factors.
    - For example, interest rates, economic growth rates, and industry metrics
- *Consider the materiality of information in other disclosures.* Companies should consider whether information contained in other documents, such as press releases, analyst calls and the company's website, should be included in MD&A.
- *Omit stale information.* The MD&A should reduce or omit discussion of issues presented in prior periods where no longer material or helpful, or revise the disclosure to make its continuing relevance apparent.
- *Focus on known material trends and uncertainties.* One of the principal objectives of MD&A is to provide information about the quality and variability of the company's earnings and cash flows so that readers can consider to what extent historical results are indicative of future performance. A discussion and analysis of known material trends, demands, commitments, events, and uncertainties is required to be provided in the MD&A. Prior SEC MD&A guidance has emphasized that 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. MD&A requires not only a discussion of material trends, etc., but also an analysis exploring the underlying reasons or implications.

Liquidity and Capital Resources

With respect to the discussion and analysis of liquidity and capital resources, the SEC suggests:

- *Consider both short-term and long-term cash requirements.* Companies should evaluate their ability to meet cash requirements over both short (12 months or less) and long terms. Matters that may warrant discussion include:
  - funds necessary to maintain current operations, complete pending projects and achieve "stated objectives or plans";
  - commitments for capital or other expenditures; and

    - reasonably likely exposure to future cash requirements associated with known trends or uncertainties (and the time periods in which resolution is anticipated).

- *Start with the contractual obligations table.* The SEC has suggested that a starting point for discussion and analysis of cash requirements is the now-required table of contractual obligations, supplemented with additional information material to understanding the cash requirements.

- *Discuss cash resources.* Discussion and analysis of cash flows should include resources available to meet cash requirements, as well as the effect of an inability to access the cash flow and financial assets of any consolidated entities.

- *Discuss material covenants.* Companies should consider whether discussion and analysis of material debt covenants may be required in "at least" the following scenarios:

    - where breach is reasonably likely (including discussion of the impact on the company); and

    - where such covenants are reasonably likely to materially limit the company's ability to undertake financing (as well as the consequences of the limitation to the company's financial condition and operating performance).[1]

  Companies should also consider whether discussion and analysis may be required regarding alternative sources of funding and material consequences of accessing them.

- *Focus on known trends here also.* Companies should describe known material trends or uncertainties relating to "determining when and how to use their cash resources to satisfy obligations and make other capital expenditures".

Critical Accounting Estimates

In the release, the SEC continues its emphasis of the need to provide disclosure about critical accounting estimates or assumptions in MD&A 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". Guidance in the release emphasizes:

- *Don't just repeat the financial statement footnotes.* Disclosures should supplement, not duplicate, disclosures in the notes to the financial statements, and should 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.

    - The discussion and analysis should include why the accounting estimates or assumptions are sensitive to change, 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.

- *Quantification of sensitivity.* The Staff has informally confirmed that the rules and guidance regarding critical accounting policies proposed in 2002 were superseded by the MD&A guidance issued in this release, and that the Staff would not be issuing further guidance to require the quantification of the impact of changes in critical accounting policies. However, the release does state that companies should provide quantitative information to the extent that it is "reasonably available" and will provide material information to investors.

Contact Information

If you have any questions or would like to learn more about these rules, please contact your usual legal advisor at Ropes & Gray.

[1] While the release may be read as limiting required disclosure on covenants to such instances, in a number of comment letters the SEC has requested that clients include other disclosures, including certain ratios and compliance status at the end of the quarter.