

## **Client Advisory**

February 2004

# SEC Issues Interpretive Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations

The Securities and Exchange Commission (SEC) recently issued interpretive guidance regarding Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A). The SEC was careful to note that it was not modifying any existing disclosure requirements or creating any new legal requirements. Instead, the guidance was intended to assist companies in preparing MD&A disclosure that is easier to follow and understand, and to assist in providing information that more completely satisfies the objectives of MD&A (as described in the next paragraph). Because the SEC has indicated that future MD&A review by the Division of Corporation Finance will consider whether companies are following this guidance, we think that public companies should revisit their MD&A disclosure with an eye toward incorporating the SEC's advice. The interpretive release (Release Nos. 33-8350; 34-48960; FR-72) is available on the SEC's Web site at <http://www.sec.gov/rules/interp/33-8350.htm>.

## **Principal Objectives of MD&A**

In considering the impact of the SEC's guidance on a company's MD&A disclosure, that company's review should be informed by the principal objectives of MD&A disclosure, which the SEC considers to be:

- providing a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management;
- enhancing the overall financial disclosure and providing the context within which financial information should be analyzed; and
- providing 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.

## **Improving MD&A Disclosure**

As a starting point for this re-evaluation of MD&A disclosure, the SEC has identified several areas where more specific guidance could be helpful:

- 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.

Consistent with the goal of producing MD&A disclosure that is informative and transparent, the SEC offers specific guidance with respect to each of the areas listed above.

### **Presentation**

The SEC believes that companies can improve the clarity of their MD&A by using language that is less convoluted. Many companies could improve their MD&A disclosure by adding an introductory section that provides a balanced discussion of the matters that management considers in evaluating the financial condition and operating performance of the company. Such an introduction might include industry-wide (or broader economic) factors relevant to the company, or the potential impact of known material trends and uncertainties. Because these factors would change from time to time, a good introductory section would also require periodic updating. Additional suggestions that may lead to more understandable MD&A disclosure would include:

- inserting additional paragraph headings;
- using a tabular presentation of relevant information, such as results of operations in different periods; and
- discussing forward-looking information where it will promote investors' understanding of the company.

### **Focus and Content**

The SEC believes that many companies could improve their MD&A by focusing on the most important information. While this may seem painfully obvious, we believe that the guidance reflects a tendency on the part of some companies to overload their shareholders with unnecessary and confusing information. In an effort to encourage companies to consider whether their MD&A disclosure promotes an understanding of that company's financial condition, the SEC has offered a number of suggestions. Some of the more notable comments included advice that companies should:

- consider whether all key variables (including non-financial data) that management uses to manage the business would be material to investors and should therefore be disclosed;
- provide a balanced view of the underlying dynamics of the business, including not only company successes, but also unrealized goals;
- 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;
- keep in mind that not all forward-looking disclosure is optional and may be required where such information is necessary to allow a reader to see the business through the eyes of management; and
- provide analysis that reveals underlying material causes of the matters described in MD&A (for example, 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).

Most importantly, however, MD&A should focus on an analysis explaining management's view of the implications and significance of the company's financial results and should not be a restatement of a company's financial statements in narrative form.

## **Liquidity and Capital Resources**

With respect to liquidity and capital resources disclosure, the SEC has noted its disapproval of the common practice of using boilerplate language to indicate that a company has adequate resources to meet its cash requirements. Instead, the SEC has suggested that companies should address the funds necessary to maintain current operations, complete in-process projects and satisfy commitments for capital expenditures. The SEC has also recommended that companies should discuss any material difficulties involved in assessing the potential impact of uncertain events on cash requirements and liquidity. For example, if failure to meet financial covenants in a loan agreement could trigger a reduction or elimination of the facility as a capital resource, disclosure of the applicable financial test may be required.

The SEC has further suggested that companies should consider whether disclosure rules necessitate expanding MD&A disclosure to address cash requirements and cash sources by its reportable segments. This suggestion would be clearly inapplicable to many companies. However, a company's operations, financing activities or corporate structure may render traditional MD&A disclosure inadequate. For these companies, the SEC's guidance in this area could create new reporting obligations.

## **Critical Accounting Estimates**

With its current guidance, the SEC is steering companies beyond rote summarizations of the description of accounting policies that is already included in the notes to the financial statements. Instead, the SEC is suggesting that MD&A disclosure should present a company's analysis of the uncertainties involved in applying a critical accounting estimate. Factors to consider in this analysis might include how the estimate was reached, the historical accuracy of the estimate or whether the estimate is reasonably likely to change in the future. While analysis will necessarily vary from company to company, such disclosure should provide greater insight into the quality of a particular company's financial condition and operating performance.

## **Conclusion**

With this release, the SEC intended to provide interpretive guidance and, in some cases, to provide additional guidance in previously addressed areas (for example, critical accounting policies (Release No. 33-8040); interpretive guidance on certain MD&A topics (Release No. 33-8056); additional MD&A disclosure requirements (Release Nos. 33-8098 and 33-8182) which releases can be found on the SEC's Web site at <http://www.sec.gov/>). It is important to remember that the SEC did not adopt any formal new rules in the area of MD&A; however, because future MD&A disclosure will be reviewed by the Division of Corporation Finance according to the principles discussed in this interpretive release and other releases cited therein, companies would be well advised to revisit their MD&A disclosure with this release in mind. Management of public companies should consult with outside legal counsel and independent accountants regarding the application of the principles articulated in this release to their particular situation. If it is determined that additional information should be provided, the companies and their advisors should work to present the information in an understandable and meaningful manner.

## **We Can Help**

Katten Muchin Zavis Rosenman is prepared to assist companies in understanding and using this guidance to enhance their MD&A disclosure. If you have any questions regarding these issues or if you wish to be on our distribution list for future Client Advisories on other securities topics, please contact:

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