

Corporate Finance Alert

January 6, 2004

SEC Issues New MD&A Guidance

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In late December, the Securities and Exchange Commission (the "Commission") published new comprehensive guidance regarding the preparation of management's discussion and analysis of financial condition and results of operations ("MD&A"). The new guidance became effective on December 29, 2003. This release (the "Release") is the latest in a long series of Commission interpretive and other releases designed to enhance the quality of MD&A disclosure.

The Commission reiterates in the Release that the purpose of the MD&A is to provide investors with information "necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations." In the Release, the Commission reiterates that the principal objectives of MD&A disclosure are:

- "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."

General Suggestions

The Release indicates that, as a result of a combination of the Commission's rules and investor demands, MD&A disclosures have become increasingly lengthy, difficult to understand and confusing. In an attempt to elicit more meaningful MD&A disclosure and to eliminate or at least limit formulaic responses to MD&A disclosure requirements, the Commission has made a number of general suggestions. These suggestions include: using an introductory paragraph to provide an executive summary that provides context for the MD&A disclosure; the use of tabular information in MD&A where appropriate; the ordering of disclosures based on materiality; and the elimination of immaterial and duplicative information. The Commission also encourages companies to simplify MD&A disclosure in an effort to make it clearer and more concise and to avoid generic or boilerplate disclosure.

The Release addresses a number of perceived deficiencies in the content and focus of existing MD&A disclosure, and contains suggestions for improving different areas of this disclosure.

Focus on Key Indicators of Financial Condition and Operating Performance

The Release discusses the need to describe key indicators of financial condition and operating performance. While most of these key variables will be financial, the Release cautions that such financial measures are only a starting point and that companies should consider the disclosure of all material factors, financial and other, that management uses to manage the business. Examples of such non-financial variables include manufacturing plant capacity, general interest rate trends and economic growth rates, industry metrics and “value drivers”.

In addition, the Commission reminds companies to review disclosures made outside their required reports (for example, press releases) to evaluate whether some of those disclosures should be included in MD&A. The Release also indicates that information should be presented in a manner designed to be informative to the reader, and that it is not necessary that information follow the order set out in the regulations respecting MD&A requirements.

The Release points out that dramatic changes in information technology have occurred since MD&A rules were first adopted, and suggests that companies should evaluate their enhanced information to determine if additional or perhaps different information should be included in MD&A. However, such information should be included only to the extent that it promotes a better understanding of a company’s condition or operations.

The Release cautions companies to provide a balanced view of the underlying dynamics of the

business by including not only a description of successes but also of instances where a company has failed to achieve a goal, to the extent material.

Focus on Materiality

With respect to materiality, the Release contains a reminder that disclosure in the 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 of future financial condition.” Where necessary to a material understanding of consolidated information, the Commission encourages companies to include segment discussion and analysis.

In addition, when preparing MD&A disclosure in quarterly reports, companies must consider the materiality of information from prior annual and quarterly reports in constructing MD&A disclosure in the current quarterly report. The Release clarifies that with respect to material changes to MD&A disclosure contained in annual reports, the discussion of the changes should be included in the quarterly report for the quarter in which the change occurs. However, where the disclosure from a prior report remains adequate, a company may not need to repeat MD&A disclosure in a subsequent quarterly report.

Known Trends and Uncertainties

The Commission provides additional guidance on the requirement that companies discuss known trends and uncertainties. The Release reiterates the general principle 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 that such trend, uncertainty or other event will not have a material effect on the company's liquidity, capital resources or results of operations. The Release indicates that quantitative disclosure of the material effects of known trends and uncertainties may be required to the extent material.

Focus on Analysis

The Release emphasizes the need for companies to provide not only a discussion, but also an analysis, of material trends and uncertainties. Accordingly, disclosures may need to include an analysis of underlying reasons or implications, interrelationships between constituent elements and other matters. The Release uses the example of a company that reports materially lower revenues resulting from a decline in the volume of products sold. According to the Release, MD&A should not only identify the decline in sales, but should also analyze the reasons underlying the decline to the extent material and determinable. Other examples of events that may necessitate further analysis include a decline in sales resulting from manufacturing difficulties, a decline in quality, loss of competitive position or market share and other factors. In addition, when a company reports material restructuring or impairment charges, MD&A should also, where material, analyze the reasons underlying these matters, such as an inability to realize projected economies of scale or other factors. If events or transactions reflect material unusual or nonrecurring items, aberrations or other significant fluctuations, companies should consider the extent of the

variability in earnings and cash flow and provide disclosure where necessary.

Liquidity and Capital Resources

The Release specifically addresses MD&A requirements applicable to the discussion of liquidity and capital resources. A company is required to include the following information in MD&A, to the extent material:

- historical information regarding sources of cash and capital expenditures;
- an evaluation of the amounts and certainty of cash flows;
- the existence and timing of commitments for capital expenditures and other known and reasonably likely cash requirements;
- discussion and analysis of known trends and uncertainties;
- a description of expected changes in the mix and relative cost of capital resources;
- indications of which balance sheet or income or cash flow items should be considered in assessing liquidity; and
- a discussion of prospective information regarding companies' sources of and needs for capital, except where otherwise clear from the discussion.

The Release provides that companies need to assess their ability to meet their cash flow needs both for the next 12 months and for longer periods of time. The Release indicates that a statement that a company has sufficient cash to meet its short-term and/or long-term cash requirements is insufficient if there are any known trends or uncertainties related to cash flow, capital resources, capital requirements or liquidity.

Cash

With respect to identifying cash requirements, the Release recommends that companies consider whether the following would have a material effect on liquidity:

- funds necessary to maintain current operations, complete projects underway and achieve stated objectives or plans;
- commitments for capital and 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.

As an example, the Release indicates that a company that has incurred material debt should explain the reason(s) for incurring the debt and the use of the proceeds, and should analyze how that incurrence of debt fits into the company's overall business plan. Where debt has been incurred for working capital purposes, the anticipated amount and timing of working capital needs should be discussed, if material. The Release also suggests that companies consider using tabular formats to disclose contractual obligations, if doing so would promote understanding.

Sources and Uses of Cash

With respect to sources and uses of cash, the Release indicates that "a mere recitation of changes and other information evident to readers from the financial statements" is not satisfactory. Rather, companies should analyze and discuss any material variability in cash flows generated and used and to

address material changes in the underlying drivers. The Release cites as an example a company that reports an increase in working capital other than cash. The Release indicates that if the increase in working capital is attributable not to an increase in sales, but rather to extended credit terms, those facts would need to be addressed in MD&A to the extent material, along with the effect of the change in cash provided by operations. If a company reports negative cash flows from operations, MD&A should clearly identify this condition, discuss the operational reasons for the condition and explain how the company intends to meet its cash requirements and maintain its operations. If the company relies on external financing, disclosure of that fact and the company's assessment of whether this financing will continue to be available and on what terms may be required. If a company is unable to access the cash flow or financial assets of a consolidated subsidiary, perhaps because of voting or legal restrictions, that fact and its effect should also be discussed.

The Release makes clear that a company must provide disclosure regarding its historical financing arrangements and their importance to cash flows. To the extent material, a company's MD&A should include an analysis of:

- its external debt financing;
- its use of off-balance sheet financing;
- the use of derivatives;
- the use of stock as a form of liquidity; and
- the potential impact of known or reasonably likely changes in credit ratings or credit outlook.

For example, where a company has decided to raise or seeks to raise material external equity or debt financing, or if it is reasonably likely to do so in the future, discussion and analysis of the amounts or ranges involved, the nature and terms of the financing, other terms of the financing and plans, and the effect on the company's cash position and liquidity (as well as results of operations where interest payments are involved) may be required. The Release indicates that the Commission believes these disclosures can be made without the potential for gun-jumping problems under the Securities Act.

Debt Instruments and Related Matters

The Release states that companies should consider including a discussion of material covenants relating to outstanding debt in MD&A in two scenarios:

First, companies that are, or are reasonably likely to be, in breach of such covenants must disclose material information about that breach and analyze the effect on the company if material. That analysis should include, if applicable and material:

- the steps the company is taking to avoid the breach;
- the steps that the company intends to take to cure, obtain a waiver of or otherwise address the breach;
- the impact or reasonably likely impact of the breach (including the effects of cross-default and cross-acceleration provisions) on financial condition or operating performance; and

- alternative sources of funding to pay off resulting obligations or replace funding.

Second, the Release cautions companies to consider the effect of debt covenants on their ability to undertake additional debt or equity financing. This warning applies even in instances when companies are not in, and are not reasonably likely to be in, breach of covenants. If debt covenants limit, or are reasonably likely to limit, a company's ability to undertake additional financing, disclosure may be required of the covenants and the consequences thereof on the company's financial condition and operating performance.

Cash Management

The Release specifies that MD&A should also consider known trends or uncertainties regarding the expenditure of cash. For example, a decision by a company in a highly capital-intensive business to curtail spending may result in long-term effects that should be disclosed if material. Such effects could include higher future repair and maintenance expenses or a higher cost base. Although not highlighted by the Release, such effects could presumably also include a diminished ability to compete and the risk of product obsolescence.

Critical Accounting Estimates

The Release states that companies should address in MD&A material implications of uncertainties associated with the methods, assumptions and estimates underlying critical

accounting measurements. Although the Commission has proposed rule changes in this area which are not yet effective, when preparing MD&A under the existing rules, companies should consider whether they have made estimates or assumptions 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; and
- the impact of the estimates and assumptions on financial condition or operating performance is material.

According to the Release, a company should address specifically why its accounting estimates or assumptions bear risks of change. Further, companies should address the identified critical estimates and assumptions by analyzing, if material, factors such as how the estimate or assumption was arrived at, how accurate the estimate or assumption has been in the past, how much the estimate or assumption has changed in the past and how likely it is that the estimate or assumption will change in the future. *This disclosure should supplement and not duplicate the description of accounting policies disclosed in the notes to the financial statements.*

As an example, the Release indicates that 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 effect that could result given a range of reasonably likely outcomes should be disclosed and quantified.

Clients having questions regarding the effects of the Release on their MD&A are urged to contact the Lowenstein Sandler attorneys with whom they work. In addition, questions can be directed to John D. Hogoboom at (973) 597-2382 or jhogoboom@lowenstein.com, or Jeffrey M. Shapiro at (973) 597-2470 or jshapiro@lowenstein.com.