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CORPORATE GOVERNANCE ALERT

On December 19, 2003, the Securities and Exchange Commission (the SEC) published interpretive guidance regarding the disclosure known as Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A). Generally, the SEC recommends that reporting companies:

- include a plain English executive summary that describes the most important matters on which the company's executives focus in evaluating financial condition and operating performance
- provide line-by-line comparisons of changes to the income statement in tabular rather than narrative form and limit narrative discussion to those changes that are most material
- assess whether certain information that may not be set forth in the SEC regulations may, nevertheless, be material and therefore necessary to disclose, e.g., certain non-financial information
- review and revise current disclosure to focus on and highlight material information and omit immaterial information that does not contribute to an understanding of the company's financial condition
- provide adequate analysis of the discussion presented so that the reader understands the reasons behind and implications of such discussion
- in the company's liquidity section, discuss those factors that may not be apparent from the face of the financial statements, e.g., impact of the company's business plan or agreements on cash flow and financing
- highlight and discuss any material financial information that is the result of changes in accounting treatment/calculations rather than changes in the company's operations
- make sure the company's discussion of critical accounting policies does not merely repeat the summary of accounting policies from the financial statements, but rather focuses on 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 following is a more detailed analysis of the SEC's guidance.

OVERALL APPROACH TO MD&A

The MD&A requirements are 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
- 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.

MD&A should not be a recitation of financial statements in narrative form or an otherwise uninformative series of technical responses to MD&A requirements.

THE PRESENTATION OF MD&A

Executive Summary

The MD&A should begin with a plain English, high-level executive summary that will provide a context for the remainder of the MD&A. The executive summary should include the most important matters on which a company's executives focus in evaluating financial condition and operating performance, but should not be a duplicative layer of disclosure that merely repeats the more detailed discussion and analysis that follows. A good introduction or overview should:

- include economic or industry-wide factors relevant to the company
- serve to inform the reader about how the company earns revenues and income and generates cash
- to the extent necessary or useful to convey this information, discuss the company's lines of business, location or locations of operations, and principal products and services (but not merely duplicate disclosure in the Description of Business section), and
- provide insight into material opportunities, challenges and risks, such as those presented by known material trends and uncertainties, on which the company's executives are most focused for both the short and long term, as well as the actions they are taking to address these opportunities, challenges and risks.

Because these matters do not generally remain static from period to period, the introduction should change over time to remain current.

TIP: Use the overview to provide a plain English discussion of two or three of the big changes (e.g., higher/lower sales) that occurred in the past year and the reasons for such changes.

TIP: Consider including the company's executive summary in the company's earnings releases.

TIP: In order to safeguard against the appearance of "burying" material disclosure in the rest of the MD&A, consider referring the reader to more detailed discussions of certain key matters under the specific headings that follow in the MD&A. There is concern that an executive summary may trigger the application of the "buried facts" doctrine, i.e., that a court would deem certain material information not contained in the summary to be "buried" in the rest of the MD&A, thus obscuring the overall significance of such information and thereby making the MD&A false and misleading. It is important to note, however, that the SEC recognizes that an introduction or overview, by its very nature, cannot disclose everything and should not be considered by itself in determining whether a company has made full disclosure.

General Presentation

In order to engender better understanding, companies should prepare the MD&A with a strong focus on the most important information. In particular, companies should:

- within the universe of material information, present their disclosure so that the most important information is most prominent
- consider whether a tabular presentation of relevant financial or other information may help a reader's understanding of MD&A
- consider whether the headings they use assist readers in understanding MD&A, and whether additional headings would be helpful
- consider using a "layered" approach to disclosure, e.g., begin a section containing detailed analysis with a statement of the principal factors, trends or other matters that are the principal subjects covered in the section.

TIP: Precede the MD&A analysis with two tables, one showing year-to-year percentage changes in each line item from the income statement for the past three years and the other breaking down by percentages all of the components of the company's revenues. For the analysis that follows, the company should set a materiality threshold and discuss only those changes or components from the tables that exceed such threshold.

THE CONTENT AND FOCUS OF MD&A

In addition to enhancing MD&A through the use of clearer language and presentation, many companies could improve their MD&A by focusing on the most important information disclosed in MD&A. Disclosure should avoid unnecessary duplicative disclosure, emphasize material information and de-emphasize (or, if appropriate, delete) immaterial information that is not required and does not promote understanding.

Include Non-financial Information

Companies should consider whether disclosure of certain non-financial information used by management to manage the business would be material to investors, and therefore required. Such information may include:

- external or macro-economic matters, e.g., interest rates or economic growth rates and their anticipated trends

- industry-specific measures (note: where there is no commonly accepted method of calculating a particular non-financial metric, the company should provide an explanation of its calculation to promote comparability across companies within the industry)
- company-specific matters.

TIP: If an investor is likely to become aware, whether through traditional news outlets or otherwise, of a significant development that such investor is likely to believe would have an impact on the company, e.g., a change in oil prices for a petroleum company, then the company should address such matter in the executive summary.

TIP: If companies disclose material information (historical or forward-looking) other than in their filed documents (such as in earnings releases or publicly accessible analysts' calls or companion Web site postings), they should consider their communications and determine what information is material and is required in, or would promote understanding of, MD&A.

Focus on Materiality

Companies must provide specified material information in their MD&A, as well as other material information that is necessary to make the required statements — in light of the circumstances in which they are made — not misleading. However, the effectiveness of MD&A decreases with the accumulation of unnecessary detail or duplicative or uninformative disclosure that obscures material information. Companies should evaluate whether there is information in their MD&A that is no longer material or useful and therefore should be deleted, e.g., where there has been a change in their business or the information has become stale.

TIP: By taking the tabular approach to changes in line items followed by analysis of only material changes, as discussed above, companies can eliminate duplicative and immaterial disclosure common in most companies' current presentation of such changes.

Focus on Material Trends and Uncertainties

One of the most important elements necessary to an understanding of a company's performance, and to the extent to which reported financial information is indicative of future results, is the discussion and analysis of known trends, demands, commitments, events and uncertainties, which generally should involve:

- consideration of financial, operational and other information known to the company
- identification, based on this information, of known trends and uncertainties
- 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.

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.

TIP: Quantification of the material effects of known material trends and uncertainties should be considered — and may be required to the extent material — if quantitative information is reasonably available.

Focus on Analysis

MD&A requires not only a "discussion" but also an "analysis" of known material trends, events, demands, commitments and uncertainties that explains the underlying reasons or implications, interrelationships between constituent elements or the relative significance of those matters.

Identifying the intermediate effects of trends, events, demands, commitments and uncertainties alone, without describing the reasons underlying these effects, may not provide sufficient insight for a reader to see the business through the eyes of management. For example, if a company's financial statements reflect materially lower revenues resulting from a decline in the volume of products sold, MD&A should not only identify the decline, but also should analyze any material and determinable reasons underlying it, including, if applicable, difficulties in manufacturing, a decline in quality, loss in competitive position or a combination of conditions.

If there is a reasonable likelihood that reported financial information is not indicative of a company's future financial condition or future operating performance due, for example, to the levels of subjectivity and judgment necessary to account for highly uncertain matters and the susceptibility of such matters to change, appropriate disclosure in MD&A should be considered and 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 addition, if events and transactions reported in the financial statements reflect material unusual or non-recurring items, aberrations or other significant fluctuations, companies should consider the extent of variability in earnings and cash flow, and provide disclosure where necessary for investors to ascertain the likelihood that past performance is indicative of future performance. Companies also should consider whether the economic characteristics of any of their business arrangements, or the methods used to account for them, materially impact their results of operations or liquidity in a structured or unusual fashion, where disclosure would be necessary to understand the amounts depicted in their financial statements.

LIQUIDITY AND CAPITAL RESOURCES

Disclosure in the related categories of liquidity and capital resources is critical to an assessment of a company's prospects for the future and even the likelihood of its survival.

Cash Requirements

In determining required or appropriate disclosure, companies should evaluate separately their ability to meet upcoming cash requirements over both the short and long term. Merely stating that a company has adequate resources is insufficient unless no additional more detailed or nuanced information is material. In particular, such a statement would be insufficient if there are any known material trends or uncertainties related to cash flow, capital resources, capital requirements or liquidity. In order to identify known material cash requirements, companies should consider whether the following information would have a material impact on liquidity:

- funds necessary to maintain current operations, complete projects under way, and achieve stated objectives or plans
- commitments for capital or other expenditures
- 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.

One starting point for a company's discussion and analysis of cash requirements is the tabular disclosure of contractual obligations, supplemented with additional information that is material to an understanding of the company's cash requirements. For example, if a company has incurred debt in material amounts, it should explain the reasons for doing so, the use of the proceeds and how the incurrence of that debt fits into the overall business plan, in each case to the extent material. Where debt has been incurred for general working capital purposes, the anticipated amount and timing of working capital needs should be discussed, to the extent material.

Companies should address, where material, the difficulties involved in assessing the effect of the amount and timing of uncertain events, such as loss contingencies, on cash requirements and liquidity. Any such discussion should be specific to the circumstances and informative, and companies should avoid generic or boilerplate disclosure.

Sources and Uses of Cash

A company's discussion and analysis of cash flows should not be a mere recitation of changes and other information evident to readers from the financial statements. In addition to explaining how the cash requirements identified in MD&A fit into a company's overall business plan, the company should focus on the resources available to satisfy those cash requirements. Where there has been material variability in historical cash flows, MD&A should focus on the underlying reasons for the changes, as well as on their reasonably likely impact on future cash flows and cash management decisions. 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.

Operations

The discussion and analysis of operating cash flows should address material changes in the underlying drivers (e.g., cash receipts from the sale of goods and services and cash payments to acquire materials for manufacture or goods for resale) rather than merely describe items identified on the face of the statement of cash flows, such as the reconciling items used in the indirect method of presenting cash flows. For example, consider a company that reports an overall increase in the components of its working capital 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 net cash provided by operations in the current period, 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. If the company reports negative cash flows from operations, the disclosure provided in MD&A should identify clearly this condition, discuss the operational reasons for the condition if material, and explain how the company intends to meet its cash requirements and maintain operations. If the company relies on external financing in these situations, disclosure of that fact and the company's assessment of whether this financing will continue to be available, and on what terms, should be considered and may be required.

A company should consider whether, in order to make required disclosures, it is 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, as well as the indicative nature of those results. A company also should discuss the effect of an inability to access the cash flow and financial assets of any consolidated entities. For example, an entity may be consolidated but, because the company lacks sufficient voting interests or the assets are legally isolated, the company may be unable to utilize the entity's cash flow, cash on hand or other assets to satisfy its own liquidity needs.

Financing

If material, a company must provide disclosure regarding its historical financing arrangements and their importance to cash flows, including material information that is not included in the financial statements. A company should discuss and analyze, to the extent material:

- its external debt financing
- its use of off-balance-sheet financing arrangements
- its issuance or purchase of derivative instruments linked to its stock
- its use of stock as a form of liquidity
- the potential impact of known or reasonably likely changes in credit ratings or ratings outlook (or inability to achieve changes).

In addition to these historical items, companies should consider including (and may be required to include) discussion and analysis of the types of financing that are, or that are reasonably likely to be, available (or of the types of financing that a company would want to use but that are, or are reasonably likely to be, unavailable) and the impact on the company's cash position and liquidity.

Debt Instruments, Guarantees and Related Covenants

There are at least two scenarios in which companies should provide discussion and analysis of material covenants related to their outstanding debt (or relating to guarantees or other contingent obligations):

- if a company is, or is reasonably likely to be, in breach of these covenants such that there will be a material impact on the company
- if these covenants limit, or are reasonably likely to limit, a company's ability to undertake additional debt or equity financing to a material extent. Companies should consider disclosing (and they may be required to do so) alternative sources of funding and the material consequences (including the cost) of accessing them.

Cash Management

Because companies generally have some degree of flexibility in determining when and how to use their cash resources, MD&A should describe known material trends or uncertainties relating to such determinations. For example, a decision by a company in a highly capital-intensive business to spend significantly less on plant and equipment than it has spent historically may result in material long-term effects, such as more cash, less interest expense and lower depreciation, but higher future repair and maintenance expenses or a higher cost base.

CRITICAL ACCOUNTING ESTIMATES

Many 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. A company should address material implications of uncertainties associated with the methods, assumptions and estimates underlying the company's critical accounting measurements.

When preparing disclosure under the current requirements, companies should consider whether they have made accounting 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
- the impact of the estimates and assumptions on financial condition or operating performance is material.

If they have done so, companies should also provide disclosure about those critical accounting estimates or assumptions in their MD&A. Such disclosure should supplement, not duplicate, the description of accounting policies that are already disclosed in the notes to the financial statements. 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.

A company should address specifically why its accounting estimates or assumptions bear the risk of change. The reason may be that there is an uncertainty attached to the estimate or assumption, or it just may be difficult to measure or value. Equally important, companies should address, to the extent material, such factors as how they 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. Since critical accounting estimates and assumptions are based on matters that are highly uncertain, a company should analyze its specific sensitivity to change, based on other outcomes that are reasonably likely to occur and would have a material effect. Companies should provide quantitative as well as qualitative disclosure when quantitative information is reasonably available and will provide material information for investors.

GENERAL REQUIREMENTS

In addition to the guidance set forth in the SEC's recent release, the existing requirements of the MD&A rules still apply. In addition to the basic requirements, companies will also be expected to provide information regarding contractual obligations and contingent liabilities and commitments, related party transactions, off-balance-sheet transactions and trading activities involving fair value.

CONTACT INFORMATION

If you have any questions or would like to learn more about this topic, please contact the partner who normally represents you, or:

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