

SEC ISSUES GUIDANCE REGARDING MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Executive Summary

On December 22, 2003, the Securities and Exchange Commission ("SEC") published interpretive guidance regarding disclosure in Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). The guidance does not modify existing legal requirements or create new disclosure obligations. Rather, the examples and concepts presented below should be viewed as suggestions or best practices for improving MD&A disclosure. The guidance focuses on eliciting more meaningful disclosure in a number of areas, including:

- the overall presentation of MD&A;
- the focus of MD&A (including materiality, analysis, key performance measures and known material trends and uncertainties);
- analysis of liquidity and capital resources; and
- analysis of critical accounting estimates.

The SEC's interpretive guidance urges companies to reassess their approach to MD&A in light of the guidance provided in order to fulfill the three principal objectives of MD&A disclosure, which 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.

Although it contains no new legal requirements, this guidance is effective as of December 29, 2003. Companies should carefully review their most recent MD&A disclosures with reference to this guidance to identify those areas in which the SEC may focus its attention in the upcoming reporting season.

Overall Presentation of MD&A

Structure and Format of MD&A

As companies grow and become more complex, their MD&A disclosures may necessarily increase in size and scope. While this may provide important benefits for readers of financial statements, the SEC believes that too often MD&A is presented in a manner that is difficult to understand and unnecessarily lengthy. Companies may wish to consider improving the clarity and understandability of their MD&A by using language that is clearer and less convoluted. However, the new guidance is not intended to effect an oversimplification or “dumbing-down” of MD&A. Rather, companies should prepare MD&A with a focus on the most important information affecting the business, presented in a manner that addresses the objectives of MD&A described above.

More specifically, companies may wish to improve the presentation of their MD&A by doing the following:

- Consider whether a tabular presentation of relevant financial or other information may help a reader’s understanding of MD&A. For example, a company may wish to present comparisons of its results from different periods in a table, followed by a narrative discussion of known changes, events, trends, uncertainties and other matters.
- Consider whether more informative headings would be useful throughout MD&A to guide the reader.
- Use a “layered” disclosure approach, presenting information in a manner that emphasizes, within the universe of material information, the information and analysis that is most important to the company and is followed by explanatory detailed information.

Use of Introduction or Overview Section

An approach that receives significant attention in the interpretive release is the use of an introductory or overview section which highlights the most important matters facing the company. The release advises that a good introduction or overview would provide a balanced, executive-level discussion that identifies the most important themes or other significant matters with which management is concerned primarily in evaluating the company’s financial condition and its operating results. Such disclosure would serve to provide context for the reader in assessing the company’s remaining MD&A and other disclosure. Companies electing to use an introduction or overview should:

- Discuss economic or industry-wide factors relevant to the company;
- Inform the reader about the methods through which the company earns revenues and income and generates cash;
- Discuss the company’s lines of business, location of operations and principal products and services, to the extent necessary or helpful (however such a discussion should 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 and the actions they are taking to address these opportunities, challenges and risks.

When discussing this introductory section in speaking engagements the SEC staff has stated that companies should look to the “Letter from the President/CEO” in the annual report to shareholders as a starting point. The staff has also suggested it may be wise to explain what the company does before describing how it performed and a discussion of whether the company believed it had a good year and why. Companies should also think about the principal factors that drive the business, the types of reports that management focuses on to assess its business and whether that information is relevant to shareholders and investors, and what risks, trends or other factors “keep management up at night.” As a counseling point, it is important to keep in mind Regulation G and Item 10 of Regulation S-K regarding the use of non-GAAP financial measures.

The SEC recognizes companies are necessarily limited in the amount of information that they can provide in an introduction or overview section, and that such a section need not contain all material items affecting the company. Furthermore, it is not intended that the exclusion of a material item from the introduction would trigger liability under the “buried facts” doctrine, whereby disclosure may be considered misleading if important information is hidden in a footnote or an appendix.

Content and Focus of MD&A

A clear theme throughout the interpretive release is to focus MD&A disclosure on the most important information, both in considering the presentation and structure of MD&A and the specific content and focus of the disclosures. To further promote that objective, the SEC is encouraging companies to de-emphasize (or, if appropriate, delete) immaterial information that is not required and does not promote understanding of the company. When considering the content of MD&A, the SEC is urging companies to focus on the following concepts: (i) key indicators of financial condition and operating performance, (ii) materiality, (iii) material trends and uncertainties and (iv) analysis of the important events facing the company.

Focus on Key Indicators of Financial Condition and Operating Performance

The interpretive guidance emphasizes that companies may present non-financial measures, in addition to financial factors, in analyzing the business. Financial measures are commonly identified in MD&A, and companies should continue to include them. In addition, the inclusion of non-financial measures may provide investors a more complete picture of how a company manages its business. These non-financial measures may pertain to broad economic concepts, or may be specific to the company’s business or industry.

More important than the nature of the information is its importance to a reader’s understanding of the business. Because of the vast amount of information to which companies have access, care should be taken to identify those key performance indicators that best accomplish the objectives of MD&A.

Focus on Materiality

In its release, the SEC observed that the effectiveness of MD&A decreases with the accumulation of unnecessary detail or duplicative or uninformative disclosure that obscures material information. In this regard, companies should evaluate their MD&A disclosure with an eye toward identifying material that is no longer useful, and therefore should be deleted.

The SEC also notes that a detailed line-by-line discussion of changes in financial statement line items often results in the disclosure of immaterial information. Instead, companies should consider grouping line items or omitting discussions of items whose disclosure is not material and would not promote understanding of MD&A.

Focus on Material Trends and Uncertainties

The interpretive release reinforces the importance of presenting a discussion and analysis of known trends, demands, commitments, events and uncertainties, which should include an assessment of whether such items will have, or are reasonably likely to have, a material impact on the company’s liquidity, capital resources or results of operations. Disclosure of this nature allows investors to ascertain the likelihood that the company’s past performance is indicative of future performance.

Companies should be aware that the disclosures required to address known material trends and uncertainties in the discussion and analysis should not be confused with optional forward-looking information. Material forward-looking information regarding known material trends and uncertainties is required to be disclosed as part of the required discussion of those matters and the analysis of their effects.

Focus on Analysis

Beyond merely reciting financial statement information in narrative form, MD&A must also provide management’s analysis of known material trends and uncertainties. The required analysis should explain the underlying reasons or implications for the trend or uncertainty, the interrelationships between constituent elements, or the relative significance of those matters.

MD&A disclosure should provide investors the ability to see the company through the eyes of management, an objective that is facilitated by thoughtful analysis of the key factors affecting the company's business. Additionally, 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 appropriate MD&A disclosure should be made and may be required.

Liquidity and Capital Resources

Beyond the structure and content of MD&A generally, the SEC's interpretive guidance is also intended to improve companies' disclosures regarding liquidity and capital resources. Companies should focus on several aspects of liquidity and capital resources in preparing their disclosures, including (i) cash requirements, (ii) sources and uses of cash, (iii) debt instruments and related covenants and (iv) cash management.

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 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.

A company's discussion of the sources and uses of cash should focus not only on 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 change. The MD&A should concentrate on material changes in operating, investing and financing cash flows, as depicted in the statement of cash flows, and the reasons underlying those changes. However, this discussion should not merely be a recitation of changes evident to readers from the financial statements. Instead, companies should discuss and analyze the important factors behind the changes in financial statement items to provide the reader the opportunity to assess the significance of these factors.

Companies that have outstanding debt containing material covenants may be required to present MD&A disclosure related to such debt. For example, companies which are, or are reasonably likely to be, in breach of material covenants must disclose material information about the breach and analyze the impact on the company if material. In addition, companies should consider the impact of debt covenants on their ability to undertake additional debt or equity financing. If these covenants impose material limitations on the company's ability to obtain additional financing, the company should present a discussion of the covenants.

Finally, with respect to cash management, companies should describe known material trends or uncertainties related to decisions on when and how to use their cash resources to satisfy obligations and make other capital expenditures. The SEC provides the example that a decision by a company in a highly capital-intensive business to spend significantly less on plant and equipment than it has historically may result in long term effects that should be disclosed in MD&A if material.

Critical Accounting Estimates

In May, 2002, the SEC proposed rules, which have not yet been finalized, that would broaden the scope of the disclosure requirements regarding the methods, assumptions and estimates underlying the company's critical accounting policies. The SEC has clarified that disclosure regarding critical accounting policies and estimates should supplement, not duplicate, the description of accounting policies that is already disclosed in the notes to the financial statements. More specifically, the disclosure should provide greater insight into the quality and variability of information regarding financial condition and operating performance, addressing why the company's accounting estimates may bear a risk of future variation and their sensitivity to change. Companies should provide quantitative information when it is reasonably available and will provide material information to shareholders and investors.

Is further MD&A rulemaking likely?

The SEC has stated it will continue to closely monitor the MD&A disclosure submitted after this guidance and consider the need for appropriate action, such as rulemaking, if the guidance is not adhered to.

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