

The SEC's New MD&A Interpretive Release

The SEC has again spoken on the state of management's discussion and analysis (MD&A) disclosure and, to use a political analogy, has told us that the state of this disclosure is not strong. A new interpretive release, which was issued on December 19, 2003 (Release No. 33-8350, <http://www.sec.gov/rules/interp/33-8350.htm>), is the fourth of its kind addressing MD&A since the adoption of the present disclosure requirements in 1980, and the second in the last 12 months.

The release states that it does not modify existing legal requirements or create new ones. Instead, it is couched as guidance to assist registrants in preparing disclosure that "more completely satisfies" the SEC's previous MD&A guidance and the formal rules that govern this area. It is fair, in reality, to hear this as a clear message from the SEC that the quality of MD&A disclosure needs to improve. This is a continuation of the theme sounded by the SEC and its staff following completion of the review of periodic reports of the Fortune 500 in 2002, where MD&A disclosure shortcomings drew the majority of comments.

The timing of the release is by no means accidental. As many public companies enter this first season of accelerated periodic reporting, the SEC wants to make its expectations, and dissatisfaction, clear. To that end, the release notes that the Division of Corporation Finance will continue to focus on reviewing MD&A and will "take action as appropriate." These messages have been repeatedly delivered by the staff of the SEC in public remarks since the publication of the release. We expect the staff actively to review MD&A disclosure during 2004, whether by reviewing 10-Ks after filing or by selecting registration statements for at least limited reviews.

So what is an issuer to do? The SEC's short answer would be to take the release seriously and focus more closely on the quality of one's MD&A. Many issuers already do so and produce disclosure that will fare well in any staff review. The following recommendations, each taken from the release, are indicative of the issues that appear to be at the top of the SEC's list at this time:

- **Senior Management Involvement.** Senior management needs actively to participate in the preparation of the MD&A. This does not mean that the CFO must participate in the precise drafting, but he or she, along with other members of senior management, do need to be involved, at an early stage, in determining the general themes that merit emphasis in the MD&A. Senior management should also remain engaged in reviewing the product as it evolves.
- **Excise, Don't Just Add.** Do not permit the MD&A to accrete from year to year. Focus as much on deleting material that is no longer relevant, or shortening material that is less relevant than it was last year, as on the addition of new material. It is far easier for each year's new material to embed itself into subsequent filings, resulting in overly long and disjointed disclosure.
- **Focus on Materiality.** The release repeatedly refers to MD&A as having grown unduly repetitive and dense. The SEC reminds us early in the release that the purpose of MD&A is not complicated. Even if the material being disclosed is complicated, companies are charged with winnowing this down (as opposed to dumbing it down) to disclosure that is clear and concise.

- **Use Formatting to Assist.** The SEC suggests providing tables to compare and contrast financial results and using headings to help guide the reader through the disclosure. And, in what is arguably a significant change from prior interpretations, the SEC has suggested that companies consider whether an introductory overview would be useful. More about this below.
- **Analyze, Don't Recite.** The SEC points out that too often, MD&A consists of simplistic repetition of facts in more or less the same form as they are presented in the financial statements. Examples include verbatim repetition of the accounting policies footnote, or simple recitation of changes in immaterial line items of the financial statements. Instead, companies should analyze the results and focus on the key variables and other factors and themes that underlie their financial performance.
- **Address Trends and Uncertainties.** MD&A requires analysis of the trends and uncertainties that may affect the company's financial performance. Given recent experiences of issuers inadequately addressing the true nature of their financial results, we expect the staff to pay particularly close attention to disclosure regarding the extent to which past performance on an income or cash flow basis is indicative of future results. This calls for forward-looking disclosure, which the release makes clear is expected and, in certain instances, required.

Of course, the irony in the SEC's pleas for simplicity and conciseness is that the increased complexity of recent MD&A is in no small part a result of new SEC rules and interpretations. Moreover, increasing complexity of the accounting literature and new accounting developments require presentation of complicated themes. Recently adopted rules regarding disclosure of contractual obligations and off-balance sheet arrangements, for instance, may thwart genuine efforts to produce brief, easily understandable disclosures.

There is substantive guidance provided in the release that is noteworthy:

- **MD&A Overview.** Perhaps at the top of this list, the SEC suggests that an overview to the MD&A may be useful. By specifically countenancing this, the SEC has taken a position in the debate over the merits of MD&A overviews. There has been a view that these are at best dangerous (in that they encourage readers to not read the entire MD&A) and at worst not permitted under SEC rules. The contrary view has been that if properly worded, an overview does not necessarily run the risk of suppressing the disclosures that follow, and no explicit rule permitting summaries or overviews is required if one would enhance the quality of the overall disclosure. The SEC has firmly aligned itself with this latter view.
- **Liquidity and Capital Resources.** Disclosure on these topics remains an area of persistent weakness, in the staff's view. The release states that merely disclosing that a company has adequate resources to meet short- and long-term cash requirements may very well be insufficient disclosure, as in many if not most cases there is detail lurking beneath this conclusion that merits separate analysis in the disclosure.
- **Restrictive Covenants.** The impact of restrictive covenants in financing instruments may merit heightened MD&A disclosure, particularly for issuers with ratings levels that result in more complicated covenant packages. These issuers should focus carefully on whether additional

disclosure regarding the actual and potential impact of these restrictions is appropriate.

- **Quarterly MD&A Need Not Be as Detailed as Full-year MD&A.** The release confirms that MD&A in quarterly reports need not necessarily address every line item, or every topic, that is included in the MD&A addressing the audited full year results.

It is also worth noting that heightened scrutiny of MD&A disclosure will occur in contexts other than SEC reviews. Auditors are giving particular focus to MD&A. Audit committees, facing new pressures and responsibilities, can be expected to pay careful attention to the adequacy of MD&A disclosure. And, issuers that have not recently accessed the capital markets will find that underwriters and their counsel closely scrutinize MD&A, in certain cases pushing for revisions to prior disclosures.

The new MD&A release is another entry on the list of required reading for those involved in preparing or advising on disclosure in this area. Preparing MD&A remains a subjective exercise, as it should, and there are few developments in the release that reflect significant changes to prior understandings or practice. However, the release makes very clear that the SEC continues to believe that MD&A can be better and that the staff will continue to push to improve the product. Those who fail to heed this warning will likely experience longer disclosure processes when dealing with auditors, the SEC and the markets.

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