

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 211, 231 and 241

[Release Nos. 33–8350; 34–48960; FR–72]

### Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Interpretation.

**SUMMARY:** The Commission is publishing interpretive guidance regarding the disclosure commonly known as Management's Discussion and Analysis of Financial Condition and Results of Operations, or MD&A, which is required by Item 303 of Regulation S–K, Items 303(b) and (c) of Regulation S–B, Item 5 of Form 20–F and Paragraph 11 of General Instruction B of Form 40–F. This guidance is intended to elicit more meaningful disclosure in MD&A in a number of areas, including the overall presentation and focus of MD&A, with general emphasis on the discussion and analysis of known trends, demands, commitments, events and uncertainties, and specific guidance on disclosures about liquidity, capital resources and critical accounting estimates.

**EFFECTIVE DATE:** December 29, 2003.

**FOR FURTHER INFORMATION CONTACT:** Questions about specific filings should be directed to staff members responsible for reviewing the documents the registrant files with the Commission. General questions about this release should be referred to Todd Hardiman, Karl Hiller, Nina Mojiri-Azad, Mara Ransom, or Sondra Stokes, Division of Corporation Finance, at (202) 824–5300, Securities and Exchange Commission, 450 5th Street NW., Washington, DC 20549–0401.

#### SUPPLEMENTARY INFORMATION:

#### I. Overview

##### A. Purpose

This release interprets requirements for Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A").<sup>1</sup> It provides guidance to assist companies:

- In preparing MD&A disclosure that is easier to follow and understand; and
- In providing information that more completely satisfies our previously enunciated principal objectives of MD&A.

We believe that management's most important responsibilities include communicating with investors in a clear and straightforward manner. MD&A is a critical component of that communication. The Commission has long sought through its rules, enforcement actions and interpretive processes to elicit MD&A that not only meets technical disclosure requirements but generally is informative and transparent. We believe and expect that when companies follow the guidance in this release, the overall quality of their MD&A will improve. The Division of Corporation Finance will continue to review MD&A submitted after this guidance is released and take action as appropriate. In addition, we have instructed the Division to keep us apprised of whether this guidance has produced improved disclosure, and to suggest additional Commission action related to MD&A as appropriate.

##### B. Approach to MD&A

The purpose of MD&A is not complicated. It is to provide readers information "necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations."<sup>2</sup> 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; 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.<sup>3</sup>

MD&A should be a discussion and analysis of a company's business as seen through the eyes of those who manage that business. Management has a unique perspective on its business that only it can present. As such, 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, neither of which provides this important management perspective. Through this release we encourage each company and its management to take a fresh look at MD&A with a view to enhancing its quality. We also encourage early top-level involvement by a company's management in identifying the key disclosure themes and items that should be included in a company's MD&A.

Based on our experience with many companies' current disclosures in MD&A, we believe there are a number of general ways for companies to enhance their MD&A consistent with its purpose. The recent review experiences of the staff of the Division of Corporation Finance, including its Fortune 500 review,<sup>4</sup> have led us to conclude that additional guidance would be especially useful in the following areas:

- 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.

Therefore, in this release, we emphasize the following points regarding overall presentation:

- Within the universe of material information, companies should present

<sup>1</sup> The requirements are set forth in Item 303 of Regulation S–K (Management's Discussion & Analysis of Financial Condition and Results of Operations) [17 CFR 229.303], Items 303(b) and (c) of Regulation S–B (Management's Discussion & Analysis of Financial Condition and Results of Operations, and Off-balance sheet arrangements) [17 CFR 228.303(b) and (c)], Item 5 of Form 20–F (Operating and Financial Review and Prospects) [17 CFR 249.220f], and General Instruction B.(11) of Form 40–F (Off-balance sheet arrangements) [17 CFR 249.240f].

Although the wording of the MD&A requirement in Form 20–F was revised in 1999, the Commission's adopting release noted that we interpret that Item as calling for the same disclosure as Item 303 of Regulation S–K. See Release No. 33–7745 (Sept. 28, 1999) [64 FR 53900 at 59304]. In addition, Instruction 1 to Item 5 in Form 20–F provides that issuers should refer to the Commission's 1989 interpretive release on MD&A disclosure under Item 303 of Regulation S–K (Interpretive Release: Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Release No. 33–6835 (May 18, 1989) [54 FR 22427] (the "1989 Release")) for guidance in preparing the discussion and analysis by management of the company's financial condition and results of operations required in Form 20–F. Therefore, although this release refers primarily to Item 303 of Regulation S–K, it also is intended to apply to MD&A drafted pursuant to Item 5 of Form 20–F.

In addition, the guidance in this release applies to small business issuers that are subject to the disclosure requirements of Items 303(b) and (c) of Regulation S–B. Small business issuers, like all other companies subject to SEC reporting obligations, should consider the interpretive guidance based on their own particular facts and circumstances.

<sup>2</sup> Item 303(a) of Regulation S–K [17 CFR 229.303(a)].

<sup>3</sup> See Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33–8056 (Jan. 22, 2002) [67 FR 3746] ("January 2002 Release").

<sup>4</sup> See Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies (Feb. 27, 2003) ("Fortune 500 Summary") available at [www.sec.gov/divisions/corpfin/fortune500rep.htm](http://www.sec.gov/divisions/corpfin/fortune500rep.htm).

their disclosure so that the most important information is most prominent;

- Companies should avoid unnecessary duplicative disclosure that can tend to overwhelm readers and act as an obstacle to identifying and understanding material matters; and
- Many companies would benefit from starting their MD&A with a section that provides an executive-level overview that provides context for the remainder of the discussion.

We also emphasize the following points regarding focus and content:

- In deciding on the content of MD&A, companies should focus on material information and eliminate immaterial information that does not promote understanding of companies' financial condition, liquidity and capital resources, changes in financial condition and results of operations (both in the context of profit and loss and cash flows);<sup>5</sup>
- Companies should identify and discuss key performance indicators, including non-financial performance indicators, that their management uses to manage the business and that would be material to investors;
- Companies must identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance;<sup>6</sup> and
- Companies should provide not only disclosure of information responsive to MD&A's requirements, but also an analysis that is responsive to those requirements that explains management's view of the implications and significance of that information and that satisfies the objectives of MD&A.

### C. Impact of Increased Amounts of Information Available to Companies

Companies have access to and use substantially more detailed and timely information about their financial condition and operating performance than they did when our MD&A

requirements initially were introduced or when we last provided general interpretive guidance.<sup>7</sup> Some of this information is itself non-financial in nature, but bears on companies' financial condition and operating performance. The increased availability of information is relevant to companies in preparing MD&A for the following reasons:

- First, companies must evaluate an increased amount of information to determine which information they must disclose. In doing so, companies should avoid the unnecessary information overload for investors that can result from disclosure of information that is not required, is immaterial, and does not promote understanding.

- Second, in identifying, discussing and analyzing known material trends and uncertainties, companies are expected to consider all relevant information, even if that information is not required to be disclosed.

### D. Liquidity and Capital Resources

We devote a separate section of this release to disclosure in MD&A regarding liquidity and capital resources. In that section, we emphasize the need for attention to disclosure of cash requirements and sources of cash. We believe that:

- Companies should consider enhanced analysis and explanation of the sources and uses of cash and material changes in particular items underlying the major captions reported in their financial statements, rather than recitation of the items in the cash flow statements;
- Companies using the indirect method<sup>8</sup> in preparing their cash flow

statements should pay particular attention to disclosure and analysis of matters that are not readily apparent from their cash flow statements; and

- Companies also should consider whether their MD&A should include enhanced disclosure regarding debt instruments, guarantees and related covenants.

### E. Critical Accounting Estimates

Finally, we have included a separate section in this release regarding accounting estimates and assumptions that may be 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 that have a material impact on financial condition or operating performance. Companies should consider enhanced discussion and analysis of these critical accounting estimates and assumptions that:

- Supplements, but does not duplicate, the description of accounting policies in the notes to the financial statements; and
- Provides greater insight into the quality and variability of information regarding financial condition and operating performance.

### F. Effect on Prior Commission Statements

This release does not modify existing legal requirements or create new legal requirements. Rather, we intend this release to assist companies in preparing MD&A by providing interpretive guidance and, in some cases, providing additional guidance in areas that the Commission has addressed previously. We do not believe that the guidance in this release conflicts with prior Commission guidance, nor is it our intention to alter any prior Commission guidance.

## II. Background

The following is a chronology of certain prior Commission action regarding MD&A:

While this release refers primarily to U.S. GAAP, the underlying events and circumstances described in the release ordinarily will be applicable to foreign private issuers and should be discussed to the extent material. Consistent with the Instructions to Form 20-F, however, companies using that form should focus on the primary financial statements in their discussion and analysis in Item 5 (Operative and Financial Review Prospects). Also, companies are required to discuss in Item 5 of Form 20-F any aspects of the differences between foreign and U.S. GAAP that they believe are necessary for an understanding of the financial statements as a whole. See Instruction 2 to Item 5 of Form 20-F [17 CFR 249.220f].

<sup>5</sup> In this release we sometimes use the term "financial condition and operating performance" to refer to the required subjects of MD&A of financial condition, liquidity and capital resources, changes in financial condition and results of operations (both in the context of profit and loss and cash flows).

<sup>6</sup> Note 27 to the 1989 Release states, "MD&A mandates disclosure of specified forward-looking information, and specifies its own standards for disclosure—i.e., reasonably likely to have a material effect. The specific standard governs the circumstances in which Item 303 requires disclosure. The probability/magnitude test for materiality approved by the Supreme Court in *Basic v. Levinson*, 108 S.Ct. 978 (1988), is inapposite to Item 303 disclosure."

<sup>7</sup> See, e.g., *Improving Business Reporting—A Customer Focus; Meeting the Information Needs of Investors and Creditors*, Comprehensive Report of the Special Committee on Financial Reporting, American Institute of Certified Public Accountants (AICPA) (1994) ("Jenkins Report").

<sup>8</sup> In Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 95, *Statement of Cash Flows* (Nov. 1987), the FASB allowed the indirect method of reporting net cash flow from operating activities by adjusting net income to reconcile it to net cash flow from operating activities. Under that method, the major classes of operating cash receipts and payments are determined indirectly by determining the change in asset and liability accounts that relate to operating income. However, in SFAS 95, the FASB encouraged companies to use the direct method of reporting net cash flow from operating activities rather than the indirect method. The direct method reports net cash flow from operations by summing major classes of gross cash receipts, such as customer payments, and gross cash payments, such as cash paid to employees. The direct method also requires a reconciliation of net income to net cash flow from operating activities. The FASB gave its opinion that the direct method is "the more comprehensive and presumably more useful approach."

1980—We adopted the present form of the disclosure requirements for MD&A.<sup>9</sup>

1981—We published the staff's interpretive guidance for MD&A after its review of disclosures that were prepared in accordance with the then-recently adopted disclosure requirements.<sup>10</sup>

1987—We sought public comment on the adequacy of MD&A and on proposed revisions submitted by members of the professional accounting community.<sup>11</sup>

1989—We published an interpretive release that addressed a number of disclosure matters that should be considered by companies in preparing MD&A.<sup>12</sup> The 1989 Release provided guidance in various areas, including required prospective information, analysis of long- and short-term liquidity and capital resources, material changes in financial statement line items, required interim period disclosure, segment analysis, participation in high-yield financings, highly leveraged transactions or non-investment grade loans and investments, the effects of federal financial assistance upon the operations of financial institutions and the disclosure of preliminary merger negotiations.

December 2001—As part of its process of reviewing financial and non-financial disclosures made by public companies, the Division of Corporation Finance announced that it would preliminarily review the annual reports filed in 2002 by the Fortune 500 companies, and undertake further review as appropriate, consistent with its selective review program. The focus of the project was to identify “disclosure that appeared to be critical to an understanding of each company's financial position and results, but which, at least on its face, seemed to conflict significantly with generally accepted accounting principles [GAAP] or SEC rules, or to be materially deficient in explanation or clarity.”<sup>13</sup> As a result of this review, comment letters, many of which commented on companies' MD&A, were sent to more than 350 of the Fortune 500 companies. Earlier this year, the

Division published a summary of the most frequent general areas of comment resulting from this review.<sup>14</sup>

December 2001—The Commission issued cautionary advice to companies regarding the need for greater investor awareness of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation. This cautionary advice encouraged public companies to include in their MD&A full explanations of their “critical accounting policies,” the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions.<sup>15</sup>

January 2002—After receiving a petition requesting additional MD&A interpretive guidance,<sup>16</sup> we issued a statement “to suggest steps that issuers should consider in meeting their current disclosure obligations with respect to the topics described.”<sup>17</sup> The statement provided explicit interpretive guidance on certain MD&A topics considered material to an understanding of companies' operations. The topics addressed by the release were liquidity and capital resources (including off-balance sheet arrangements), trading activities involving non-exchange traded contracts accounted for at fair value, and relationships and transactions with persons or entities that derive benefits from their non-independent relationships with the company or the company's related parties.<sup>18</sup>

May 2002—We proposed additional MD&A disclosure requirements, which remain under consideration, regarding the application of companies' critical accounting estimates.<sup>19</sup>

January 2003—We adopted additional disclosure requirements regarding off-balance sheet arrangements and aggregate contractual obligations.<sup>20</sup> The

new rules require the disclosure of off-balance sheet arrangements in a designated section of MD&A and an overview of certain known contractual obligations in a tabular format.<sup>21</sup>

We also have brought numerous enforcement actions based on alleged violations of MD&A requirements and will continue to bring such actions under appropriate circumstances.<sup>22</sup>

Based on recent experiences, we have determined that additional interpretive guidance regarding the requirements of MD&A will be useful to companies in enhancing overall disclosure under MD&A requirements.

### III. Overall Approach to MD&A

#### A. The Presentation of MD&A

Since the introduction of our MD&A requirements, many companies have become larger, more global and more complex. At the same time, the combination of our rules and investors' demands have led to an increase in the number of subjects and matters addressed in MD&A. For these and other reasons, many companies' MD&A have become necessarily lengthy and complex. Unfortunately, the

Arrangements and Aggregate Contractual Obligations, Release No. 33–8182 (Jan. 28, 2003) [68 FR 5982] (“2003 Off-Balance Sheet Release”).

The overall guidance in this Interpretive Release is applicable to all MD&A discussions, including those related to off-balance sheet arrangements. As such, it should be applied to General Instruction B.(11) of Form 40–F and Item 303(c) of Regulation S–B, in addition to the other sections set out in note 1, above. We are not addressing specifically disclosures of off-balance sheet arrangements in this release, however, because we have little experience with companies' application of the new rules, which are effective for companies' registration statements, annual reports and proxy or information statements that are required to include financial statements for their fiscal years ending on or after June 15, 2003. Companies (other than small business issuers) must include the table of contractual obligations in registration statements, annual reports, and proxy or information statements that are required to include financial statements for the fiscal years ending on or after December 15, 2003. In addition, Section 401(c) of the Sarbanes-Oxley Act requires us to complete a study and report to the President and Congress next year on these types of disclosures.

<sup>21</sup> The tabular disclosure is not required for small business issuers by Item 303 of Regulation S–B.

<sup>22</sup> See, e.g., *In the Matter of Edison Schools, Inc.*, Release No. 34–45925 (May 14, 2002); *In the Matter of Sony Corporation and Sumio Sano*, Release No. 34–40305 (Aug. 5, 1998); *In the Matter of Bank of Boston Corp.*, Initial Decision Release No. 81 (Dec. 22, 1995); *In the Matter of Gibson Greetings, Inc.*, *Ward A. Cavanaugh, and James H. Johnsen*, Release No. 34–36357 (Oct. 11, 1995); *In the Matter of America West Airlines, Inc.*, Release No. 34–34047 (May 12, 1994); *In the Matter of Salant Corporation and Martin F. Tynan*, Release No. 34–34046 (May 12, 1994); *In the Matter of Shared Medical Systems Corporation*, Release No. 34–33632 (Feb. 17, 1994); *In the Matter of Caterpillar Inc.*, Release No. 34–30532 (Mar. 31, 1992); *In the Matter of American Express Company*, Release No. 34–23332 (June 17, 1986).

<sup>9</sup> Final Rule: Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides; Integration of Securities Acts Disclosure Systems, Release No. 33–6231 (Sept. 2, 1980) [45 FR 63630].

<sup>10</sup> Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33–6349 (Sept. 28, 1981) 23 SEC Docket 962 [Release not published in the *Federal Register*].

<sup>11</sup> Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Release No. 33–6711 (April 24, 1987) [52 FR 13715].

<sup>12</sup> 1989 Release.

<sup>13</sup> Fortune 500 Summary.

<sup>14</sup> *Id.*

<sup>15</sup> Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Release No. 33–8040 (Dec. 12, 2001) [66 FR 65013] (“December 2001 Release”).

<sup>16</sup> On December 31, 2001 the Commission received a petition from Arthur Andersen LLP, Deloitte and Touche, LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP. The American Institute of Certified Public Accountants endorsed the petition. A copy of the petition is available at [www.sec.gov/rules/petitions/petndiscl\\_12312001.htm](http://www.sec.gov/rules/petitions/petndiscl_12312001.htm).

<sup>17</sup> See January 2002 Release.

<sup>18</sup> *Id.*

<sup>19</sup> Proposed Rule: Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies, Release No. 33–8098 (May 10, 2002) [67 FR 35620] (“2002 Critical Accounting Policies Proposal”).

<sup>20</sup> Final Rule: Disclosure in Management's Discussion and Analysis About Off-Balance Sheet

presentation of the MD&A of too many companies also may have become unnecessarily lengthy, difficult to understand and confusing.

MD&A, like other disclosure, should be presented in clear and understandable language. We understand that complex companies and situations require disclosure of complex matters and we are not in any way seeking over-simplification or "dumbing down" of MD&A. However, we believe that companies can improve the clarity and understandability of their MD&A by using language that is clearer and less convoluted. We believe that efforts by companies to provide clearer and better organized presentations of MD&A can result in more understandable disclosure that does not sacrifice the appropriate level of complexity or nuance. In order to engender better understanding, companies should prepare MD&A with a strong focus on the most important information, provided in a manner intended to address the objectives of MD&A. In particular:

- Companies should consider whether a tabular presentation of relevant financial or other information may help a reader's understanding of MD&A. For example, a company's MD&A might be clearer and more concise if it provides a tabular comparison of its results in different periods, which could include line items and percentage changes as well as other information determined by a company to be useful, followed by a narrative discussion and analysis of known changes, events, trends, uncertainties and other matters. A reader's understanding of a company's fair value calculations or discounted cash flow figures also could, in some situations, be enhanced by providing a tabular summary of the company's various material interest and discount rate assumptions in one location.

- Companies should consider whether the headings they use assist readers in following the flow of, or otherwise assist in understanding, MD&A, and whether additional headings would be helpful in this regard.

- Many companies' MD&A could benefit from adding an introductory section or overview that would facilitate a reader's understanding. As with all disclosure, what companies would appropriately include in an introduction or overview will depend on the circumstances of the particular company. As a general matter, an introduction or overview should include the most important matters on which a company's executives focus in

evaluating financial condition and operating performance and provide the context for the discussion and analysis of the financial statements. Therefore, an introduction or overview should not be a duplicative layer of disclosure that merely repeats the more detailed discussion and analysis that follows.

- While all required information must of course be disclosed, companies should consider using a "layered" approach. Such an approach would present information in a manner that emphasizes, within the universe of material information that is disclosed, the information and analysis that is most important. This presentation would assist readers in identifying more readily the most important information. Using an overview or introduction is one example of a layered approach. Another is to begin a section containing detailed analysis, such as an analysis of period-to-period information, with a statement of the principal factors, trends or other matters that are the principal subjects covered in more detail in the section.

We would expect a good introduction or overview to 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 operating results. A good introduction or overview would:

- 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 an introduction 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 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, we would expect the introduction to change over time to remain current. As is true with all sections of MD&A, boilerplate disclaimers and other generic language generally are not helpful in providing useful information or achieving balance,

and would detract from the purpose of the introduction or overview.

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. Further, the failure to include disclosure of every material item in an introduction or overview should not trigger automatically the application of the "buried facts" doctrine, in which a court would consider disclosure to be false and misleading if its overall significance is obscured because material is "buried," such as in a footnote or an appendix.<sup>23</sup>

Throughout MD&A, including in an introduction or overview, discussion and analysis of financial condition and operating performance includes both past and prospective matters. In addressing prospective financial condition and operating performance, there are circumstances, particularly regarding known material trends and uncertainties, where forward-looking information is required to be disclosed. We also encourage companies to discuss prospective matters and include forward-looking information in circumstances where that information may not be required, but will provide useful material information for investors that promotes understanding.

#### *B. 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 emphasize material information that is required or promotes understanding and de-emphasize (or, if appropriate, delete) immaterial information that is not required and does not promote understanding.

Our MD&A requirements call for companies to provide investors and other users with material information that is necessary to an understanding of the company's financial condition and operating performance, as well as its prospects for the future.<sup>24</sup> While the desired focus of MD&A for a particular company will depend on the facts and circumstances of the company, some guidance about the content and focus of MD&A is generally applicable.

<sup>23</sup> See, e.g., Final Rule: Plain English Disclosure, Release No. 33-7497 (Jan. 28, 1998) [63 FR 6370 at 6375] (citing *Gould v. American Hawaiian Steamship Company*, 331 F. Supp. 981 (D. Del. 1971); *Kohn v. American Metal Climax, Inc.*, 322 F. Supp. 1331 (E.D. Pa. 1970), modified, 458 F.2d 255 (3d Cir. 1972).)

<sup>24</sup> See 1989 Release, Part III.A.

## 1. Focus on Key Indicators of Financial Condition and Operating Performance

As discussed, one of the principal objectives of MD&A is to give readers a view of the company through the eyes of management by providing both a short and long-term analysis of the business.<sup>25</sup> To do this, companies should “identify and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the individual company.”<sup>26</sup>

Financial measures generally are the starting point in ascertaining these key variables and other factors. However, financial measures often tell only part of how a company manages its business. Therefore, when preparing MD&A, companies should consider whether disclosure of all key variables and other factors that management uses to manage the business would be material to investors, and therefore required.<sup>27</sup> These key variables and other factors may be non-financial, and companies should consider whether that non-financial information should be disclosed.

Many companies currently disclose non-financial business and operational data.<sup>28</sup> Academics, authors, and

consultants also have researched the types of information, outside of financial statement measures, that would be helpful to investors and other users.<sup>29</sup> Such information may relate to external or macro-economic matters as well as those specific to a company or industry. For example, interest rates or economic growth rates and their anticipated trends can be important variables for many companies. Industry-specific measures can also be important for analysis, although common standards for the measures also are important. Some industries commonly use non-financial data, such as industry metrics and value drivers.<sup>30</sup> Where a company discloses such information, and there is no commonly accepted method of calculating a particular non-financial metric, it should provide an explanation of its calculation to promote comparability across companies within the industry. Finally, companies may use non-financial performance measures that are company-specific.

In addition, 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 website postings) they also should evaluate that material information to determine whether it is required to be included in MD&A, either because it falls within a specific disclosure requirement or because its omission would render misleading the filed document in which the MD&A appears. We are not seeking to sweep into MD&A all the information that a company communicates. Rather, companies should consider their communications and determine what information is material and is required in, or would promote understanding of, MD&A.

Since we adopted the MD&A requirements, and even since the last comprehensive guidance on MD&A we released in 1989, there have been significant advancements in the ability to develop and access information quickly and effectively. Changes in business enterprise systems, communications and other aspects of information technology have significantly increased the amount of information available to management, as well as the speed with which they receive and are able to use

information.<sup>31</sup> There is therefore a larger and more up-to-date universe of information, financial and non-financial alike, that companies have and should evaluate in determining whether disclosure is required. This situation presents companies with the challenge of identifying information that is required to be disclosed or that promotes understanding, while avoiding unnecessary information overload for readers by not disclosing a greater body of information, just because it is available, where disclosure is not required and does not promote understanding. Further, with advances in technology contributing to increasing amounts and currency of information, the factors relied upon by companies to operate and analyze the business may change. As this occurs, the discussion in MD&A should change over time to maintain an appropriate focus on material factors.

The focus on key performance indicators can be enhanced not only through the language and content of the discussion, but also through a format that will enhance the understanding of the discussion and analysis. The order of the information need not follow the order presented in Item 303 of Regulation S-K if another order of presentation would better facilitate readers’ understanding. MD&A should provide a frame of reference that allows readers to understand the effects of material changes and events and known material trends and uncertainties arising during the periods being discussed, as well as their relative importance. To satisfy the objectives of MD&A, companies also should provide a balanced view of the underlying dynamics of the business, including not only a description of a company’s successes, but also of instances when it failed to realize goals, if material. Good MD&A will focus readers’ attention on these key matters.

## 2. Focus on Materiality

Companies must provide specified material information in their MD&A,<sup>32</sup> and they also must provide other material information that is necessary to make the required statements, in light of the circumstances in which they are

<sup>25</sup> See, e.g., Release No. 33-6711 (Apr. 24, 1987) [52 FR 13715 at 13717] (“an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company.”).

<sup>26</sup> 1989 Release, Part III.A (citing Release No. 33-6349 (Sept. 28, 1981) 23 SEC Docket 962 at 964 [Release not published in the *Federal Register*]).

<sup>27</sup> Examples of such other factors, depending on the circumstances of a particular company, can include manufacturing plant capacity and utilization, backlog, trends in bookings and employee turnover rates. See, e.g., *Quality, Transparency, Accountability*, Lynn E. Turner, Chief Accountant, Securities and Exchange Commission, Remarks before Financial Executives Institute (Apr. 26, 2001), available at [www.sec.gov/news/speech/spch485.htm](http://www.sec.gov/news/speech/spch485.htm).

Companies should also consider disclosing information that may be peripheral to the accounting function, but is integral to the business or operating activity. Examples of such measures, depending on the circumstances of a particular company, can include those based on units or volume, customer satisfaction, time-to-market, interest rates, product development, service offerings, throughput capacity, affiliations/joint undertakings, market demand, customer/vendor relations, employee retention, business strategy, changes in the managerial approach or structure, regulatory actions or regulatory environment, and any other pertinent macroeconomic measures. Because these measures are generally non-financial in nature, we do not believe that their disclosure generally will raise issues under Item 10(e) of Regulation S-K [17 CFR 229.10(e)] or Item 10(h) of Regulation S-B [17 CFR 228.10(h)].

<sup>28</sup> See *Improving Business Reporting: Insights into Enhancing Voluntary Disclosures*, Steering Committee Report of the Business Reporting Research Project of the FASB (2001) available at [www.fasb.org](http://www.fasb.org); the Jenkins Report; Financial

Accounting Series Special Report, *Business and Financial Reporting, Challenges from the New Economy* (FASB) (2001) (“Special Report on Improving Business Reporting”).

<sup>29</sup> See Special Report on Improving Business Reporting.

<sup>30</sup> See, e.g., the Jenkins Report; the Special Report on Improving Business Reporting.

<sup>31</sup> See the Jenkins Report.

<sup>32</sup> See, e.g., Item 303(a)(1) of Regulation S-K [17 CFR 229.303(a)(1)] (requiring the identification of “known trends or known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant’s liquidity increasing or decreasing in any material way”). See also Item 303(a)(2)(i) of Regulation S-K [17 CFR 229.303(a)(2)(i)] (requiring a description of registrant’s material commitments for capital expenditures).

made, not misleading.<sup>33</sup> 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.<sup>34</sup> Companies must determine, based on their own particular facts and circumstances, whether disclosure of a particular matter is required in MD&A. However, the effectiveness of MD&A decreases with the accumulation of unnecessary detail or duplicative or uninformative disclosure that obscures material information.<sup>35</sup> Companies should view this guidance as an opportunity to evaluate whether there is information in their MD&A that is no longer material or useful, and therefore should be deleted, for example where there has been a change in their business or the information has become stale.

As the complexity of business structures and financial transactions increase, and as the activities undertaken by companies become more diverse, it is increasingly important for companies to focus their MD&A on material information. In preparing MD&A, companies should 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.

Companies also should focus on an analysis of the consolidated financial condition and operating performance, with segment data provided where material to an understanding of consolidated information. Segment discussion and analysis should be designed to avoid unnecessary duplication and immaterial detail that is not required and does not promote understanding of a company's overall financial condition and operating performance.

Both Instruction 4 to Item 303 of Regulation S-K and the 1989 Release address the requirement of discussion and analysis of changes in line items. A review of current MD&A provided by some companies, however, reveals that this is a portion of MD&A that can include an excessive amount of duplicative disclosure, as well as disclosure of immaterial items that do not promote understanding. The 1989 Release explicitly provides for the grouping of line items for purposes of discussion and analysis in a manner that avoids duplicative disclosure. In addition, Instruction 4 and the guidance in the 1989 Release do not require a discussion of every line item and its changes without regard to materiality. Discussion of a line item and its changes should be avoided where the information that would be disclosed is not material and would not promote understanding of MD&A.

Companies also must assess the materiality of items in preparing disclosure in their quarterly reports. There may be different quantitative and qualitative factors to consider when deciding whether to include certain information in a specific quarterly or annual report. The 1989 Release addresses some aspects of MD&A disclosure in the context of quarterly filings. That release clarifies that material changes to items disclosed in MD&A in annual reports should be discussed in the quarter in which they occur.<sup>36</sup> There also may be circumstances where an item may not be material in the context of a discussion of annual results of operations but is material in the context of interim results.

Disclosure in MD&A in quarterly reports is complementary to that made in the most recent annual report and in any intervening quarterly reports. Therefore, there may be cases, particularly where adequate disclosure is included in the MD&A in those earlier reports, where further disclosure in a

quarterly report is not necessary. If, however, disclosure in those earlier reports does not adequately foreshadow subsequent events, or if new information that impacts known trends and uncertainties becomes apparent in a quarterly period, additional disclosure should be considered and may be required.

### 3. Focus on Material Trends and Uncertainties

One of the most important elements necessary to an understanding of a company's performance, and 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. Disclosure decisions concerning trends, demands, commitments, events, and uncertainties generally should involve the:

- Consideration of financial, operational and other information known to the company;
- Identification, based on this information, of known trends and uncertainties; and
- 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.

As we have explained in prior guidance, 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.<sup>37</sup> (In this release we sometimes use the term "known material trends and uncertainties" to describe trends, demands, commitments, events or uncertainties as to which disclosure is required.)

In identifying known material trends and uncertainties, companies should consider the substantial amount of

<sup>33</sup> See Securities Act Rule 408 [17 CFR 230.408], Securities Exchange Act of 1934 Section 10(b) [15 U.S.C. 78j(b)], Exchange Act Rule 10b-5 [17 CFR 240.10b-5], and Exchange Act Rule 12b-20 [17 CFR 240.12b-20]. See also, *In the Matter of Edison Schools, Inc.*, Release No. 34-45925 (May 14, 2002) (finding, among other things, that the company failed to provide accurate and complete disclosure about its reported revenues); *In the Matter of Sony Corporation and Sumio Sano*, Release No. 34-40305 (Aug. 5, 1998) (finding that the company violated Section 13(a) of the Exchange Act by making inadequate disclosures about the nature and the extent of Sony Pictures' net losses and their impact on the consolidated results Sony was reporting); *In the Matter of Caterpillar Inc.*, Release No. 34-30532 (Mar. 31, 1992) (finding failure to disclose the impact of a subsidiary's foreign operations on the company's results of operations violated Section 13(a) of the Exchange Act).

<sup>34</sup> Instruction 3 to Item 303(a) of Regulation S-K [17 CFR 229.303(a)].

<sup>35</sup> See, e.g., Instruction 4 to Item 303(a) of Regulation S-K (indicating that repetition and line-by-line analysis is not required nor is it appropriate when the causes for a change in one line item also relate to other line items and indicating that, to the extent the changes from year to year are readily computable from the financial statements, the changes need not be recited in the discussion). The 1989 Release also addressed these points directly. See 1989 Release, Part III.D.

Where companies believe that information from the face of financial statements is helpful to readers in MD&A, they should consider using a tabular presentation that shows the decimal percentages of components or year-over-year percentage changes of the financial statement line items. An appropriate analysis of this data, to the extent that it is material, should accompany the tabular presentation consistent with the guidance in Section III.B.3 of this Release.

<sup>36</sup> See 1989 Release, Part III.E.

<sup>37</sup> See January 2002 Release at 3748 ("two assessments management must make where a trend, demand, commitment, event or uncertainty is known: 1. Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required. 2. If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur" (citing the 1989 Release)).

financial and non-financial information available to them, and whether or not the available information itself is required to be disclosed. This information, over time, may reveal a trend or general pattern in activity, a departure or isolated variance from an established trend, an uncertainty, or a reasonable likelihood of the occurrence of such an event that should be disclosed.

One of the principal objectives of MD&A is to provide information about the quality and potential variability of a company's earnings and cash flow, so that readers can ascertain the likelihood that past performance is indicative of future performance. Ascertaining this indicative value depends to a significant degree on the quality of disclosure about the facts and circumstances surrounding known material trends and uncertainties in MD&A. Quantification of the material effects of known material trends and uncertainties can promote understanding. Quantitative disclosure should be considered and may be required to the extent material if quantitative information is reasonably available.

As discussed in the 1989 Release, the disclosures required to address known material trends and uncertainties in the discussion and analysis should not be confused with optional forward-looking information. Not all forward-looking information falls within the realm of optional disclosure. In particular, 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.<sup>38</sup> In addition, forward-looking information is required in connection with the disclosure in MD&A regarding off-balance sheet arrangements.<sup>39</sup>

#### 4. Focus on Analysis

MD&A requires not only a "discussion" but also an "analysis" of known material trends, events, demands, commitments and uncertainties. MD&A should not be merely a restatement of financial

statement information in a narrative form. When a description of known material trends, events, demands, commitments and uncertainties is set forth, companies should consider including, and may be required to include, an analysis explaining 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. A thorough analysis often will involve discussing both the intermediate effects of those matters and the reasons underlying those intermediate effects. For example, if a company's financial statements reflect materially lower revenues resulting from a decline in the volume of products sold when compared to a prior period, MD&A should not only identify the decline in sales volume, but also should analyze the reasons underlying the decline in sales when the reasons are also material and determinable. The analysis should reveal underlying material causes of the matters described, including for example, if applicable, 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.

Similarly, where a company's financial statements reflect material restructuring or impairment charges, or a decline in the profitability of a plant or other business activity, MD&A should also, where material, analyze the reasons underlying these matters, such as an inability to realize previously projected economies of scale, a failure to renew or secure key customer contracts, or a failure to keep downtime at acceptable levels due to aging equipment. Whether favorable or unfavorable conditions constitute or give rise to the material trends, demands, commitments, events or uncertainties being discussed, the analysis should consist of material substantive information and present a balanced view of the underlying dynamics of the business.

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.

#### IV. Liquidity and Capital Resources

Our rules require companies to provide disclosure in the related categories of liquidity and capital resources.<sup>40</sup> This information is critical to an assessment of a company's prospects for the future and even the likelihood of its survival.<sup>41</sup> A company is required to include in MD&A the following information, 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.<sup>42</sup>

<sup>40</sup> See Item 303(a)(1) and (2) of Regulation S-K [17 CFR 229.303(a)(1) and (2)].

<sup>41</sup> See January 2002 Release; 2003 Off-Balance Sheet Release.

<sup>42</sup> See 1989 Release, Part III.C. See also Item 303(a)(1) and (2) of Regulation S-K [17 CFR

<sup>38</sup> See 1989 Release, Part III.B.

<sup>39</sup> In connection with our adoption of the off-balance sheet arrangements disclosure requirements, we eliminated a portion of the instructions in Item 303 of Regulation S-K that stated that registrants were not required to provide forward-looking information. Deleting that portion of the instructions did not affect requirements to provide forward-looking information in other circumstances where required or reduce the availability of any safe harbor for forward-looking information. See also 2003 Off-Balance Sheet Release. See Securities Act Section 27A [15 U.S.C. 77z-2], Securities Act Rule 175 [17 CFR 230.175], Exchange Act Section 21E [17 U.S.C. 78u-5], and Exchange Act Rule 3b-6 [17 CFR 240.3b-6].



Discussion and analysis of this information should be considered and may be required to provide a clear picture of the company's ability to generate cash and to meet existing and known or reasonably likely future 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.<sup>43</sup> Merely stating that a company has adequate resources to meet its short-term and/or long-term cash requirements 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.

#### A. Cash Requirements

In order to identify known material cash requirements, companies should consider whether the following information would have a material impact on liquidity (discussion of immaterial matters, and especially generic disclosure or boilerplate, should be avoided):

- Funds necessary to maintain current operations, complete projects underway and achieve stated objectives or plans;
- Commitments for capital or other expenditures;<sup>44</sup> 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.

One starting point for a company's discussion and analysis of cash requirements is the tabular disclosure of contractual obligations,<sup>45</sup> supplemented with additional information that is material to an understanding of the company's cash requirements.<sup>46</sup>

<sup>43</sup> 229.303(a)(1) and (2)], and Instructions 2 and 5 thereto.

<sup>44</sup> Short-term liquidity is defined as a period of twelve months or less and long-term is defined as a period in excess of twelve months. See 1989 Release, Part III.C. Note that the period of time over which a long-term discussion of liquidity is relevant is dependent upon the timing of the cash requirements of a company, as well as the period of time over which cash flows are managed. A vague reference to periods in excess of twelve months may not be sufficient.

<sup>45</sup> See Item 303(a)(2)(i) of Regulation S-K [17 CFR 229.303(a)(2)(i)].

<sup>46</sup> See Item 303(a)(5) of Regulation S-K [17 CFR 229.303(a)(5)].

<sup>47</sup> For example, the cash requirements for items such as interest, taxes or amounts to be funded to cover post-employment (including retirement)

For example, if a company has incurred debt in material amounts, it should explain the reasons for incurring that debt and the use of the proceeds, and analyze how the incurrence of that debt fits into the overall business plan, in each case to the extent material.<sup>47</sup>

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.<sup>48</sup>

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. In addition, because of these difficulties and uncertainties, companies should consider whether they need to make or change disclosure in connection with quarterly as well as annual reports.

#### B. Sources and Uses of Cash

As with the discussion and analysis of the results of operations, 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. Rather, MD&A should focus on the primary drivers of and other material factors necessary to an understanding of the company's cash flows and the indicative value of historical cash flows.

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

benefits may not be included in the tabular disclosure, but should be discussed if material.

<sup>47</sup> For example, debt may have been issued to fund the construction of a new plant, which will allow the company to expand its operations into a specific geographic area. Understanding that relationship and the expected commencement date of plant operations puts the cash requirement for the debt into an appropriate context to understand liquidity.

<sup>48</sup> Companies are reminded of their related disclosure obligations under Item 504 (Use of Proceeds) of Regulation S-K [17 CFR 229.504] and the requirement to update this disclosure in Item 701(f) (Use of Proceeds) of Regulation S-K [17 CFR 229.701(f)].

have materially varied, analysis of that variability should be provided. The discussion and analysis of liquidity should focus on material changes in operating, investing and financing cash flows, as depicted in the statement of cash flows, and the reasons underlying those changes.

#### 1. Operations

The discussion and analysis of operating cash flows should not be limited by the manner of presentation in the statement of cash flows.<sup>49</sup> Alternate accounting methods of deriving and presenting cash flows exist, and while they generally yield the same numeric result in the major captions, they involve the disclosure of different types of information. When preparing the discussion and analysis of operating cash flows, companies 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.<sup>50</sup>

For example, consider a company that reports an overall increase in the components of its working capital other than cash<sup>51</sup> with the effect of having a material decrease in net cash provided by operations in the current period. If the increase in working capital was 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 cash provided by operations, 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.<sup>52</sup> While a cash flow statement prepared using the indirect method would report that various individual components of working capital increased or decreased during the

<sup>49</sup> See Instruction 4 to Item 303(a) of Regulation S-K [17 CFR 229.303(a)].

<sup>50</sup> See SFAS No. 95.

<sup>51</sup> Working capital is defined as current assets less current liabilities. See Chapter 3, AICPA Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins* (June 1953).

<sup>52</sup> To the extent that this change also materially impacts results of operations, discussion and analysis would also be required in that section, but companies should attempt to avoid unnecessary or confusing duplication.



period by a specified amount, it would not provide a sufficient basis for a reader to analyze the change. 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.<sup>53</sup> 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.

## 2. Financing

To the extent material, a company must provide disclosure regarding its historical financing arrangements and their importance to cash flows, including, to the extent 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; and
- 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, 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, should be considered and may be required. 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 the terms of the financing, other features of the financing and plans, and the impact on the company's cash position and liquidity (as well as results of operations in the case of matters such as interest payments) should be considered and may be required.<sup>54</sup>

### C. Debt Instruments, Guarantees and Related Covenants

There are at least two scenarios in which companies should consider whether discussion and analysis of material covenants related to their outstanding debt (or covenants applicable to the companies or third parties in respect of guarantees or other contingent obligations)<sup>55</sup> may be required.<sup>56</sup>

First, companies that are, or are reasonably likely to be, in breach of such covenants<sup>57</sup> must disclose material information about that breach and analyze the impact on the company if material. That analysis should include, as applicable and to the extent material:

- The steps that 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 any cross-default or cross-acceleration or similar provisions) on financial condition or operating performance; and
- Alternate sources of funding to pay off resulting obligations or replace funding.

Second, companies should consider the impact of debt covenants on their

<sup>54</sup> We believe that disclosure satisfying the requirements of MD&A can be made consistently with the restrictions of Section 5 of the Securities Act. See, e.g., Securities Act Rules 135c [17 CFR 230.135c].

<sup>55</sup> See FASB Interpretation No. (FIN) 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (Nov. 2002); 2003 Off-Balance Sheet Release; and the discussion *infra*, regarding off-balance sheet arrangements.

<sup>56</sup> See *In the Matter of America West Airlines, Inc.*, Release No. 34-34047 (May 12, 1994) (finding that the company failed to discuss uncertainties regarding its ability to comply with covenants).

<sup>57</sup> Companies also must take a similar approach to discussion and analysis with respect to mandatory prepayment provisions, "put" rights and other similar provisions.

ability to undertake additional debt or equity financing. Examples of these covenants include, but are not limited to, debt incurrence restrictions, limitations on interest payments, restrictions on dividend payments and various debt ratio limits. If these covenants limit, or are reasonably likely to limit, a company's ability to undertake financing to a material extent, the company is required to discuss the covenants in question and the consequences of the limitation to the company's financial condition and operating performance. Disclosure of alternate sources of funding and, to the extent material, the consequences (including but not limited to the cost) of accessing them should also be considered and may be required.

### D. Cash Management

Companies generally have some degree of flexibility in determining when and how to use their cash resources to satisfy obligations and make other capital expenditures. 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 historically may result in long-term effects that should be disclosed if material. Material effects could include more cash, less interest expense and lower depreciation, but higher future repair and maintenance expenses or a higher cost base than the company would otherwise have.

## V. 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. Our December 2001 Release reminded companies that, under the existing MD&A disclosure requirements, a company should address material implications of uncertainties associated with the methods, assumptions and estimates underlying the company's critical accounting measurements.<sup>58</sup> In May 2002 we proposed rules, which remain under consideration, that would broaden the scope of disclosures beyond those currently required.<sup>59</sup>

When preparing disclosure under the current requirements, companies should consider whether they have made

<sup>58</sup> December 2001 Release.

<sup>59</sup> See 2002 Critical Accounting Policies Proposal.

<sup>53</sup> See Item 303(a) of Regulation S-K [17 CFR 229.303(a)].

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; and

- The impact of the estimates and assumptions on financial condition or operating performance is material.

If so, companies should 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. The disclosure should provide greater insight into the quality and variability of information regarding financial condition and operating performance. 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 the questions that arise once the critical accounting estimate or assumption has been identified, by analyzing, 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 their 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.

For example, 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 impact that could result given the range of reasonably likely outcomes should be disclosed and, because of the nature of estimates of long-term rates of return, quantified.

#### **Amendments to the Codification of Financial Reporting Policies**

The "Codification of Financial Reporting Policies" announced in Financial Reporting Release 1 (April 15, 1982) [47 FR 21028] is updated:

1. By adding to the following new sections to the Financial Reporting Codification from the release:

- (III) Overall Approach to MD&A.
- (IV) Liquidity and Capital Resources.
- (V) Critical Accounting Estimates.

2. By revising the footnotes from those sections of the release which contain a short form citation to include the complete citation form rather than the short form.

3. By renumbering the footnotes from those sections of the release to run in the Financial Reporting Codification consecutively from number 1 through number 37.

The Codification is a separate publication of the Commission. It will

not be published in the Code of Federal Regulations System.

#### **List of Subjects in 17 CFR Parts 211, 231 and 241**

Securities.

#### **Amendments to the Code of Federal Regulations**

■ For the reasons set forth above, the Commission is amending title 17, chapter II of the Code of Federal Regulations as set forth below:

#### **PART 211—INTERPRETATIONS RELATING TO FINANCIAL REPORTING MATTERS**

■ 1. Part 211, Subpart A, is amended by adding Release No. FR-72 and the release date of December 19, 2003 to the list of interpretive releases.

#### **PART 231—INTERPRETATIVE RELEASES RELATING TO THE SECURITIES ACT OF 1933 AND GENERAL RULES AND REGULATIONS THEREUNDER**

■ 2. Part 231 is amended by adding Release No. 33-8350 and the release date of December 19, 2003 to the list of interpretive releases.

#### **PART 241—INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER**

■ 3. Part 241 is amended by adding Release No. 34-48960 and the release date of December 19, 2003 to the list of interpretive releases.

Dated: December 19, 2003.

By the Commission.

**Margaret H. McFarland,**

*Deputy Secretary.*

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