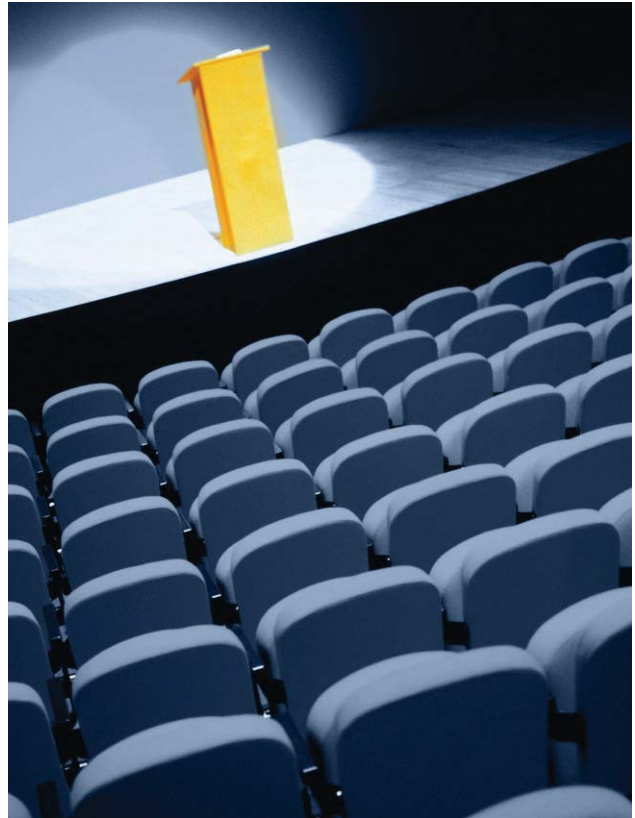


defining issues[®]

JANUARY 2004 No. 04-1



Presentation	2
Determining Content	2
Liquidity and Capital Resources	3
Critical Accounting Estimates	4

Analysis Emphasized in SEC Guidance on MD&A

New guidance on Management’s Discussion and Analysis applies to all MD&A disclosures filed with the SEC after December 29, 2003 by both domestic and foreign public companies. The SEC’s new release—Financial Reporting Release No. 72 (or FRR 72)—is expected to significantly affect disclosures in upcoming 2003 annual reports.¹

The release pertains to both the information that should be presented and how it should be presented. It emphasizes the need to present the most important information prominently and to convey management’s unique perspective. It reflects the SEC’s conclusion that companies must remind themselves of MD&A’s objectives and move away from narrow technical compliance with the rules, calling on management to explain its view of the implications and significance of the disclosed information.² Management needs to “start with a clean sheet of paper,” rather than rolling forward and updating last year’s MD&A.

(1) SEC Release No. 33-8350 (Financial Reporting Release No. 72), Interpretation: Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations, issued December 19, 2003, available at <http://www.sec.gov/rules/interp/33-8350.htm>.

The release applies to the MD&A included in annual reports, proxy and registration statements of all domestic (including small-business issuers) and foreign-private issuers. The release also applies explicitly to Canadian issuers reporting under the Multi-Jurisdictional Disclosure System on Form 40-F (when used as either an annual report or a registration statement) only as it relates to disclosures of off-balance-sheet arrangements in accordance with General Instruction B.(11) of Form 40-F. However, the SEC Staff encourages general application of the guidance in preparing MD&A included on Form 40-F.

(2) Regulation S-K, Item 303, Management’s Discussion and Analysis of Financial Condition and Results of Operations, Items 303(b) and (c) of Regulation S-B, Management’s Discussion and Analysis or Plan of Operations, Item 5 of Form 20-F, Operating and Financial Review and Prospects, and General Instruction B.(11) of Form 40-F, Off-balance sheet arrangements.

The release's guidance on content includes how to determine what should be disclosed and more specific guidance on disclosures about liquidity and capital resources and critical accounting estimates. This edition of *Defining Issues* summarizes the guidance.

PRESENTATION

The release encourages companies to employ what it calls a “layered” approach to discussing information in MD&A. Under this approach, the most important information and analysis is presented first, followed by more detailed explanation. In keeping with that approach, the SEC strongly suggests that management include an introduction or overview that describes the most important matters on which a company's executives focus in evaluating financial condition and operating performance and suggests what to include in an overview. An overview's content should depend on a company's circumstances and would change over time. According to the SEC, every material item need not be included in an overview to avoid application of the “buried facts” doctrine.³ Company counsel is likely to have specific views on the use of such an introduction or overview.

CHARACTERISTICS OF AN EFFECTIVE INTRODUCTION OR OVERVIEW

The SEC release cites several characteristics of a good introduction or overview. It should provide the context for the discussion and analysis of the financial statements and would cover:

- ◆ The economic or industry-wide factors relevant to the company.
- ◆ How the company earns revenues and income and generates cash.
- ◆ The company's lines of business, locations of operations, and principal products and services.
- ◆ The material opportunities, challenges, and risks the company's executives are focused on and the actions being taken to address them.

The release also suggests putting information in tables and evaluating the usefulness of current headings and whether additional headings would help readers.

DETERMINING CONTENT

The release provides guidance on the considerations that should be brought to bear in determining what to disclose. The guidance stresses circumstances that make disclosure unnecessary as well as circumstances that make it required.

Materiality. MD&A should include only information that is expected to be important to the reader. Companies should omit immaterial or duplicative disclosure. For example, a line-by-line discussion and analysis of changes in immaterial financial-statement line items would not help readers understand a company or the most relevant factors affecting a company. Similarly, segments should be discussed and analyzed if the disclosure is material to an understanding of consolidated information, but the discussion and analysis should avoid immaterial detail and unnecessary duplication of the segment disclosures in the notes.

Changes in a company's circumstances could render disclosures made in prior periods irrelevant or less relevant. If so, according to the release, unnecessary information should be either eliminated or revised in light of the new circumstances to make it relevant and necessary.

Analysis. Disclosure about known material trends, events, demands, commitments, and uncertainties should go beyond descriptive identification and analyze what is identified. The disclosure should describe what happened, why it happened, and its effect.

For example, assume a company's financial statements reflect materially lower revenues caused by a decline in sales volume. The company's MD&A should identify the decline in sales volume and analyze the reasons for the decline, which might be a loss in market share traceable to a decline in product quality explained by problems in the manufacturing process. Similarly, the inclusion of material restructuring or impairment charges in the financial statements should trigger discussion of the events or situations giving rise to the charges. The discussion might describe the company's 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.

⁽³⁾ Under the “buried facts” doctrine, a court might consider disclosure to be false and misleading if its overall significance is obscured because material information is buried in a footnote or an appendix.

Management's analysis should be clear about whether and why current financial information is or is not indicative of future financial condition or future operating performance. This explanation should cite the role of material unusual or nonrecurring items and other sources of significant fluctuations in financial-statement amounts. Companies should disclose changes in estimates, the economic characteristics of business arrangements, and the methods used to account for them, if they materially affect results of operations or liquidity in a structured or unusual fashion.

Key Indicators of Financial Condition and Operating

Performance. Companies should identify and address the key variables and other qualitative and quantitative factors that are peculiar to and necessary for an understanding and evaluation of the individual company, even if that information historically has been provided in other public forums, such as publicly accessible analysts' calls or Web sites. The disclosure should include key nonfinancial variables and other information used to manage the company, such as plant capacity and utilization, backlog, trends in bookings, and employee turnover rates. Useful information may relate to external or macro-economic matters, such as interest rates and economic growth rates, as well as to matters specific to the company or its industry. Companies should explain how their nonfinancial metrics are calculated.

The release strongly encourages management to provide key financial *and nonfinancial* performance indicators that provide a look at a company through the "eyes of management." It points out that *nonfinancial* measures are not necessarily non-GAAP financial measures. However, companies should remain mindful of the SEC's guidelines for using non-GAAP financial measures when disclosing key *financial* performance indicators.⁴ Clear disclosure of how management uses these measures and why they are useful to investors will remain important to the discussion of company performance.

Material Trends and Uncertainties. Disclosures should provide a basis for investors and readers to understand the significance of the known trends, demands, commitments, events, and uncertainties that are discussed and analyzed in MD&A. This might require forward-looking information even when

discussing off-balance-sheet arrangements.⁵ Companies should quantify the effects of known material trends and uncertainties when the information is reasonably available.

LIQUIDITY AND CAPITAL RESOURCES

The SEC considers general statements that the company is liquid and has sufficient resources to continue its operations for the next year to be deficient disclosure in the presence of known material trends or uncertainties related to cash flow, capital resources, capital requirements, or liquidity. The release provides guidance on identifying these conditions.

Cash Requirements. In order to identify known material cash requirements, companies should consider whether the following information would have a material effect on liquidity:

- Funds necessary to maintain current operations, complete projects that are 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 the time periods during which resolution of the uncertainties is anticipated.

A possible starting point for a company's discussion and analysis of cash requirements is the already required tabular disclosure of contractual obligations, supplemented with additional information that is material to an understanding of the company's cash requirements. The release mentions that cash requirements for interest, taxes, or amounts to be funded to cover retirement and other post-employment benefits should be discussed if they are material even if they are not included in the tabular disclosure.

Companies should explain why they have incurred material amounts of debt and how the proceeds have been or will be used. Loss contingencies should be addressed in detail, because the amount and timing of the cash requirements may be difficult to assess. The disclosure should be updated in interim periods as needed.

(4) SEC Release No. 33-8176, *Conditions for Use of Non-GAAP Financial Measures*, January 22, 2003.

(5) SEC Release No. 33-8182, *Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*, January 28, 2003.

Sources and Uses of Cash. The release calls on companies to provide enhanced analysis of the sources and uses of cash and the reasons for material changes in items underlying cash flows from operating, investing, and financing activities reported in the financial statements, rather than merely reciting line-item amounts and changes in the cash flow statements. For example, if cash generated by and used in operating, investing, and financing activities is consistent, but the underlying sources and uses of cash have materially changed, the changes should be analyzed. The analysis should explain why the changes occurred and their effect on the company's current and long-term liquidity and cash position.

The release notes that a cash flow statement prepared using the "indirect" method reports increases or decreases in individual components of working capital, but does not provide a sufficient basis to analyze the changes. For purposes of the discussion and analysis of operating cash flows, companies should consider using the "direct" method to describe changes in cash flows and their 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).

Each company should consider whether its circumstances make enhancing its disclosures on these subjects required:

- External debt financing, guarantees, and related covenants,
- Off-balance-sheet financing arrangements,
- Issuance or purchase of derivative instruments linked to its stock,
- The use of stock as a form of liquidity, and
- The potential effect of known or reasonably likely changes in credit ratings or ratings outlook (or inability to achieve changes).

In addition to these items, the company should consider discussing and analyzing the types of financing that are available or are reasonably likely to be available (or the types of financing that a company would want to use but are unavailable or are reasonably likely to be unavailable) and the effect on the company's cash position and liquidity. In some circumstances

these disclosures could be required. The disclosure should include the specific terms of planned financings and their expected effects on cash position and liquidity.

Debt Instruments, Guarantees, and Related Covenants.

Companies should discuss and analyze material covenants related to their outstanding debt (or covenants applicable to the companies or third parties in respect of guarantees or other contingent obligations) in at least the following two circumstances.

First, if they are, or are reasonably likely to be, in breach of the covenants (or subject to mandatory prepayment provisions or put rights), they must disclose the breach and analyze its effect on the company. The release specifies several items for disclosure in this situation, such as steps being taken to avoid or cure a breach, the reasonably likely impact of a breach, and alternative sources of funding.

Second, companies should consider the effect of debt covenants on their ability to undertake additional debt or equity financing. If covenants materially limit, or are reasonably likely to materially limit, a company's ability to undertake future financing, the company must discuss the covenants and the consequences of the limitation to financial condition and operating performance.

Cash Management. MD&A should describe known material trends or uncertainties related to cash management decisions. For example, the material effects of a decision to reduce capital expenditures in a highly capital-intensive business should be disclosed.

CRITICAL ACCOUNTING ESTIMATES

The release clarifies what the SEC expects in the way of MD&A discussions of critical accounting estimates. The SEC believes that *current* MD&A requirements require such discussions. The requirement is independent of what may become required as a result of the SEC's proposed rule on MD&A disclosures about critical accounting policies.⁶

Companies should discuss critical accounting estimates if both of these conditions are present: (1) Accounting estimates or

(6) SEC Release No. 33-8098, Proposed Rule: Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies, May 10, 2002.



assumptions are material because of the levels of subjectivity and judgment necessary to account for matters that are either highly uncertain or highly susceptible to change; and (2) the effect of the estimates and assumptions on financial condition or operating performance is material.

Disclosures made in response to these conditions should address why the company’s accounting estimates or assumptions bear the risk of change, such as circumstances that cause uncertainty or difficulty in measuring or valuing amounts subject to the estimate or assumption. Management should explain how it arrived at each of its critical accounting estimates and assumptions, 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.

Companies should also disclose the resulting accounting measures’ sensitivity to change based on other outcomes that are reasonably likely to occur and would have a material effect. The sensitivity should be quantified if the information is reasonably available and material to investors. For example, if reasonably likely changes in the long-term rate of return used in accounting for a company’s pension plan would materially affect the company’s financial condition or operating performance, the SEC staff would expect the potential effect given the range of reasonably likely outcomes to be quantified and disclosed.

Accounting policy disclosures in MD&A should supplement, not duplicate, the description of accounting policies in the notes to the financial statements. The MD&A disclosure should provide greater insight into the quality and potential variability of financial condition and operating performance.



This is a publication of
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The release responds, in part, to the results of the SEC’s Fortune 500 review and to the SEC’s concern that a significant number of MD&A disclosures merely recite financial-statement information or boilerplate analysis that does not facilitate a readers’ understanding of a company’s current and future financial condition and operating performance.⁷ The Division of Corporate Finance will continue its focus on MD&A as part of its ongoing filing reviews and will determine whether to take additional action to improve the disclosures.

Calendar year-end companies, particularly accelerated filers, will have limited time to consider this guidance in drafting MD&A for 2003 annual reports. The SEC urges top-level management to get involved early in the process. Prompt consideration of the SEC’s interpretations will be critical.

The summary statements in this brief description of the release should not be substituted for the release’s text or be assumed to apply to the specific circumstances facing any particular company. Companies applying the guidance in Release No. 33-8350 should consult its text and their accounting and legal advisors and should consider their specific circumstances.

(7) Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies.