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Client Advisory

February 2002

New Focus on MD&A Disclosure Needed in Post-Enron Environment

By Mark D. Wood

In light of the Enron debacle, the events of September 11, 2001, the continuing difficult economic climate and financial market condition and recent pronouncements by the Securities and Exchange Commission (SEC), public companies should place increased focus on the clarity and completeness of their financial disclosure. In particular, each company should devote substantial attention to the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) to be included in its periodic reports filed with the SEC. The MD&A should be carefully crafted to enable investors to evaluate the company's performance and financial condition and gauge its prospects for the future. Achieving this objective may require a reexamination of the disclosure that has been provided in prior periods.

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The following are some of our general guidelines for management for preparing MD&A, with the assistance of professional advisors, for the 2001 fiscal year or any other period:

1. Prepare and circulate internally an initial draft of the MD&A as soon as is reasonably possible before the targeted filing date for the periodic report to allow for subsequent review and revision.

2. Do not delegate too much responsibility for MD&A preparation to lower level accounting or legal staff; the company's senior management must be actively involved. Always keep in mind that it is "management's discussion," and management will be held accountable.

3. Do due diligence. When evaluating what should be disclosed in the MD&A, review relevant materials, particularly those that may shed light on the issues and trends affecting the company and its industry. Materials to be reviewed may include:

   - press releases issued by the company;
   - scripts or transcripts of analyst conference calls;
   - minutes of meetings of the company's board of directors, board committees and shareholders;

- materials distributed to the board, shareholders and analysts;
- the company's Web site;
- litigation files;
- the company's debt instruments;
- significant new contracts;
- recent SEC comment letters;
- operating budgets and assumptions;
- reports and studies regarding the company, its industry and its competitors; and
- public filings made by the company's competitors.

4. Allow outside legal counsel and the independent auditors sufficient time to properly review and comment on each draft of the MD&A; avoid the apparent Enron practice of submitting the disclosure to the attorneys "with a relatively short time frame within which to respond with comments," as was noted in a now infamous letter from Enron's law firm. Also, provide your counsel with relevant documents and information so that they can provide you with meaningful perspective and guidance.

5. Ensure that the company's audit committee has ample opportunity to review the MD&A. The committee should exercise its oversight responsibility with respect to the company's financial reporting process, including both financial statements and MD&A.

6. Focus the discussion on the trends that may affect the company's operating results and financial condition. Although a company is not obligated to include earnings projections in its MD&A, Item 303 of Regulation S-K (the MD&A rule) does require it to discuss:

   - any known trends or any 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;
   - any known material trends, favorable or unfavorable, in the registrant's capital resources; and
   - any known trends or uncertainties that have had or that the registrant reasonably expects to have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.

   In fact, such trend-related information can be the most useful part of the MD&A disclosure. For some companies, however, MD&A consists largely of a recitation, in dollars and percentages, of the period to period changes in financial statement line items, along with brief textual explanations of the reasons for these historical changes (at least until a financial crisis is reached). That type of disclosure will often be inadequate. Management should strive to present a clear and complete picture of the company's current financial health and trends and uncertainties that could impact that health.

7. Discuss (where appropriate, directly in the MD&A and otherwise in an accompanying "Risk Factors" section) the important risks facing the company's business and its industry today. Revisit any previously identified risks, making appropriate changes and deleting those that are no longer relevant, and describe material new ones. This risk disclosure not only will go a long way in completing the picture of the state of the company's business, but also will help the company avail itself of the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995.

In addition, companies should consider the applicability of the guidance offered by the SEC in three recent releases:

- "Cautionary Advice Regarding the Use of 'Pro Forma' Financial Information in Earnings Releases," dated December 4, 2001, available on the SEC's Web site at http://www.sec.gov/rules/other/33-8039.htm;
- "Cautionary Advice Regarding Disclosure About Critical Accounting Policies," dated December 12, 2001, available on the SEC's Web site at http://www.sec.gov/rules/other/33-8040.htm; and
- "Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations," dated January 22, 2002, available on the SEC's Web site at http://www.sec.gov/rules/other/33-8056.htm.

Anyone with significant responsibility for a public company's financial disclosure should review these SEC releases in their entirety. We also advise any such person to read (or re-read) the SEC's 1989 MD&A interpretive release (Securities Act Release No. 6835, available on the SEC's Web site at http://www.sec.gov/rules/interp/33-6835.htm). The 1989 release provides guidance with respect to several key disclosure issues, including disclosure regarding known contingencies, capital expenditures and deficiencies in liquidity.

The following is a discussion of the SEC releases issued in December 2001 and January 2002 that impact MD&A disclosure:

I. "Cautionary Advice Regarding the Use of 'Pro Forma' Financial Information in Earnings Releases"

In its release of December 4, 2001, the SEC expressed to public companies its views on disclosure of "pro forma" financial information, i.e., financial performance measures that do not conform to Generally Accepted Accounting Principles (GAAP). At the same time, the SEC issued an alert, "Pro Forma Financial Information: Tips for Investors" that gives investors a "few things to keep in mind" when analyzing pro forma financial statements. Additionally, in January 2002, the SEC brought an enforcement action against Trump Hotels and Casino Resorts for inappropriate use of pro forma financial data. Through these actions, the SEC made clear that such data should not be used in a way that misleads investors, while recognizing that there are legitimate reasons to present this type of information.

Presentation of pro forma financial information, particularly in press releases, has become increasingly prevalent. In certain industries, where securities analysts focus their analysis on non-GAAP operating measures, such disclosure has become almost mandatory. According to a survey by the National Investor Relations Institute (NIRI) of 233 member companies, released on January 17, 2002, 57 percent prominently report pro forma financial information.

The SEC release discusses use of pro forma data in earnings releases, and certainly such data is more commonly found in press releases than in the much more rigid framework imposed upon SEC filings. However, where the pro forma data is important for investors' understanding of a company's business, and the company's prominent presentation of the data in an earnings release is evidence that management believes that it is, inclusion of such data in MD&A would generally be appropriate.

Wherever a company provides pro forma information, it should do so in a way that is fair and balanced, in the context of the GAAP financial statements and the company's historical presentations of its operating results. Based on the SEC cautionary statement, earnings release guidelines issued jointly by

Financial Executives International and NIRI (commended by the SEC in its release and available on NIRI's Web site at http://www.niri.org), and the Trump Hotels enforcement action, we recommend that:

- pro forma information be accompanied by at least as prominent a disclosure of GAAP operating results;
- the basis of the pro forma financial presentation, describing the transactions and other items omitted and/or included, be clearly disclosed;
- there be a line-by-line reconciliation to GAAP results (e.g., in a table);
- the pro forma information be presented consistently from period to period; and
- the pro forma information not be inherently misleading. For example, if "non-recurring" expenses are excluded, then non-recurring revenues should also be omitted. The SEC brought its action against Trump Hotels because Trump, in an earnings release, used a net income figure that explicitly excluded a one-time charge but included a very significant, undisclosed one-time gain. The SEC found that the earning release "was materially misleading because it created a false and misleading impression that the company had exceeded analyst expectations primarily through operational improvements, when in fact it had not." Accordingly, the SEC concluded that Trump had violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder (the general anti-fraud provision).

Excellent examples of disclosure of non-GAAP data in a non-abusive manner, consistent with the FEI/NIRI guidelines, are provided by the recent earnings releases and periodic reports of Amazon.com, which had previously come under criticism for its pro forma presentations.

II. "Cautionary Advice Regarding Disclosure About Critical Accounting Policies"

In its release of December 12, 2001, the SEC reminded companies that the selection and application of critical accounting policies (i.e., those that "are most important to the portrayal of the company's financial condition and results" and "require management's most difficult, subjective or complex judgments") must be appropriately reasoned. Furthermore, the SEC encouraged companies to include in their MD&As full explanations, in plain English of, their critical accounting policies, the judgments and uncertainties affecting the applications of those policies, and the possibility that materially different figures would be reported using different methods or assumptions. Finally, the SEC recommended that each company employ a disclosure scheme in which:

- management and the auditors devote special attention to the evaluation of the critical accounting policies used in financial statements;
- management ensures that MD&A disclosure is balanced, is fully responsive and explains the effects of the critical accounting policies applied;
- the audit committee reviews the selection, application and disclosure of critical accounting policies prior to finalizing and filing annual reports; and
- if management, the audit committee or the auditors are uncertain about the application of specific GAAP principles, they consult with the SEC accounting staff.

Each company should consider the advice offered by the SEC in this release and should determine, in consultation with its professional advisors, what additional disclosure regarding critical accounting policies is necessary. Eventually, the SEC plans to propose new rules to mandate specific disclosure in this area.

III. "Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations"

The SEC's release of January 22, 2002, addresses a few MD&A disclosure matters: liquidity and capital resources, including off-balance sheet arrangements; certain trading activities that include non-exchange traded contracts accounted for at fair value; and effects of transactions with related and certain other parties. This release was issued in response to a recent petition for guidance on these issues by the "Big 5" accounting firms, obviously as a direct result of the Enron financial disclosure failure. The SEC's prompt issuance of this "statement" demonstrates the SEC's current concerns about the adequacy of financial disclosure and its emphasis on MD&A as the vehicle for providing the financial disclosure transparency that may not be offered by financial statements and the dense and complex financial statement footnotes that are often of little value to investors. The release not only discusses key disclosure topics but also advises companies that they should provide information that is both useful and understandable and that information relating to a specific matter is generally more meaningful if presented in a single location in a filing (e.g., the "Liquidity and Capital Resources" section of MD&A).

Disclosures Concerning Liquidity and Capital Resources, Including "Off-Balance Sheet" Arrangements

In the release, the SEC indicated that the typical statement made by a company in its MD&A to the effect that it "has sufficient short-term funding to meet its liquidity needs for the next year" is insufficient. The SEC asked companies instead to consider describing in detail their material sources of liquidity and financing, including off-balance sheet financing arrangements. Companies are also reminded that they must identify circumstances that could materially affect liquidity if they are "reasonably likely to occur." Pointing to its 1989 MD&A release, the SEC reiterated the two assessments a company must make with respect to a known trend, demand, commitment, event or uncertainty:

The SEC indicated that the typical statement made by a company in its MD&A to the effect that it "has sufficient short-term funding to meet its liquidity needs for the next year" is insufficient.

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.

The SEC also provided a list of items that a company should consider to identify any trends, demands, commitments, events or uncertainties. These items include provisions in debt or lease agreements that could result in early repayment, additional collateral support, change in terms, acceleration of maturity or additional financial obligations, and factors that could have a significant impact on the company's credit rating or ability to raise capital.

The SEC requested that companies consider the need to include information regarding transactions and other relationships with structured finance entities and other unconsolidated, limited-purpose entities that are reasonably likely to materially affect liquidity or the availability of, or obligations with respect to, capital resources. According to the SEC, companies should provide detailed information about the nature, purpose, economic substance, terms and conditions, and effects of, as well as the risks associated with,

these arrangements. Additionally, the SEC suggested that companies furnish, in a single location within MD&A, information regarding all of their cash payment obligations under debt and lease agreements and other contracts and under contingent commitments, such as debt guarantees. The release includes examples of tabular formats for providing this information.

Disclosure about Certain Trading Activities that Include Non-Exchange Trade Contracts Accounted for at Fair Value

In the release, the SEC asked for additional MD&A disclosure by companies that are engaged, to a material extent, in trading activities involving commodity contracts (indexed to measures of weather, prices for energy storage, etc.) that are accounted for at fair value but where, due to a lack of market price quotations, fair value estimation techniques must be used. The SEC advised these companies to provide comprehensive information about the trading activities, the contracts, modeling methodologies, assumptions and variables, and the different potential outcomes. Furthermore, the SEC proposed that companies provide a schedule that "disaggregates realized and unrealized changes in fair value; identifies changes in fair value attributable to changes in valuation techniques; disaggregates estimated fair values at the latest balance sheet date based on whether fair values are determined directly from quoted market prices or are estimated; and indicates maturities of contracts at the latest balance sheet date (e.g., within one year, within years one through three, within years four and five, and after five years)."

Disclosure about Effects of Transactions with Related and Certain Other Parties

The SEC advised companies that their MD&A disclosure should contain detailed discussions of material related party transactions to the extent needed to provide investors with an understanding of their current and prospective financial positions and operating results. Going further, the SEC asked companies to consider including discussions regarding all material transactions with related persons or entities, as well as other parties with whom the company or the related parties have relationships that allow such other parties to negotiate transaction terms that may not be available from clearly independent parties on an arm's length basis. The SEC recommended that companies include in these discussions information regarding the nature, purpose and economic substance of, and risks associated with, the transactions. This MD&A disclosure is in addition to, and not in lieu of, the related party transaction information that must be provided pursuant to Item 404 of Regulation S-K ("Certain Relationships and Related Party Transactions") and in financial statement footnotes.

IV. Conclusion

In none of the three recent releases discussed above did the SEC adopt any formal new rules. The SEC indicated that it was merely advising companies as to compliance with existing requirements, offering disclosure recommendations and encouraging companies to furnish additional disclosure in important areas. Certainly, however, the SEC is seeking the inclusion in MD&A of a potentially substantial amount of information that has rarely been presented. Management of each public company should consult with the company's outside legal counsel and independent accountants regarding the application of the principles articulated in these releases to its particular situation. To the extent it is determined that additional information should be provided, the company and its advisors should work to present the information in a way that will be easily understandable and meaningful. The company's audit committee should be involved in reviewing these disclosure decisions. In this Enron-tainted environment, MD&A disclosure will be under increased scrutiny, and any company that ignores the guidance contained in the SEC releases may face a greater risk of SEC enforcement action and civil liability.

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04/16/2002