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An Overview of MD&A

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

Management's discussion and analysis of financial condition and results of operation, commonly referred to as MD&A, is an integral part of annual (Form 10-K) and quarterly (Form 10-Q) reports filed with the Securities and Exchange Commission (SEC). MD&A is also included in registration statements filed under both the Securities Exchange Act of 1934 (Form 10) and Securities Act of 1933 (Form S-1). MD&A requires the most input and effort from officers and directors of a company and, due to the many components of required information, often generates SEC review and comments. Item 303 of Regulation S-K sets forth the required content for MD&A. This discussion will be limited to the requirements for small public companies (i.e., those with revenues of less than $75 million).

A MD&A discussion for quarterly reports on Form 10-Q is abbreviated from the requirements for annual reports on Form 10-K and registration statements and should concentrate on updating and supplementing the annual report discussion. Although quarterly reports must discuss each item enumerated below, the discussion is expected to be more focused, concentrating on the most relevant and material items.

In December 2003, the SEC issued detailed interpretive guidance regarding disclosure in MD&A, which is helpful in understanding its required content. Pursuant to the SEC, MD&A has three primary purposes. These are:

- to provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management;
- to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and

- to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

Management and company counsel should keep these purposes in mind in drafting and finalizing MD&A. The content should not be overly technical, but neither should it be a forum for marketing content. MD&A should include an executive-level overview to provide a context for its presentation. In order to avoid a long, rambling discussion, MD&A should concentrate on the most material, relevant information in light of the particular areas of disclosure required by Rule 303. Moreover, MD&A should not be a recitation of financial statement footnotes or a duplication of disclosures in other areas of the subject report.

In addition, as guidance in drafting the MD&A, management should identify and discuss the key performance metrics that management uses to run the business, focus on material information, and explain management's view of the significance of the information presented. MD&A also requires a discussion of known trends and uncertainties that can impact the issuer's business and prospects and management's view of these trends.

In the MD&A portion of each annual report on Forms 10-Q and 10-K, and registration statements on either Form 10 or S-1, a company must discuss its financial condition, changes in financial condition and results of operations. In addition to the areas of discussion listed below, a company must include any other relevant information within its knowledge, which information provides a better or more complete understanding of the company's finances and financial condition. MD&A discussion must include:

1. Overview of Business

Without merely repeating the business section of the report or registration statement, MD&A should discuss a company's lines of business, locations of operations, and principal products and services, including any weaknesses and strengths and plans to improve the weaknesses and capitalize on the strengths. This discussion should include material opportunities, challenges and risks, trends and economic factors. Moreover, this discussion should both a short-term and long-term perspective.

2. Liquidity

A company must identify any known trends or known demands, commitments, events or uncertainties that will result in or reasonably could result in an increase or decrease in liquidity. In addition, a company must identify sources and uses of liquidity and any known changes thereto. An explanation of the information provided is required. In layman's terms, liquidity is a discussion of sources of cash and uses of cash, and factors that could change or impact either, both as reflected in the financial period covered by the subject report, and for the future. Although not all-inclusive, the discussion, at a minimum, should address the items included in the statement of cash flows provided as part of the financial statements.

Discussions on liquidity and capital resources are considered so important that in September 2010, the SEC issued an interpretive release addressing these two areas separately from the rest of MD&A. The SEC reminded companies to "identify and separately describe internal and external sources of liquidity, and briefly discuss any material unused sources of liquidity."

Both the 2003 and 2010 interpretive releases emphasize the need to "provide investors with disclosure that facilitates an appreciation of known trends and uncertainties that have impacted historical results or are reasonably likely to shape future periods." The "reasonably likely" standard is higher than "possible."

Companies should identify trends, demands, commitments and uncertainties relating to liquidity and capital resources, such as any trends or uncertainties relating to the company's ability to access the capital markets, including both debt and equity markets. Additional important trends and uncertainties include reliance on commercial paper or other short-term financing arrangements, maturity mismatches between borrowing sources and the assets funded by those sources, changes in terms requested by counterparties, changes in the valuation of collateral and counterparty risk.

In addition, the SEC advised companies to disclose material variations in liquidity and capital resources (for example, arising from the issuance of commercial paper), the company's cash and risk management policies and the nature and composition of the company's cash portfolio. The SEC has emphasized many times the need to disclose any known commitment, event or uncertainty that will result in or is reasonably likely to result in an increase or decrease in liquidity in a material way.

Companies should also provide detailed disclosure regarding debt instruments, guarantees and related covenants that will impact the liquidity. A detailed discussion of short-term debt should be a part of all liquidity disclosures. The SEC even proposed a separate rule related to short-term debt disclosure, which, although never enacted into law, provided insight into the SEC's view of the importance of this area of disclosure.

3. Capital Resources

A discussion of capital resources includes all material commitments for capital expenditures, the purpose and the source of funds for these commitments. This would include outstanding debts and obligations and, simply put, where the money will come from to pay them. In addition, capital resources includes a discussion of trends, favorable and unfavorable, that could impact capital resources and management's view and plans related to these trends. An obvious example would be a change in government regulation directly related to the company's business.

4. Results of Operations

Results of operations include four areas of discussion: (i) unusual or infrequent events that have impacted on a companies' financial condition. An example would be a discontinuance of a specific product line, or sale of company subsidiary; (ii) trends that could have an impact on sales or revenues or income in general, including trends impacting costs and expenses; (iii) a narrative discussion of increases or decreases in sale or revenues; and (iv) impact of inflation and other external financial conditions.

5. Off-Balance-Sheet Arrangements

Off-balance-sheet arrangements gained notoriety during the mortgage scandal and economic turmoil that resulted. An off-balance-sheet arrangement is any arrangement that could have an impact on a balance sheet, but does not currently appear on the balance sheet, the most obvious example being a guarantee of a third party's obligation. A second material off-balance-sheet arrangement involves re-purchase agreements. A repurchase agreement is generally where a company sells an asset and concurrently enters into an agreement that would allow or require the company to repurchase the asset under certain circumstances. Accordingly, if a company has such an arrangement to report, they are required to provide a detailed analysis including the potential impact and relative importance of the arrangement.

6. Critical Accounting Estimates

Although management is not required to and should not merely repeat the critical accounting policies set forth in the notes to financial statements, they should include a discussion of estimates and assumptions that resulted from the accounting policies, especially where such involved judgment calls on the part of management.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the Producer and host of LawCast.com, The Securities Law Network.

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