In the SEC's recent focus on the quality of management's discussion and analysis, or MD&A, disclosure, it has re-emphasized the need to identify and analyze material trends, demands, commitments, events and uncertainties that could impact a company's liquidity, financial condition or operating results. This disclosure, the SEC believes, is critical to understanding a company's reported financial information and the extent to which reported information is indicative of future results or financial condition.

The SEC Has Faulted Some Companies' MD&A For Failure to Adequately Discuss or Disclose Trends and Uncertainties

To illustrate the importance of disclosure concerning trends and uncertainties, the SEC continues to refer to its 1989 enforcement action against Caterpillar Inc. In that action, the SEC found that Caterpillar not only failed to discuss the significant bottom line impact of a Brazilian subsidiary, but also failed to discuss Caterpillar's uncertainty over the future impact of the subsidiary's results on Caterpillar's overall results due to anticipated sweeping, yet unspecified, economic reforms that were expected to be instituted in Brazil.

Other examples where the SEC found fault with a company's MD&A include:

- Burroughs Corporation, for failing to discuss the future impact of inventory obsolescence, among other things; and
- The Charter Company, for not only failing to disclose favorable effects of an accounting method used, but also the anticipated substantial reduction in future profits that would result from use of that method.

When Does a Company Have a Duty to Disclose Trends and Uncertainties?

SEC regulations require that MD&A focus on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or future financial condition. A disclosure duty exists where a trend, demand, commitment, event or uncertainty is both:

- presently known to management, and
- reasonably likely to have a material effect on a company's liquidity, financial condition or results of operations.

The "reasonably likely" threshold is higher than "possible" but lower than "more likely than not." In the SEC's most recent interpretive release, it indicated that it expects disclosure of an identified trend, future event or uncertainty unless management concludes that either:

- it is not reasonably likely the trend, event or uncertainty will occur or come to fruition; or
- the trend or uncertainty is not reasonably likely to have a material effect on the company's liquidity, capital resources or results of operations.
In addition to identifying a known trend or uncertainty itself, the SEC has emphasized the value of disclosing the facts and circumstances surrounding a known trend or uncertainty, including quantification of material effects. Quantification may even be required if reasonably available.

The SEC regulations state that "[t]his would include descriptions and amounts of (A) matters that would have an impact on future operations and have not had an impact in the past, and (B) matters that have had an impact on reported operations and are not expected to have an impact upon future operations."

For example, a company may know that a government contract that represented 20% of its revenues over the last two fiscal years is about to expire and will be put out for competitive bid. The company may be uncertain as to whether the contract will be renewed, but nevertheless will be able to assess facts relating to the prospects for renewal. If the company knows that a competitor has found a way to provide the same service or product at a price less than that charged by the company, it is unlikely management could conclude that the nonrenewal of the contract is "not reasonably likely." Presumably, the company would also have factual information relevant to the financial impact of nonrenewal. Thus, the company would have identified a known uncertainty reasonably likely to have material future effects on its financial condition or results of operations, and disclosure would be required, including quantification of the impact of the contract nonrenewal on future operating results.

When Must a Company Disclose Prospective Information?

Disclosure of known trends and uncertainties involves disclosure not only concerning the financial information reported during the period covered (i.e., assessing the "quality" of the reported financial information), but also forward-looking information about the potential impact on future liquidity, capital resources and operating results.

For instance, Caterpillar should have reported not only an increase in sales in Brazil for its completed year-end due to hyperinflation in Brazil combined with lagging exchange rates, but also should have reported that the rampant hyperinflation, among other issues, was likely to lead to sweeping economic reforms that might negatively impact future results.

As another example, a company that reasonably expects a further decline in reported unit sales of mature products must disclose the known trend. That disclosure may state, for instance:

While market conditions in general remained relatively unchanged, unit sales volumes declined 10% as our older products, representing 40% of overall revenues, continue to approach the end of their life cycle. We anticipate that our revenues and operating profits in future periods will be adversely affected by continued declines in unit sales volumes of our older products, which we expect to accelerate in the future.

As distinguished from "optional" forward-looking information, required disclosure is based on currently known trends, events and uncertainties that are reasonably likely to have material effects, such as:

- reduction in product prices;
- loss of market share;
- changes in insurance coverage; or
- nonrenewal of a material contract.

In contrast, optional forward-looking disclosure involves anticipating a future trend or event or anticipating a less predictable impact of a known trend, event or uncertainty.

MD&A Disclosure May Be Required to Include an Analysis of Trends and Uncertainties

In addition to identifying known trends and uncertainties, MD&A disclosure should and may be required to include an analysis explaining:

- the reasons or implications of the known trends or uncertainties;
- the relationship between elements of the trends and uncertainties and the financial results of the company; and
- the relative significance of those matters.
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 analyze the reasons underlying the decline when the reasons are material and determinable.

The analysis should reveal underlying material causes, such as, for example:

- difficulties in the manufacturing process;
- a decline in the quality of product;
- loss in competitive position and market share;
- adverse economic or regulatory conditions affecting target customers' industries; 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.

**Practical Tip: MD&A Disclosure Should Focus on Specific Categories of Known Data**

In preparing MD&A disclosure, a company should focus on each of the specific categories of known data. For example, Item 303(a)(2)(i) of Regulation S-K requires a description of material “commitments” for capital expenditures. However, even where no legal commitments have been made, disclosure is required if material planned capital expenditures result from a known demand, as where the expenditures are necessary to continue the company's current growth trend.

Similarly, if the same company has determined not to incur such capital expenditures, a known uncertainty would exist regarding continuation of the current growth trend. If the adverse effect from discontinuation of the growth trend is reasonably likely to be material, disclosure is required. Disclosure of planned material expenditures is also required, for example, when such expenditures are necessary to support a new, publicly announced product or line of business.

**MD&A Disclosure May Be Required Where Reported Financial Information Is Not Indicative of Future Results**

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 instance, 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 nonrecurring 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.

**Additional Information**

This Update is a discussion based on interpretive and other SEC releases as well as Item 303 of Regulation S-K.

You can find the full text of Regulation S-K at [http://www.sec.gov/divisions/corpfin/forms/regsk.htm](http://www.sec.gov/divisions/corpfin/forms/regsk.htm). You can find the full text of the relevant releases as adopted as follows:

- SEC Interpretation: Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures at [http://www.sec.gov/rules/interp/33-6835.htm](http://www.sec.gov/rules/interp/33-6835.htm); and

You can find a general discussion of related topics and of recent laws, regulations and rules and proposals of interest to public companies on our website.

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