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CORPORATE GOVERNANCE

What Europe can learn from America's scandals

America's response to Enron and WorldCom is a new style in-depth annual company report that aims to reveal what makes a business tick. With the UK and Europe about to follow suit, **John Basnage** and **Jeff Hurlburt** outline the US model and the example it offers the rest of the world

After the plethora of corporate scandals that have dogged the United States it is no surprise that Europe is seeking to make moves towards stronger mechanisms of accountability for public companies. As each new disgraced company hits the headlines, more weight is given to the view that simple presentation of the financial details of a company cannot give an adequate picture of its overall performance.

To understand what the regulators are thinking it is instructive to look at what is happening in the US not least because of the impact on overseas companies listed there but also as a potential model for the UK and Europe. On 19 December 2003, the US Securities and Exchange Commission (SEC) issued additional interpretive guidance regarding disclosure in SEC filings known as Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A).

The SEC separately considers four principal areas of disclosure: presentation of MD&A; content and focus of MD&A; liquidity and capital resources; and critical accounting estimates. It has provided guidance on the application of these requirements in the form of cautionary statements, interpretive releases, comments made during the filing review process and SEC views conveyed in enforcement actions. The SEC's guidance applies to domestic SEC registrants, as well as to foreign private issuers, and must be reflected in Form 10-K and 20-F annual reports filed in respect of companies' 2003 financial year. The guidelines may also be relevant for companies not subject to the SEC's reporting obligations because of liability concerns and/or market expectations.

Acknowledging that MD&A has become "necessarily lengthy and complex" the SEC nevertheless emphasises that it should be presented in clear and understandable language. To provide a focus on the most important information and improve clarity, the SEC recommends that companies consider including the following:

- a tabular presentation of financial and other information, followed by a narrative discussion and analysis of that information;
- an overview that includes the most important matters used in evaluating the company's financial condition and operating performance;
- 'layered' disclosure that highlights the most important factors, trends and themes before providing detailed discussion and analysis;
- frequent use of headings to assist readers in following the flow of disclosure; and
- a discussion of prospective matters and other material forward-looking information.

Ultimately, the MD&A should leave a reader with sufficient information to understand how a company earns revenue and income and generates cash, provide insight into material short and long-term opportunities, challenges and risks faced by the company and explain the company's plan for responding to such opportunities, challenges and risks.

The SEC noted that companies should enhance the clarity of MD&A by highlighting material information and de-emphasising or deleting immaterial information.

Companies should focus their disclosures on key variables and other factors that are specific to, and necessary to understand and evaluate, their businesses. Key variables may include financial measures and non-financial business and operational data, such as industry-specific measures and interest rates, economic growth rates and other macro-economic matters. Companies should provide a balanced view of the dynamics of their businesses by describing their successes and any failures to achieve material goals. Companies should refrain from disclosing unnecessary or duplicative information to avoid subjecting readers to "unnecessary information overload".

MD&A disclosure must focus on the disclosure of material information. This may mean culling from a company's disclosure stale, irrelevant and redundant information and information relating to issues that were relevant, but no longer continue to be relevant. Companies should also consider providing segment data where such data are material to an understanding of consolidated information. Materiality should generally be considered in light of the period to which MD&A relates.

A company's MD&A must disclose material trends, demands, commitments, events and uncertainties unless the company is able to conclude either that it is not reasonably likely that the trend will come to fruition or that such trend will not have a material effect on the company's liquidity, capital resources or results of operations.

The MD&A must include an analysis as well as a discussion of the disclosure elements. Accordingly, it should not merely be a restatement of financial information in narrative form. Companies should include a thorough analysis of known material trends, events, commitments and uncertainties, explaining the underlying reasons or implications, the interrelationships between constituent elements and the relative significance of these matters. In the case of material unusual or non-recurring items, a company should provide analysis necessary for readers to ascertain that the company's past performance is not indicative of its future performance.

Consistent with its prior guidance, the SEC reiterated its view that, to the extent that it is material, a company must

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consider in its discussion and analysis of liquidity and capital resources: historical information regarding sources of cash and capital expenditures; the amounts and certainty of cash flows; the existence and timing of commitments for capital expenditures and other known and reasonably likely cash requirements; known trends and uncertainties; expected changes in, and costs of, capital resources; and the company's future sources of, and need for, capital. Companies must evaluate their ability to meet their cash needs on both a short-term and long-term basis.

In identifying their known material cash requirements, generic disclosure should be avoided. A company should describe and analyse: funds necessary to maintain its current operations, complete projects underway and achieve stated objectives or plans; its capital commitments; and the effects of known trends or uncertainties (including a statement as to the time period in which resolution of any uncertainties is anticipated and any difficulty related to assessing the effect of such uncertainties).

The company must not merely recite changes and other information evident from the financial statements. Companies should address material changes by focusing on 'underlying drivers' of operating cash flows. A company must describe its historical financing arrangements and their importance to cash flows. Historical financing disclosure might include a description of external debt financing, the use of off-balance sheet financing arrangements, the issuance or purchase of derivative instruments linked to the company's share capital, the use of share capital as a form of liquidity and the potential impact of known or reasonably likely changes in credit ratings or ratings outlook.

A company that is, or is likely to be, in breach of material covenants relating to outstanding debt, guarantees or other contingent obligations must disclose material information about the breach and analyse the impact on it, including, to the extent material, the disclosure of the steps the company is taking to avoid or cure the breach, the impact of the breach on financial condition or operating performance (including the effects of any cross-default, cross-acceleration or similar provision) and alternative sources of financing to pay off resulting obligations or replace funding. Companies must provide similar discussion and analysis of any mandatory prepayment provisions, 'put' rights and other similar provisions and should consider the impact of debt covenants, such as debt incurrence and restricted payment limitations and ratio maintenance tests, on their ability to undertake additional debt or equity financing.

> Companies should provide a balanced view of the dynamics of their businesses by describing their successes and any failures to achieve material goals and refrain from disclosing unnecessary or duplicative information

Disclosure relating to liquidity and capital sources should describe known material trends or uncertainties relating to determinations of when and how companies use their cash resources to satisfy obligations and make other capital expenditures.

When preparing MD&A under the current requirements, companies should disclose 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.

This disclosure should supplement, not duplicate, the description of accounting policies already disclosed in the notes to the company's financial statements, should provide greater insight than such notes into the quality and variability of information regarding financial condition and operating performance and should involve quantitative as well as qualitative information when quantitative information is reasonably available and will provide material information. Although the SEC has proposed rules on disclosure of critical accounting estimates that would broaden the scope of the disclosures required under the current rules, it has not yet acted on such proposals.

The SEC's MD&A guidance addresses what it perceives to be continuing deficiencies in MD&A disclosure in recent corporate filings. Preparation for future filings will involve both the challenge of implementing the new guidance and that of complying with the rules adopted by the SEC last year requiring MD&A disclosure of off-balance sheet arrangements and aggregate contractual obligations.

There are some practical steps that companies should consider, including taking a fresh look at MD&A. The company should consider whether its current MD&A should be fundamentally revamped in light of the SEC's guidance, rather than simply updated and supplemented to comply with the new rules. Even if the overall presentation and focus of its MD&A is sound, the company should critically review the individual components of MD&A to identify potential areas for improvement.

MD&A must extend beyond a review of financial measures to encompass a discussion and analysis of all of the most important matters on which management focuses in evaluating the company's business. Accordingly, the SEC encourages "early top-level involvement by a company's management in identifying the key disclosure themes and items."

Companies should also compare MD&A disclosure with other internal and external disclosures such as board packages, presentations to and by management, press releases and analyst calls to see if key indicators discussed outside of MD&A should be discussed in the MD&A.

In conclusion, sufficient time should be devoted to MD&A. A company should begin the MD&A drafting process at any early enough date to permit the internal team and any outside advisers sufficient time to prepare an MD&A that complies with existing and new requirements and is responsive to the SEC's new guidance. ■

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