MD&A: The Tightrope of Disclosure

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I. INTRODUCTION

The Securities and Exchange Commission envisioned Item 303 of the Securities Act and Exchange Act regulations, referred to as Management's Discussion and Analysis (MD&A),[1] as a means to elicit and to improve corporate communication with the public concerning what has already occurred

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1. 17 C.F.R. § 229.303 (1993); *see also* Securities Act Release No. 6835, 54 Fed. Reg. 22,427 (May 18, 1989) [hereinafter Securities Act Release No. 6835] (providing interpretive guidance of the disclosure required by Item 303).

and what lies ahead financially for public companies (registrants).[2] However, compliance with the federal securities disclosure laws is an arduous task for public companies even under the best of circumstances. Under Item 303 and its applicable interpretive releases, the MD&A disclosure requirements are open-ended and exceedingly complex. An encounter with the disclosure requirements of the federal securities laws has been aptly described as analogous to "a fencing match conducted on a tightrope."[3] On one hand, failure to comply with Item 303 may subject the registrant to the wrath of the Commission[4] and perhaps expose the registrant to other potential sources of liability.[5] On the other hand, unabridged MD&A disclosure may be

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2. *See, e.g*, Securities Act Release No. 6711, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,118 (Apr. 20, 1987) (presenting detailed summary of MD&A's origins and the evolution of the SEC's approach to the disclosure requirements of public companies) [hereinafter Securities Act Release No. 6711]; *see also* Ray Garrett, Jr., Address before the Chicago Chapter of American Society of Corporate Secretaries (Mar. 13, 1974) (the former SEC Chairman noting that the Commission had adopted a hands-off approach to "free writing" communications with shareholders); Carl W. Schneider, *MD&A Disclosure*, REV. SEC. & COMMODITIES REG., Aug. 23, 1989, at 149 (discussing requirements of MD&A and the resulting possibility of increased liability).

3. SEC v. Bausch & Lomb Inc., 565 F.2d 8, 9 (2d Cir. 1977).

4. The SEC has broad investigatory and remedial powers. The Commission's enforcement powers include bringing suit in federal district court to enjoin violations of the securities laws, referring violations of the securities laws to the Justice Department for criminal prosecution, and instituting administrative proceedings to require compliance through cease and desist orders and monetary penalties. *See* 15 U.S.C. § 77u-v (1988).

5. While a comprehensive analysis of possible sources of corporate liability for violations of the federal securities laws is beyond the scope of this article, a limited discussion is in order. In general, registrants view periodic SEC filings as liability documents, because such filings are routinely incorporated by reference into proxies, registration statements, and other informational filings. *See* 17 C.F.R. §§ 240.12b-23, 230.411, 201.24 (1993). When a person relies on documents filed with the Commission in connection with a purchase or sale of securities, the Exchange Act provides a private remedy for false of misleading statements contained within such documents. *See* Exchange Act of 1934 § 18, 15 U.S.C. § 78r (1988). Section 78n makes it unlawful to solicit a proxy in violation of any SEC rules or regulation. *See id.* § 78n. One such rule is 14a-9, which prohibits proxy solicitations that contain false statements or material omissions. *See* 17 C.F.R. § 240.14a-9 (1993). Further, the omnipresent Rule 10b-5 general anti-fraud provision prohibits the use of manipulative or deceptive devices in connection with the purchase or sale of securities. *See* Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (1993). Additionally, Section 20 of the Exchange Act imposes joint and several liability on controlling persons for any violations by persons under their control. *See* 15 U.S.C. § 78t (1988). Sections 11, 12, and 17 of the Securities Act also impose liability for violations in connection with a purchase or sale of securities. Section 11 creates civil liability when a registration statement contains an untrue statement of a material fact or an omission of a material fact. *See* 15 U.S.C. § 77k (1988). Section 12(1) imposes liability on persons selling securities without an effective registration statement, while Section 12(2) imposes civil lability on a seller for misrepresentations in a prospectus or oral communication. *See* 15 U.S.C. § 77l (1988). A general prohibition against fraudulent interstate offers or sales of securities is contained in Section 17. *See* 15 U.S.C. § 77q (1988).

Croft: MD&A: The Tightrope of Disclosure

imprudent or even detrimental to the best interests of the corporation and its shareholders.

This article considers the more salient issues that the MD&A disclosure requirements raise and reviews recent MD&A litigation. Part I discusses the evolution of MD&A from its inception in 1968 to its current form. Part II focuses on the registrant's duty to disclose material non-public information and the requisite materiality standard of MD&A. In particular, this Part compares the *Basic Inc. v. Levinson*[6] probability/magnitude materiality balancing test with the approach the Commission adopted in Securities Act Release No. 6835.[7] Part III explores the paradoxical distinction between required MD&A prospective disclosure and voluntary forward-looking statements, as well as the role, if any, that Rule 175's[8] safe-harbor provisions play with elective Item 303 disclosure. To underscore the dilemma registrants and their legal counsel face, Part IV engages in an extensive analysis of the statutory language of Item 303. Specifically, this section discusses the MD&A disclosure requirements regarding liquidity, capital resources, results of operations, segment/subdivision, line item, and interim reporting. Part V examines the response, or more appropriately the lack thereof, to MD&A by the accounting profession and the self-regulating organizations. Finally, the last section considers recent litigation involving MD&A, focusing specifically on a recent and enlightening administrative proceeding the SEC brought against Caterpillar, Inc.[9]

II. THE ORIGINS OF MD&A

The inception of MD&A lies in the SEC's 1968 adoption of the *Guides for Preparation and Filing of Registration Statements*.[10] The Guides directed that persons subject to the Securities Act of 1933[11] disclose in a summary of earnings any unusual conditions affecting those earnings and footnote any adverse changes "in operating results subsequent to the latest period included in the summary of earnings."[12]

In 1974 the Commission expanded the guidelines[13] to encompass

6. 485 U.S. 224 (1988).

7. *See supra* note 1.

8. 17 C.F.R. § 230.175 (1993).

9. Exchange Act Release No. 30,532 (*In re.* Caterpillar Inc.) [1992 Transfer Binder] 7 Fed. Sec. L. Rep. (CCH) ¶ 73,830 (March 31, 1992) [hereinafter Exchange Act Release No. 30,532].

10. Securities Act Release No. 4936, 33 Fed. Reg. 18,617 (Dec. 9, 1968) [hereinafter Securities Act Release No. 4936].

11. 15 U.S.C. § 77a-aa ((1988) & Supps. II-IV 1990-92).

12. Securities Act Release No. 4936, *supra* note 10, at 18,620.

13. Securities Act Release No. 5520, 39 Fed. Reg. 31,894 (Aug. 14, 1974) [hereinafter Securities Act Release No. 5520].

required filings under the Securities Exchange Act of 1934.[14] Devised to enable investors and other users to better understand a registrant's earnings summary, the new guidelines also mandated an extensive narrative explanation of the summary.[15] The Commission intended "to enable investors to compare periodic results of operation and to assess the source and probability of [the] recurrence of earnings (losses)."[16] The 1974 guidelines adopted percentage tests to help registrants discern which items of revenue and expense merited discussion.[17] However, the Commission cautioned that some items not meeting the percentage tests would still require discussion and analysis if such were necessary to understand the summary.[18]

Skyrocketing inflation and upwardly-spiraling interest rates marked the late 1970s. The Commission soon realized that the narrow focus of the 1974 guidelines, coupled with the economic climate and the tendency of registrants to apply the percentage tests in a mechanical fashion, resulted in the sought after disclosure becoming nearly worthless.[19] Responding to the perceived inadequacies of the existing guidelines, the Commission revamped MD&A in 1980.[20] The new guidelines emphasized the concepts of "materiality" and "relevance."[21] The new rules were flexible and drafted to preclude "boiler-plate" discussions.[22]

The Commission issued its final promulgation of MD&A in 1989 with Interpretive Release No. 6835, entitled *Management's Discussion and Analysis*

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14. Ch. 404, 48 Stat. 881 (codified as amended in scattered sections of 15 U.S.C. (1988) & Supps. I-IV 1989-92).

15. Securities Act Release No. 5520, *supra* note 13, at 31,895. The separate discussion and analysis was required to address the "(1) material changes from period to period in the amounts of the items of revenues and expenses, and (2) changes in accounting principles or practices or in the method of their application that have a material effect on net income as reported." *Id.*; *see also* Securities Act Release No. 6711, *supra* note 2, at ¶ 88,623-624 (reaffirming the usefulness of the guidelines provided in Act Release No. 5520).

16. Securities Act Release No. 5520, *supra* note 13, at 31,895.

17. *Id.* at 31,896 The percentage tests compelled disclosure when an item of revenue or expense changed by more than ten percent from the previous period or when the average net income or loss for the three most recent periods changed by more than two percent. *Id.*

18. *Id.*

19. *See* Securities Act Release No. 6231, 45 Fed. Reg. 63,630 (Sept. 25, 1980).

20. *Id.*

21. *See id.* at 63,636.

22. *Id.* The Commission rescinded the percentage tests and encouraged forward-looking statements. Moreover, for the first time, the 1980 revised MD&A required the discussion of favorable or unfavorable trends, material events, or uncertainties as they related to a registrant's liquidity, capital resources, and results of operations. *Id.* Further, in 1981 the Commission announced it would monitor the MD&A of registrants and issued examples of several registrants' MD&As without passing on their merit. *See* Securities Act Release No. 6349, 23 SEC Docket (CCH) 962 (Sept. 28, 1981) (not published in Fed. Reg.)[hereinafter Securities Act Release No. 6349].

of Financial Condition and Results of Operations; Certain Investment Company Disclosures.[23] Today, both Item 303 and Interpretive Release No. 6835 govern MD&A Disclosure. Regarding the aim of Item 303 and the Interpretive Release, the Commission remarked:

> In preparing MD&A disclosure, registrants should be guided by the general purpose of the MD&A requirements: to give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's financial condition and results of operations, with particular emphasis on the registrant's prospects for the future. The MD&A requirements are intentionally flexible and general. Because no two registrants are identical, good MD&A disclosure for one registrant is not necessarily good MD&A disclosure for another. The same is true for MD&A disclosure of the same registrant in different years. The flexibility of MD&A creates a framework for providing the marketplace with appropriate information concerning the registrant's financial condition, changes in financial condition and results of operation.[24]

Apparently, the intent of both Item 303 and the Release is to emphasize the quality, not the quantity of disclosure.[25]

III. The MD&A Duty to Disclose and Its Unique Materiality Standard

It is now a well-settled principle of law that a duty to disclose material information does not arise unless a disclosure "trigger" exists.[26] The situations that principally trigger an obligation to disclose material non-public

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23. Securities Release Act No. 6835, *supra* note 1, at 22,427.

24. Securities Act Release No. 6835, *supra* note 1, at 22,436.

25. *See, e.g.*, Terry Lloyd & Vincent J. Love, *Management's Discussion and Analysis, in Understanding Financial Statements 1992: Accounting for Lawyers — A Corporate Law and Practice Course Handbook* (PLI Corp. Law & Practice Course Handbook Series No. B4-7000, 1992).

26. The mere possession of non-public market information does not give rise to a duty to disclose. Chiarella v. United States, 445 U.S. 222, 235 (1980). There is also no general obligation to disclose non-public material information. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988) (Under the federal securities laws, "[s]ilence absent a duty to disclose, is not misleading . . . ."). "[T]he established view is that a 'duty to speak' must exist *before* the disclosure of material facts is required . . . ." Starkman v. Marathon Oil Co., 772 F.2d 231, 238 (6th Cir. 1985), *cert. denied*, 475 U.S. 1015 (1986) (emphasis added). If a registrant voluntarily chooses to reveal material information "even though there it had no duty to do so, it must disclose the whole truth." Grossman v. Waste Management, Inc., 589 F. Supp. 395, 409 (N.D. Ill. 1984) (citing First Virginia Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978)).

information occur when a registrant has made "inaccurate, incomplete, or misleading prior disclosure;" when a registrant has made an accurate prior disclosure which has remained alive, thereby creating a duty to correct or update that disclosure in light of new material events; when a statute or regulation requires disclosure; or when an insider trades on or misuses such information.[27] Hence, Item 303 is clearly a disclosure trigger; however, the inquiry does not stop at this juncture. Only "material" non-public information need be disclosed in the face of an established duty to disclose.

In general, for information to be material, "there must be a substantial likelihood that the disclosure of the omitted fact[s] would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[28] In other words, the information "is material if there is a substantial likelihood that a reasonable [investor or other user] would consider it important [in making an investment decision]."[29] In the context of preliminary merger negotiations, the Supreme Court in *Basic Inc. v. Levinson*[30] endorsed a probability/magnitude balancing test.[31] The *Basic* test of materiality depends upon the probability that the event will occur and the significance of the event to the registrant.[32]

However, in announcing the materiality standard for MD&A disclosure, the Commission declared that "[t]he probability/magnitude test for materiality approved by the Supreme Court in *Basic, Inc. v. Levinson* . . . is inapposite to Item 303 disclosure."[33] In Securities Act Release No. 6835, the Commission set forth the requirement that registrants apply the following two-prong materiality test when management knows of a trend, demand, commitment, event or uncertainty:

> (1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not

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27. *See* Backman v. Polaroid Corp., 910 F.2d 10, 18-20 (1st Cir. 1990) (*en banc*) (Bownes, J., dissenting) (*citing* Roeder v. Alpha Industries, Inc., 814 F.2d 22, 26-27 (1st Cir. 1987)).

28. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (footnotes omitted).

29. *Id.*

30. 485 U.S. 224 (1988).

31. *Id.* at 231-32, 249. Post-*Basic* cases applying the probability/magnitude test include: Taylor v. First Union Corp., 857 F.2d 240, 244 (4th Cir. 1988), *cert. denied*, 489 U.S. 108 (1989); Jackvony v. RIHT Financial Corp., 873 F.2d 411, 415 (1st Cir. 1989).

32. *Basic*, 485 U.S. at 250. To assess the probability that an event will occur, the registrant is required to evaluate the indicia of interest in the event at the highest levels within the corporation. *Id.* at 239. In the potential merger context, the Court noted that such indicia would include, but not be limited to, board resolutions, discussions with investment bankers, and actual negotiations between principals or their agents. *Id.* Likewise, to assess the magnitude of the event to the registrant, a consideration may be necessary of the size of the merging entities, the amount of a potential premium over market value, or other particular factors. *Id.*

33. Securities Act Release No. 6835, *supra* note 1, at 22,430 n.27.

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.[34]

There may be trends, demands, commitments, events, or uncertainties for which the probability of an occurrence is relatively low (not reasonably likely to occur), but for which there may be a significant impact on the registrant. Consequently, under the *Basic* probability/magnitude balancing test, the information might be "material" and require disclosure; however, MD&A would not dictate disclosure until the trend, demand, commitment, event, or uncertainty appeared "reasonably likely to occur."[35]

IV. PROSPECTIVE DISCLOSURE

Prior to the 1970s, the Commission's approach to MD&A was to discourage predictive statements and to focus primarily on historical information, on the theory that although soft information[36] was inherently unreliable, the public might give it undue credence.[37] For example, the Commission believed that predictions of dividend estimates, expected earnings forecasts,

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34. *Id.* at 22,430.

35. *See id.*; *see also infra* note 48 and accompanying text (discussing the "reasonably likely to occur" standard).

36. One respected commentator defines soft information as:

> (1) forward-looking statements concerning the future, such as projections, forecasts, predictions, and statements concerning plans and expectations;
> (2) statements concerning past or present situations when the maker of the statement lacks the data necessary to prove its accuracy . . . ;
> (3) information based primarily on subjective evaluations . . . ;
> (4) statements of motive, purpose, or intention . . . ;
> (5) statements involving qualifying words . . . for which there are no generally accepted objective standards of measurement . . . .

Carl W. Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254, 255 (1972).

37. *See, e.g*, Walker v. Action Indus., Inc., 802 F.2d 703, 707-09 (4th Cir. 1986), *cert. denied*, 479 U.S. 1065 (1987) (discussing the historical development of the Commission's position and the various circuits' approaches to soft information and predictive statements); South Coast Serv. Corp. v. Santa Ana Valley Irrigation Co., 669 F.2d 1265, 1271 (9th Cir. 1982) (discussing the policy rationale for the disclosure of soft information); *see also* Securities Act Release No. 5180, 36 Fed. Reg. 16,506 (1971) (stating that required disclosure at a time when an offering is in process or being contemplated must be accomplished in a manner that does not unduly influence the proposed offering) [hereinafter Securities Act Release No. 5180].

and future market values of a registrant's securities were particularly misleading.[38] Courts and commentators roundly criticized the Commission's position,[39] and in 1976, the Commission responded to that criticism by deleting earnings projections from the list of potentially misleading disclosure items.[40] By 1978 the Commission had completely reversed its earlier position by encouraging registrants to include forward-looking statements in their filings.[41] One year later, the Commission enacted Rule 175, a safe-harbor rule for prospective information statements, to coax registrants to voluntarily disclose predictions in periodic filings.[42] Rule 175 protects registrants from liability under the federal securities laws for fraudulent statement when the prospective or "forward-looking"[43] statements are made in good faith and based on reasonable assumptions.[44]

MD&A presents many instances that call for the disclosure of prospective information.[45] However, the oxymoronic language of Item 303 has generated

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38. Securities Act Release No. 5180, *supra* note 37, at 16,507.

39. *See Walker*, 802 F.2d at 707; *see also* 1 THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION, 118-20 (2d ed. 1990) (discussing the Commission's policy and perspective, and some leading commentator's criticisms of the Commission's perspective on soft information); Alan R. Bromberg & Lewis D. Lowenfels, 2 *Securities Fraud and Commodities Fraud*, § 6.5 (431)(3), at 136.123 (1992).

40. *See* Securities Act Release No. 5699, [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,461 (Apr. 23, 1976).

41. *See* Securities Act Release No. 5993, 43 Fed. Reg. 53,251 (Nov. 7, 1978).

42. *See* Securities Act Rule 175, 17 C.F.R. § 230.175 (1993); *see also* Securities Act Release No. 6084, [1979 transfer binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117 (July 30, 1979) (discussing the background and purpose of the safe harbour rule).

43. Rule 175 defines forward-looking statements to mean:

> (1) A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;
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> (2) A statement of management's plans and objectives for future operations;
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> (3) A statement of future economic performance contained in management's discussion and analysis of financial condition and results of operations included pursuant to Item 303 of Regulation S-K . . . ; or
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> (4) Disclosed statements of the assumptions underlying or relating to any of the statements described . . . . [by the three sections above].

Securities Exchange Act Rule 175(c), 17 C.F.R. § 230.175(c) (1993).

44. 17 C.F.R. 230.175(a). Courts have placed the burden of proof as to "reasonable basis" and "good faith" on the party challenging their existence. *See* Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 513 (7th Cir. 1989); *In re* VeriFone Securities Litigation, 784 F. Supp. 1471, 1480 (N.D. Cal. 1992), *aff'd*, No. 92-15156, 1993 WL 469265 (9th Cir. 1993).

45. For example, a registrant's liquidity discussion must address "any known trends . . . demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in . . ." material changes. 17 C.F.R. § 229.303(a)(1) (1993); *see also infra* notes 60-71 and accompanying text (discussing liquidity). With respect to capital resources, MD&A calls for the disclosure of "any known material trends, favorable or unfavorable . . . ." 17 C.F.R. § 303(a)(2)(ii); *see also infra* notes 72-75 and accompanying text (discussing capital resources).

great consternation for registrants and their legal counsel. The phrases "known trend" and "known uncertainties" used throughout Item 303 are examples of such antithetical, incongruous terms. Item 303's instructions regarding predictive information disclosure are inconsistent. One instruction states that "[r]egistrants are encouraged, but not required, to supply forward-looking information."[46] The next sentence in that same instruction states that forward-looking statements should be distinguished from presently known data that will have a future impact on the registrant's future operating results or financial condition. Notwithstanding the instruction to Item 303 that the disclosure of predictive information is volitional and not compulsory, a registrant may be obligated to disclose forward-looking information in certain situations. The Commission attempted to shed some light on this subject in Securities Act Release No. 6835, which states:

> Both required disclosure regarding the future impact of presently known trends, events or uncertainties and optional forward-looking information may involve some prediction or projection. The distinction between the two rests with the nature of the prediction required. Required disclosure is based on *currently known trends, events, and uncertainties that are reasonably expected to have material effects*. . . . In contrast, optional forward-looking disclosure involves *anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty*.[47]

Former SEC Commissioner and current adjunct professor of law at the New York University School of Law, Edward H. Fleischman, has opined that, for purposes of MD&A, "reasonably likely [or expected]" suggests a likelihood of about forty percent.[48] Unfortunately, this suggestion is far from a bright-line rule and is of little solace to anxious registrants. The paradox

Regarding results of operations, Item 303 compels registrants to describe "any known trends or uncertainties . . . reasonably [expected to] . . . have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." 17 C.F.R. § 229.303(a)(3)(ii); *see also infra* notes 76-89 and accompanying text (discussing results of operations). Instruction 3 to Item 303 imparts the general requirement that MD&A "shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition." 17 C.F.R. § 229.303(a) Instruction 3.

46. 17 C.F.R. § 229.303(a) Instruction 7 (1993).

47. Securities Act Release No 6835, *supra* note 1, at 22,429 (quoting the "Concept Release," Securities Act Release No. 6711, 52 Fed. Reg. 13715, 13717 (Apr. 20, 1987)).

48. Edward H. Fleischman, The Intersection of Business Needs and Disclosure Requirements: MD&A, Address before the Eleventh Annual Southern Securities Institute (Mar. 1, 1991). Mr. Fleischman's comments were directed towards the MD&A materiality standard. However, one may assume that the forty percent range notion would have equal application to the disclosure of predictive information question as well.

between prospective optional disclosure and required disclosure has engendered much controversy and will likely continue to do so in the foreseeable future.[49]

Rightfully, many registrants fear potential fraudulent misstatement or omission liability if a prediction of financial results or future conditions in a forward-looking statement do not materialize. Registrants are also concerned when they must report unanticipated results or conditions that the prior year's MD&A failed to anticipate. In both situations, the Commission has the benefit of hindsight when it reviews ex post facto a registrant's MD&A for a possible violation of the securities laws.

V. MD&A DISCLOSURE UNDER ITEM 303

The express goal of the MD&A discussion is to provide investors and other users with relevant information concerning the amounts and certainty of cash flows from operations and outside sources so that investors may properly evaluate the financial condition and results of operations of a registrant.[50]

49. *See generally* Greg W. Corso & Richard A. Sifen, *Disclosure of Financial Information in Contested Proxy Solicitations*, 4 INSIGHTS 9 (Sept. 1990) (discussing the use of prospective information in contested proxy contests); Victor Brudney, *A Note on Materiality and Soft Information under the Federal Securities Laws*, 75 VA. L. REV. 723 (1989) (discussing materiality standards that vary with the nature of the soft information disclosed); James R. Repetti, *Management Buyouts, Efficient Markets, Fair Value, and Soft Information*, 67 N.C. L. REV. 121 (1988) (calling for mandatory disclosure of soft information pertaining to buyouts and bailouts); Roger J. Dennis, *Management Disclosure Theory and Management Projections: A Law and Economics Perspective*, 46 MD. L. REV. 1197 (1987) (discussing disclosure in specific transactions and materiality levels); Theresa A. Gabaldon, *The Disclosure of Preliminary Merger Negotiations as an Imperfect Paradigm of Rule 10b-5 Analysis*, 62 N.Y.U. L. REV. 1218 (1987) (discussing the duty to disclose preliminary merger discussions); Thomas L. Hazen, *Rumor Control and Disclosure of Merger Negotiations or Other Control-Related Transactions: Full Disclosure or "No Comment" — The Only Safe-Harbors*, 46 MD. L. REV. 954 (1987) (regarding disclosure obligations during on-going merger negotiations); Bruce A. Hiler, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 MD. L. REV. 1114 (1987) (surveying various materiality standards); Janet E. Kerr, *A Walk Through the Circuits: The Duty to Disclose Soft Information*, 46 MD. L. REV. 1071 (1987) (surveying various interpretations of the duty to disclose soft information); Marc I. Steinberg & Robin M. Goldman, *Issuer Affirmative Disclosure Obligations — An Analytical Framework for Merger Negotiations, Soft Information, and Bad News*, 46 MD. L. REV. 923 (1987) (discussing interpretations of the duty to disclose soft information); Carl. W. Schneider, Panel Discussion Comments *in New Approaches to Disclosure in Registered Securities Offerings*, 28 BUS. LAW. 505, 506-18 (1973) (discussing materiality standards and soft information disclosure); Carl W. Schneider, *Nits, Grits, and Soft Information in Sec Filings*, 121 U. PA. L. REV. 254 (1972) (discussing materiality standards based on the relevance of soft information).

50. 17 C.F.R § 229.303(a) Instruction 2 (1993); *see also* John W. Bagby, et al., *Management Discussion of Business Performance: Analytical and Empirical Evaluation*, 26 AM. BUS. L.J. 57

Goff: MD&A: The Eighth Year of Disclosure

Considering that objective, MD&A mandates that a registrant's discussion and analysis include financial statements and other statistical data that the registrant believes will enhance the user's understanding of the enterprise's financial condition and results of operations.[51] In general, Item 303(a) directs that the discussion include a year-to-year comparison[52] of the financial statements over a three year period.[53] Information provided pursuant to Item 303(a) "need only include that which is available to the registrant without undue effort or expense and which does not clearly appear in the registrant's financial statements."[54]

As will be discussed in detail, Item 303(a) charges registrants with the task of addressing three essential matters in their MD&A: (1) liquidity,[55] (2) capital resources,[56] and (3) results of operations.[57] Registrants must also determine whether reporting supplemental segment or subdivision information[58] or engaging in line item disclosure[59] to facilitate a better understanding of the registrant's business as a whole is necessary. Further, Item 303(b) instructs registrants to update their MD&As through interim period reporting.

A. Liquidity

MD&A requires all registrants to present a discussion and analysis of liquidity. Liquidity in Item 303(a) is defined as "the ability of an enterprise to generate adequate amounts of cash to meet the enterprise's needs for cash."[60] Liquidity encompasses not only the registrant's ability to meet its obligations as they become due, but also the registrant's ability to preserve existing capacity and provide for planned expansion.[61] Liquidity for purposes of MD&A is significantly broader than the Financial Accounting Standards Board's (FASB) concept of liquidity, because MD&A liquidity encompasses

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(1988) (discussing recent changes in SEC disclosure requirements and presenting a theoretical framework for classification of information).

51. 17 C.F.R. § 229.303(a) Instruction 1 (1993).

52. The registrant may use any format which, in the registrant's best judgement, will enhance the user's understanding. *See* 17 C.F.R. § 229.303(a) Instruction 1. However, the onus will be upon the registrant to substantiate the reasonableness of an alternative format used as appropriate if later challenged as fraudulent or materially misleading.

53. *See id.* The instruction also directs that when trend information is relevant, reference to five-year selected financial data may be necessary. *Id.*

54. 17 C.F.R. § 229.303 Instruction 2 (1993).

55. 17 C.F.R. § 229.303(a)(1)(1993).

56. *Id.* § 229.303(a)(2).

57. *Id.* § 229.303(a)(3).

58. *See* 17 C.F.R. § 229.303(a) (1993).

59. *See id.* Instruction 4.

60. 17 C.F.R. § 229.303 Instruction 5 (1993).

61. *See supra* note 25 and accompanying text.

all potential sources of cash[62] and is not limited to balance sheet accounts.[63] Nevertheless, when appropriate, registrants are expected to feature traditional balance sheet indicators[64] in their MD&As unless they otherwise make clear the company's liquidity in the explanatory discussion.[65]

In circumstances when financial statements incorporated by reference or presented in a registration statement are required to include a disclosure of restrictions on the ability of consolidated and unconsolidated subsidiaries to transfer funds to the registrant in the form of cash dividends, loans, or advances, the MD&A must discuss the extent, nature, and impact of such restrictions on the parent companies' ability to meet their cash obligations.[66]

The liquidity discussion must present both a long-term and short-term analysis in the context of the registrant's business or businesses.[67] Registrants must also identify "any known trends . . . 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."[68] If a registrant identifies material deficiencies, the registrant must indicate the course of action that has or will be taken to alleviate the deficiency.[69] Furthermore, registrants are obligated not only to identify, but also to describe separately all internal and external sources of liquidity and briefly discuss any surplus sources of material liquid assets.[70]

Registrants are often faced with a Hobson's choice: If the registrant's

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62. MD&A liquidity encompasses all internal and external source of cash. In order to foster meaningful dialogue, the drafters of Item 303 opted to avoid a precise or narrow definition to the term "liquidity." Instead, Item 303 gives registrants wide latitude to fix the appropriate indices of liquidity.

63. *See* Securities Act Release No. 6835, *supra* note 1, at 22,430 n.31. The Commission's concept of liquidity is analogous to the FASB's concept of financial flexibility regarding the enterprise's ability to adjust its future cash flow to meet anticipated and unanticipated requirements and opportunities. *Id.*

64. Balance sheet liquidity indicators might include cash reserves, marketable securities, accounts receivables, and inventory levels.

65. Securities Act Release No. 6835, *supra* note 1, at 22,431. This release states:

> Registrants are expected to use the statement of cash flows, and other appropriate indicators, in analyzing their liquidity, and to present a balanced discussion dealing with cash flows from investing and financing activities as well as from operations. This discussion should address those matters that have materially affected the most recent period presented but are not expected to have short or long-term implications, and those matters that have not materially affected the most recent period presented but are expected materially to affect future periods.

Id.

66. 17 C.F.R. § 229.303(a) Instruction 6 (1993).

67. *Id.* Instruction 5.

68. *Id.* § 229.303(a)(1).

69. *Id.*

70. *Id.*

liquidity situation is problematic, failure to disclose adequately such information is a clear and flagrant violation of Item 303.[71] However, full public disclosure can potentially exacerbate the situation. For example, perceiving a risk of default, commercial and institutional lenders as well as trade creditors may simply terminate lines of credit, hesitate to extend new credit, seek to tighten existing credit terms and conditions, or demand higher interest rates. Nevertheless, the potential adverse impact of full disclosure can be mitigated if a registrant puts forth a feasible strategy that is expected to rectify the problem in its MD&A.

In summary, good faith compliance with Item 303(a) regarding a registrant's liquidity discussion and analysis calls for an extensive and ongoing study of the enterprise's internal cash flow. Multiple cash flow projections based on public companies' best judgment of the optimal, most likely, and worst case liquidity scenarios would benefit the companies. Because MD&A directs registrants to consider their long and short-term liquidity positions, registrants would be prudent to prepare cash flow projections on both positions as well.

B. Capital Resources

MD&A mandates that registrants discuss their "material commitments for capital expenditures as of the end of the latest fiscal period, and indicate the general purpose of such commitments and the anticipated source of funds needed to fulfill such commitments."[72] Registrants must communicate any known material capital resource trends, whether they are favorable or unfavorable.[73] Further, registrants must address material changes in the mix and relative cost of such resources, as well as appraise changes among equity, debt, and any off-balance sheet financing arrangements.[74] Under Item 303(a), a registrant's capital resource commitment disclosure should not be limited to present, legally binding commitments; rather, it should encompass all reasonably anticipated capital resource expenditures.[75] Thus, a regis-

71. *See In re* Francis, [1982-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,503 (June 20, 1986) (finding Exchange Act violation for offering to sell refinery interest at a price well below the value shown on the financial statement without taking a write-down); *In re* VanLaningham, [1982-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,502 (June 20, 1986) (finding materially false and misleading MD&A due to failure to disclose liquidity concerns such as losses of trade credit, demands by the registrant's banks for restrictive loan covenants, and discussions between the registrant and its banks regarding asset sales, dividends, and operational changes).

72. 17 C.F.R. § 229.303(a)(2)(i) (1993). The discussion of capital resources and liquidity may be merged where appropriate under Item 303(a).

73. *Id.* § 229.303(a)(2)(ii).

74. *Id.*

75. *See* Securities Act Release No. 6835, *supra* note 1, at 22,429 (discussing the expansive

trant's compliance with the capital resources discussion in MD&A necessitates an appraisal of the organization's overall capacity to raise additional capital — be it debt or equity — and the associated cost of so doing. In particular, registrants should consider the limits of their existing lines of credit and any untapped potential sources of commercial borrowing. Prudence also dictates that registrants regularly examine the potential impact of any restrictive debt covenants and their ability to recapitalize or financially restructure, if necessary.

C. Results of Operations

The registrant's MD&A must include an extensive delineation of the results of its operations. Registrants must describe any significant or unusual economic events or transactions that have materially affected the amount of reported income from continuing operations, indicating the extent to which income was so affected.[76] Further, they must also describe other significant components of revenues or expenses necessary to understand the results of operations.[77]

Registrants must communicate any known material trends or uncertainties, favorable or unfavorable, reasonably expected to impact net sales, revenues, or income from continuing operations.[78] Additionally, Item 303(a) states a duty to disclose any known trends, demands, commitments, events, or uncertainties that will materially alter the relationship between revenues and expenses.[79]

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nature of a registrant's disclosure obligation regarding capital resource expenditures). The release states:

> In preparing the MD&A disclosure, registrants should focus on each of the specific categories of known data. For example, Item 303(a)(2)(i) requires a description of the registrant's material "commitments" for capital expenditures as of the end of the latest fiscal period. However, even where no legal commitments, contractual or otherwise, have been made, disclosure is required if material planned capital expenditures result from a known demand, as where the expenditures are necessary to a continuation of the registrant's current growth trend. Similarly, if the same registrant determines not to incur such expenditures, a known uncertainty would exist regarding continuation of the current growth trend. If the adverse effect on the registrant 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.

Id.

76. 17 C.F.R. § 229.303(a)(3)(i) (1993).

77. *Id.*

78. *Id.* § 229.303(a)(3)(ii).

79. *Id.* Examples would be "known future increases in costs of labor or materials or price increases or inventory adjustments . . . ." *Id.*

If the registrants' financial statements disclose material increases in net sales or revenues, a narrative discussion must accompany the MD&A to explain the extent that such increases are attributable to increases in prices, volume, the amount of goods or services being sold, or the introduction of new products or services.[80] The Commission's position is that a narrative explanation of the financial statements is necessary "'because a numerical presentation and brief accompanying footnotes alone may be insufficient for an investor to judge the quality of earnings and the likelihood that past performance is indicative of future performance.'"[81] The Commission stated that "[i]t is the responsibility of management to identify and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the individual company."[82]

Item 303 instructs registrants to assess the impact of material inflation and changes in prices on its net sales, revenues, and income from operations.[83] The item requires such disclosure for the three most recent fiscal years.[84] The Commission gives registrants considerable latitude in determining which inflationary effect and other changes in prices are material.[85] The registrants need not present any specific numerical financial data.[86] Rather, the rules require only a "brief textual presentation" of management's views of this subject.[87] The Commission encourages the registrant to experiment with the various methods of disclosure (which is required when the impact of inflation is material) to determine the most meaningful presentation, by allowing registrants to elect voluntary disclosure of supplemental information[88] on the impact of changing prices on the registrant's financial statements as provided for in Statement of Financial Accounting Standards No. 89, *Financial*

80. *Id.* § 229.303(a)(3)(iii) (1993).

81. Securities Act Release No. 6835, *supra* note 1, at 22,428 (*quoting* Securities Act Release 6711, *supra* note 2, at 88,623).

82. Securities Act Release No. 6349, *supra* note 22, at 964.

83. 17 C.F.R. § 229.303(a)(3)(iv) (1993).

84. *Id.* Disclosure is required for the shorter period of either the three most recent fiscal years after Dec. 25, 1979 or the number of fiscal years in which the registrant has been engaged in business. *Id.*

85. *See* 17 C.F.R. § 229.303(a) Instruction 8 (1993).

86. *Id.* However, foreign private registrants and registrants subject to hyper-inflation must comply with the disclosure requirements of Rule 3-20(c) of Regulation S-X. *See* 17 C.F.R. § 210.3-20(c) (1993).

87. 17 C.F.R. § 229.303(a) Instruction 8 (1993).

88. *Id.* Instructions 8-9. Further, Instruction 9 to Item 303(a) permits a registrant that elects to disclose supplemental information on the effects of changing prices pursuant to Statement of Financial Accounting Standards No. 89 to combine such explanation and analysis with other required disclosure under the Item or separately state such information with appropriate cross references. *Id.* Instruction 9.

Reporting and Changing Prices.[89]

D. Segment/Subdivision Reporting

Item 303(a) dictates that registrants focus on each relevant, reportable business segment or subdivision and on the enterprise as a whole when, in the registrant's best judgment, a discussion of business segments or subdivisions would be germane to the understanding of its business.[90] The Commission has declared that "[i]n formulating a judgment as to whether a discussion of segment information is necessary to an understanding of the business, a multi-segment registrant . . . should analyze revenues, profitability and the cash needs of its . . . segments."[91] Further, the Commission noted that a registrant should include segment disclosure in his MD&A to the extent discussion on a consolidated basis would be misleading or present an incomplete picture of the business, or when any segment or subdivision's contribution is materially disproportionate.[92]

E. Line Item Disclosure

Similar to the registrant's obligation to disclose segment or subdivision information is the line item disclosure requirement.[93] The instructions to Item 303(a) stipulate that a registrant must describe material consolidated financial statement line item changes each year to the extent necessary for investors or other users to appreciate the registrant's business as a whole, with one caveat: If the reason for a change in a certain line item relates to other line item fluctuations, then repetition and line-by-line analysis of the financial statements as a whole is not required or appropriate.[94] The Commission has

89. *Id.* SFAS No. 89 supersedes SFAS No. 33, becoming effective for fiscal years ending after Dec. 2, 1986. Financial Accounting Standards Board Statement 14, 1 Original Pronouncements § C28.101 (1991).

90. 17 C.F.R. § 229.303(a) (1993).

91. Securities Act Release No. 6835, *supra* note 1, at 22,432.

92. *Id.* Segment or subdivision MD&A disclosure may be necessary when there are legal or other restrictions placed upon the free flow of funds between segments or subdivisions; when known material trends, demands, commitments, events or uncertainties within a segment or subdivision are reasonably likely to occur and may effect the enterprise as a whole; when the financial flexibility of a registrant is constrained by its ability to divest certain assets of a segment or subdivision; and when disclosure of segment or subdivision data is otherwise prudent to assist user's of the registrant's MD&A to fully appreciate its business. *Id.*

93. *See* 17 C.F.R. § 229.303(a) Instruction 4.

94. *Id.* Registrants are not required to recite the amount for variation of a line item if it can be easily calculated from the consolidated financial statement data and are discouraged from pointlessly repeating numerical information contained in the financial statements. *Id.* However, according to the Commission, "quantification should otherwise be as precise, including use of

announced that an analysis of changes in line items is required when there exists a material and divergent change from related line items in the registrant's financial statements.[95] Thus, registrants are to identify, and, if possible, quantify the extent of the contribution of each of two or more contributing factors.[96]

F. Interim Period Reporting

Registrants under Item 303(b) are instructed to include a "discussion and analysis of the financial condition and results of operations to . . . enable the reader to assess material changes in financial conditions."[97] The interim period discussion and analysis[98] must include those items listed in Item 303(a), except the registrant does not need to address the impact of inflation and changing prices on the results of operations.[99]

The interim period MD&A compels a registrant to "[d]iscuss material changes in [its] financial condition from the end of the preceding fiscal year to the date of the most recent interim balance sheet provided."[100] Also, if the registrant provides in its financial statements a balance sheet dated as of the corresponding interim date of the preceding fiscal year, then the registrant must discuss any material changes in its financial condition from that date to the date of the most recent balance sheet provided in the MD&A.[101]

Registrants must also include a discussion of the results of operations in

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dollar amounts or percentages, as reasonably practicable." Securities Act Release No. 6835, *supra* note 1, at 22,431.

95. *See* Securities Act Release No. 6835, *supra* note 1, at 22,431. The Commission has also stated:

> Discussion of the impact of discontinued operations and of extraordinary gains and losses is also required where these items have had or are reasonably likely to have a material effect on reported or future financial condition or results of operations. Other non-recurring items should be discussed as "unusual or infrequent" events or transaction "that materially affected the amount of reported income from continuing operations."

Id. (quoting 17 C.F.R. § 229.303(a)(3)(i)); *see also* SEC v. Allegheny Int'l, Inc., 39 SEC Docket (CCH) 196 (Sept. 9, 1967) (finding a failure to disclose a real estate sale as an unusual and infrequent event).

96. *See* Securities Act Release No. 6835, *supra* note 1, at 22,431.

97. 17 C.F.R. § 229.303(b) (1993).

98. The interim period reporting requirements delineated in Article 3 of Regulation S-X include Forms 10-K and 10-Q. *See* 17 C.F.R §§ 210.3-01 to .3-20 (1993).

99. 17 C.F.R. § 229.303(b); *see also* 17 C.F.R. §§ 210.3-01 to .3-20 (1993) (providing general instructions concerning the preparation of financial statements, including interim statements).

100. 17 C.F.R. § 229.303(b)(1) (1993).

101. *Id.* The registrant may combine the discussion of changes from the end of the fiscal year and the corresponding interim date of the preceding fiscal year. *Id.*

their interim period MD&As.[102] The discussion is designed to address material changes from "the most recent fiscal year-to-date period for which an income statement is provided and the corresponding year-to-date period of the preceding fiscal year."[103] For example, if a registrant elects or is required to provide an income statement for the most recent fiscal quarter, the discussion must also cover material changes between that fiscal quarter and the corresponding prior year fiscal quarter.[104] When a registrant

> has elected to provide an income statement for the twelve-month period ending as of the date of the most recent interim balance sheet provided, the discussion also shall cover material changes with respect to that twelve-month period and the twelve-month period ended as of the corresponding interim balance sheet date of the preceding fiscal year.[105]

In certain situations the Commission steadfastly maintains that registrants have a duty to update MD&A disclosure periodically.[106] Accordingly, the existence of "known trends, demands, commitments, events, or uncertainties" that arise during the interim reporting period may constitute required interim MD&A disclosure if they are reasonably likely to have a material effect on the registrant's financial condition or results of operation.[107]

VI. THE FUNCTION OF SROs AND THE ACCOUNTING PROFESSION IN MD&A

While the Commission has studied the issue of adequate MD&A disclosure and has attempted to implement a framework for compliance, the accounting profession and Self-Regulating Organizations[108] have remained

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102. *Id.* § 229.303(b)(2).

103. *Id.*

104. *Id.*

105. 17 C.F.R. § 229.303(b)(2) (1993). Item 303(b)(2) stipulates the following regarding a registration income statement:

> [If] . . . a registrant . . . provides a statement of income for the twelve-month period ended as of the date of the most recent interim balance sheet provided in lieu of the interim income statements otherwise required, the discussion of material changes in that twelve-month period will be in respect to the preceding fiscal year rather than the corresponding preceding period.

Id.; *see also* 17 C.F.R. § 210.3-03(b) (1993) (providing the option of including a statement of income for either period).

106. *See* Securities Release Act No. 6835, *supra* note 1, at 22,432.

107. *Id.* Changes sufficient to warrant interim period reporting would include expected material changes in "internal and external sources of liquidity, expected material changes in the mix and relative cost of such resources, and unusual or infrequent events or transactions that materially affected the amount of reported income from continuing operations." *Id.*

108. The Self-Regulating Organizations (SROs) include the New York Stock Exchange

in the shadows. A strong argument can be made that the disclosure of public companies could be improved if the public accountants and SROs assumed a more active role.

A. The Function of the Accounting Profession

Generally Accepted Accounting Principles (GAAP) are a set of conventions used to assemble financial accounting data and present such information in the form of financial statements. GAAP deals primarily with quantifiable, historic financial data. All entities are subject to transactions or events that have a profound impact on them, but are not readily quantifiable. For years the accounting profession has struggled to find the appropriate means to capture and report such information.

In 1986 the managing partners of seven accounting firms released a white paper that "called for increased risk disclosure, but contemplated that such disclosure would be separate from MD&A and would be subjected to audit coverage."[109] Thereafter, the accounting profession issued an Exposure Draft that would have established performance and reporting criteria for auditors who attested to a public company's MD&A representations.[110]

Although public accounting firms are uniquely positioned to assess the accuracy and completeness of a registrant's MD&A disclosure during the course of an audit, their role in MD&A remains somewhat disingenuous because MD&A is generally deemed beyond the scope of the financial statements. Consequently, MD&A is neither subject to GAAP nor to an audit.[111] However, much of the information disclosed in MD&A relates to

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(NYSE), the American Stock Exchange (AMEX), and the National Association of Securities Dealers (NASD).

109. Securities Act Release No. 6835, *supra* note 1, at 22,427.

110. The Auditing Standards Board issued an exposure draft of a proposed statement on standards for attestation engagements entitled *Examination of Management's Discussion and Analysis* on Feb. 14, 1987.

111. The auditor's involvement with MD&A is limited to a few auditing standards. *See* AICPA PROFESSIONAL STANDARDS, Statement on Auditing Standards No. 8, Other Information in Documents Containing Audited Financial Statements, AU § 550 (Am. Inst. of Certified Pub. Accountants 1992); AICPA PROFESSIONAL STANDARDS, Statement on Auditing Standards No. 53, The Auditor's Responsibility to Detect and Report Errors and Irregularities, AU § 316 (Am. Inst. of Certified Pub. Accountants 1992); AICPA PROFESSIONAL STANDARDS, Statement on Auditing Standards No. 54, Illegal Acts by Clients, AU § 317 (Am. Inst. of Certified Pub. Accountants 1992) (requiring certain matters to be communicated to the audit committee); *see also* AICPA PROFESSIONAL STANDARDS, Statement on Auditing Standards No. 19, Client Representations, AU § 333 (Am. Inst. of Certified Pub. Accountants 1992) (requiring the independent auditor to obtain written representations from management); AICPA PROFESSIONAL STANDARDS, Statement on Auditing Standards No. 61, Communication With Audit Committee, AU § 380 (Am. Inst. of Certified Pub. Accountants 1992) (requiring certain matters to be communicated to the audit committee); AICPA PROFESSIONAL STANDARDS, Statement on

matters routinely falling within the scope of an audit. While auditors are generally not obligated to corroborate information outside the report's financial statements, they are required to read the other information included in the document containing the audit report, such as MD&A, to determine whether such information or its manner of presentation is consistent with the financial statements on which the accountant expresses the audit opinion.[112] Further, the auditor is to take appropriate measures if inconsistencies or misstatements are present.[113]

Many contend that public accountants should assume a more prominent role in evaluating the MD&A of public companies. In fact, the American Institute of Certified Public Accountants (AICPA) recently issued an exposure draft of a proposed statement of position regarding financial statement disclosure.[114] The Accounting Standards Executive Committee of the AICPA concluded in this proposal that "[r]eporting entities should make disclosure in the notes to the financial statements beyond those now required or generally made in financial statements about the risks and uncertainties existing as of the date of those statements . . . ."[115] The Committee identified the following non-mutually exclusive disclosure areas: (1) nature of operations,[116] (2) use of estimates in the preparation of financial statements,[117] (3) certain significant estimates,[118] (4) current vulnerability due

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Auditing Standards No. 7, Communications Between Predecessor and Successor Auditors, AU § 315 (Am. Inst. of Certified Pub. Accountants 1992) (providing guidance on communication when a change of auditors occurs).

112. Statement on Auditing Standards No. 8, *supra* note 111.

113. *Id.*

114. Exposure Draft, Proposed Statement of Position, *Disclosure of Certain Significant Risks and Uncertainties and Financial Flexibility*, American Institute of Certified Public Accountants (Mar. 31, 1993).

115. *Id.* at 11.

116. *Id.* at 11. Regarding the nature of operations, the Committee opined:

> Notes to financial statements should include a description of the major products or services the reporting entity sells or provides and its principal markets, including the locations of those markets. If the entity operates in more than one industry, the disclosure should also indicate the relative importance of its operations in each industry and the basis for the determination . . . . Disclosures about the nature of operations need not be quantified; relative importance could be conveyed by use of terms such as *predominately*, *about equally*, or *major and other*.

Id. at 12 (footnotes omitted).

117. *Id.* at 11. "Notes to all financial statements prepared in conformity with GAAP should include an explanation that the preparation of financial statements in conformity with GAAP requires the use of management's estimates." *Id.* at 12.

118. *Id.* at 11. The AICPA Proposal stated that:

> Notes to financial statements should discuss the potential near-term effects on the financial statements of the risks and uncertainties associated with estimates used in the determination of the carrying amounts of assets or liabilities or disclosure of gain or

to concentrations,[119] and (5) financial flexibility.[120]

Several members of the Committee criticized the proposal. First, they believed that the proposal increased the responsibility of independent accountants and significantly altered the accountants' relationship to the information disclosed by requiring that the information become an integral part of the financial statements.[121] Further, they objected to the subjective nature of the information, which one could easily challenge and thereby expose the accountant to excessive legal risks.[122] Lastly, those critical of the proposal claimed that compliance with the proposal placed a disproportionate economic burden on private entities and their accountants.[123] Interestingly, these are some of the same arguments cited by critics of MD&A.

The proposal varies from the requirements of Item 303 in at least three respects. First, MD&A requires a discussion of liquidity and capital resources in all situations, whereas the proposal "requires a discussion of financial flexibility only when it is reasonably possible that the reporting entity's financial flexibility will be called on in the near term."[124] Second, while MD&A requires a discussion of a registrant's liquidity and capital resources on both a long and short-term basis, the proposal applies only to the near term.[125] Finally, Item 303 requires registrants to use a cash flow statement to analyze their liquidity and capital resources in terms of investing, financing, and operating activities; the proposal's disclosure does not mandate a statement of cash flows or categorization of the items discussed.[126]

> loss contingencies when *both* of the following criteria are met:
> * It is at least reasonably possible that the estimate will change in the near term.
> * The effect of the change would be material to the financial statements.
>
> These evaluations should be based on information available prior to issuance of the financial statements and of which management is reasonably expected to have knowledge.

Id. at 12 (footnote omitted).

119. *Id.* at 11. Current vulnerability due to concentration means "[a]ny concentration existing at the date of the financial statements that makes the enterprise vulnerable to the risk of a near-term severe impact [that] should be disclosed when it is at least reasonably possible that the events that could cause the near-term severe impact will occur." *Id.* at 15.

120. *Id.* at 11. The proposal requires "a discussion of management's expected course of action when it is determined that it is at least reasonably possible that the entity will not have the ability over the near term to pay its expected cash outflows without taking certain actions." *Id.* at 16. This determination should be made by management "based on information available prior to the issuance of the financial statements and which management is reasonably expected to have knowledge." *Id.*

121. *Id.* at 18-19.

122. *Id.* at 19.

123. *Id.*

124. *Id.* at 59.

125. *Id.*

126. *Id.*

The proposal's aim is to improve "disclosure about the risks and uncertainties that face reporting entities . . . ."[127] Unfortunately, due to the proposal's substantial deviations from the requirements of MD&A, it fails to achieve its objective and is of little value to registrants attempting to comply with the MD&A disclosure requirements.

B. *The Function of the Self-Regulating Organizations*

The listing agreements of both the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX) require listed companies to promptly disclose material information, but they also include liberal business judgement exceptions.[128] Notwithstanding their less than aggressive stance on disclosure, both exchanges have issued strict rules explicitly enjoining the selective disclosure of information.[129]

The National Association of Securities Dealers (NASD) also insists that its members make timely disclosures of material information.[130] However,

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127. *Id.* at 9.

128. The New York Stock Exchange (NYSE) Listed Company Manual states that listed companies are "expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities." NYSE Listed Company Manual § 202.05 (1989). The Manual describes the business judgement exception as follows:

> Judgment must be exercised as to the timing of a public release on those corporate developments where . . . disclosure would endanger the company's goals or provide information helpful to a competitor. In these cases, the company should weigh the fairness to both present and potential shareholders who at any given moment may be considering buying or selling the company's stock.

Id. § 202.06(A).

The American Stock Exchange (AMEX) Guide maintains that "[a] listed company is required to make immediate public disclosure of all material information concerning its affairs, except in unusual circumstances." AMEX Stock Exchange Guide (CCH) ¶ 10,121 § 401(a) (1993). The AMEX Guide permits a listed company to exercise its business judgement by withholding material information "[w]hen immediate disclosure would prejudice the ability of the company to pursue its corporate objectives. . . . [and] [w]hen the facts are in a state of flux and a more appropriate moment for disclosure is imminent." *Id.* ¶ 10,122, § 402(a).

129. The NYSE Manual instructs public companies "not to give information to one inquirer which it would not give to another, nor should it reveal information it would not willingly give or has not given to the press for publication." NYSE Listed Company Manual § 202.02(A). Therefore, for listed companies "to give advance earnings, dividend, stock split, merger, or tender information to analysts . . . would clearly violate Exchange policy." *Id.*

The AMEX Guide similarly instructs listed organization to "make available to the public information necessary for informed investing and to take reasonable steps to ensure that all who invest in its securities enjoy equal access to such information." AMEX Company Guide ¶ 10,121, § 401.

130. The NASD Manual states that member companies must disclose "any material information which may affect the value of their securities or influence investors' decisions . . . ." NASD Manual (CCH) ¶ 1806A, at 1572 (1993).

unlike the other SROs, NASD neither expressly provides a business judgement exception nor addresses the problem of selective disclosure. Nevertheless, as a practical matter, NASD would be obliged to afford companies some latitude to temporarily withhold disclosure.

VII. Recent Authorities

A. In re *Caterpillar, Inc.*

In the first enforcement action solely involving MD&A disclosure, *In re Caterpillar Inc.*,[131] the Commission alleged that a public company failed to adequately disclose information concerning its subsidiary's results of operations and the impact of those results on the consolidated financial statements presented in the company's required periodic SEC filings.

Caterpillar is a respected international corporation engaged in the manufacture of earth-moving and other heavy-duty construction equipment. In 1989, Caterpillar's wholly-owned subsidiary, Caterpillar Brazil, S.A. (CBSA), was exceptionally profitable. On a consolidated basis, CBSA accounted for approximately twenty-three percent of Caterpillar's net profits, yet it represented only five percent of the parent company's total revenues.[132]

While CBSA's operating results were comparable to those of previous years, several external factors contributed to its immense profits. The following four nonoperating factors contributed significantly to CBSA's performance: (1) currency translation gains, (2) export subsidies, (3) interest income, and (4) Brazilian tax loss carry-forwards. Brazil's hyperinflation generated most of these gains.[133] In a country suffering from hyperinflation, a rational consumer will purchase hard goods rather than hold currency.

Caterpillar consolidated CBSA's financial results with those of its other operations and presented those results together; consequently, the impact of CBSA's performance on Caterpillar's overall results was not readily apparent from Caterpillar's financial statements.[134]

Historically, Caterpillar reported its financial results on a consolidated basis in accordance with its perception of the company as an integrated organization.[135] Under GAAP, Caterpillar was not compelled to present CBSA as either a separate industry segment or a foreign operation.[136] The

131. Exchange Act Release No. 30,532, *supra* note 9.
132. *Id.* at 63,051.
133. *Id.*
134. *Id.* at 63,051 & n.1.
135. *Id.*
136. *Id.* at 63,055.

Financial Accounting Standards Board Statement No. 14[137] (FASB Statement 14) defines an industry segment by looking to functional product differences.[138] CBSA's products were not functionally different from those of its parent company; therefore, CBSA was not a separate industry segment.[139] Furthermore, although CBSA was a foreign operation, Caterpillar was not obligated under FASB Statement 14 to report separately CBSA's results because CBSA accounted for less than ten percent of Caterpillar's consolidated revenues, and CBSA's assets were less than ten percent of the consolidated total assets.[140]

Given CBSA's significant contribution to Caterpillar's overall results of operations, in January 1990, Caterpillar began separately analyzing CBSA's 1989 accounting data compared with 1990 financial forecasts.[141] During the February 1990 meeting of Caterpillar's Board of Directors, management informed the Board that there was substantial uncertainty whether CBSA's 1989 performance would be repeated in 1990. Management also informed the Board that CBSA's results would have a significant negative impact on Caterpillar as a whole.[142] Specifically, management cautioned the Board that Brazil was "volatile."[143] The Board of Directors was told that "the impact of Brazil [was] so significant to reduced 1990 projected results, [that management] felt it was necessary to explain it [to the directors] in some detail."[144] This management report ultimately induced the Commission to sanction Caterpillar.

At its April 1990 meeting, management informed the Caterpillar Board that the outcome of ongoing economic reforms in Brazil was uncertain, and there existed a considerable risk that the reforms could exert additional pressure on CBSA's 1990 performance.[145] After monitoring the operating

137. FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise, 2 Original Pronouncements 3393 (1993) [hereinafter FASB Statement 14]; *see also* Exchange Act Release No. 30,532, *supra* note 9, at 63,055 n.9 (discussing the application of FASB Statement 14 on Caterpillar).

138. FASB Statement No. 14, *supra* note 137, at 3430.

139. Exchange Act Release No. 30,532, *supra* note 9, at 63,055 n.9.

140. FASB Statement 14, *supra* note 137, at 3409-10; Exchange Act Release No. 30,532, *supra* note 9, at 63,055 n.9.

141. Exchange Act Release No. 30,532, *supra* note 9, at 63,051.

142. *Id.* The minutes of the February 1990 Board meeting contained the following statement: "[Management] commented on results of operations in Brazil because of the significant [negative] impact they will have on overall results for 1990." *Id.*

143. *Id.*

144. *Id.*

145. *See id.* at 63,051-52. Fernando Collor de Mello was elected president of Brazil in December of 1989 and inaugurated on March 15, 1990. After taking office, President Collor immediately instituted sweeping economic and monetary reforms in an attempt to control the hyperinflation that was plaguing the Brazilian economy. However, Brazil was thrust into further

results of CBSA, it became clear to Caterpillar that the new Brazilian economic policies would cause CBSA to suffer significant losses in 1990. Furthermore, Caterpillar realized that CBSA's losses would not be absorbed by gains in other international markets and, consequently, Caterpillar's consolidated results of operations would be lower than originally anticipated.[146] Caterpillar voluntarily issued a press release on June 25, 1990, announcing that it anticipated substantially lower 1990 results than had been previously projected.[147]

Despite the emerging developments in Brazil, the MD&A sections of Caterpillar's 1989 Annual Report (Form 10-K) (filed in March 1990) and its first Quarterly Report (Form 10-Q) failed to separately disclose CBSA's effect on Caterpillar's consolidated results for 1989. Further, the reports did not indicate the disproportionate impact which Caterpillar anticipated the deterioration in CBSA's performance would have upon its 1990 consolidated results. Instead, both reports appeared to down play both the importance of the faltering Brazilian economy and the extent that CBSA's anticipated adverse results would affect Caterpillar as a whole.[148] Consequently, the relationship between Caterpillar's overall results of operations and that of CBSA was not apparent to investors and other users of the periodic reports.

Regarding Caterpillar's Annual Report (Form 10-K) MD&A of the results

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economic turmoil when President Collor de Mello removed approximately 80% of outstanding currency from circulation and adopted a plan to devalue the cruzado. *Id.*

146. *See id.* at 63,052.

147. *Id.* The June 25, 1990 press release stated that "more than half of the decrease in forecasted 1990 profit is due to a dramatic decline in results for [CBSA]." *Id.*

148. *See id.* at 63,053. The Commission's Opinion included the following excerpts from Caterpillar's 1989 Annual Report (Form 10-K):

> Dealer machine sales rose in most selling areas, with demand especially strong in . . . Brazil . . . .
>
> . . .
>
> Sales rose 14% in 1989, the sixth consecutive year of improvement. The biggest gain was in Brazil, where very high inflation rates increased demand for hard goods, including earth moving equipment. (Given the extraordinary high rate of inflation in Brazil, many contractors preferred to own hard assets, such as equipment, rather than depreciating cruzados.) Toward year-end, however, sales growth in Brazil moderated as interest rates rose.
>
> . . .
>
> Latin American countries continue to be plagued with debt problems. However, debt rescheduling; stable profitable commodity prices; and increased privatization should help business in some countries. Sales in Brazil, however, could be hurt by post-election policies which will likely aim at curbing inflation.

Id. at 63,053 n.4. The Commission also included in its Opinion the following statements of George Schaefer, Caterpillar's Chairman of the Board of Directors, from its 1990 Quarterly Report (Form 10-Q): "First-quarter sales were somewhat stronger than anticipated. Nevertheless, the company continues to be concerned about tight monetary policies in major industrial countries; . . . and the uncertainty of the economic situation in Brazil." *Id.*

of operations for 1989, the Commission held: "Given the magnitude of CBSA's contribution to Caterpillar's overall earnings, disclosure of the extent of that contribution was required under the MD&A provisions of Regulation S-K since CBSA's earnings materially affected Caterpillar's reported income from continuing operations."[149] The Commission opined: "Furthermore, the MD&A should have discussed various factors which contributed to CBSA's earnings . . . since such items were significant components of CBSA's revenues that should have been identified and addressed in order for a reader of the company's financial statements to understand Caterpillar's results of operations."[150]

With respect to Caterpillar's inadequate discussion of the uncertainties affecting CBSA's prospects for 1990 and the possible material impact on Caterpillar's overall results, the Commission began its analysis by reiterating the Securities Act Release No. 6835 test for determining when disclosure is required.[151] In concluding that Caterpillar had not satisfied that test and therefore, disclosure was required, the Commission noted:

> By the time of the February 14, 1990, board meeting — two weeks before Caterpillar's Form 10-K for 1989 was filed — management could not conclude that lower earnings from CBSA were not reasonably likely to occur, nor could management conclude that a material effect on Caterpillar's results of operations was not reasonably likely to occur due to CBSA's lower earnings.[152]

This was true because management communicated to directors at that meeting the negative impact of CBSA on 1990 projected results. Further, the Commission noted that disclosure was required because "[b]y the end of the first quarter of 1990, before Caterpillar's Form 10-Q for the first quarter of 1990 was filed, management had concluded that 'the profit in Brazil will be substantially lower than in 1989.'"[153] Finally, the Commission determined that "it became even more apparent that management could not conclude that lower earnings from CBSA were not reasonably likely to occur, nor could management conclude that a material effect on Caterpillar's results of operations was not reasonably likely to occur due to CBSA's lower earnings."[154]

The Commission's Order resolved that Caterpillar's MD&A was deficient

149. *Id.* at 63,055. The Commission referenced the requirements of Item 303(a)(3)(i) as the basis for such disclosure. *Id.*

150. *Id.*

151. *See id.*

152. *Id.* at 63,055.

153. *Id.* (quoting management).

154. *Id.*

in two respects. First, Caterpillar's 1989 Annual Report (Form 10-K) failed to provide adequate discussion and analysis of CBSA's impact on Caterpillar's consolidated results of operations for the period.[155] Second, the Commission ruled that Caterpillar violated § 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 by failing to adequately disclose in its 1989 Annual Report (Form 10-K) and 1990 Quarterly Report (Form 10-Q) known uncertainties reasonably likely to materially affect future results of operations of Caterpillar, as a whole, due to CBSA's doubtful ability to repeat its 1989 performance.[156]

B. Implications of Caterpillar

Careful review of *Caterpillar* reveals that the Commission stressed certain key factors it believes should alert the registrant of the need for more extensive MD&A disclosure. These factors include the following: (1) unusual or atypical financial results; (2) significant financial or operational developments; (3) items that could have a significant impact on the registrant's financial or operational prospects; (4) matters of which the registrant's management is cognizant, but which shareholders might not readily ascertain from the face of the registrant's financial statement or the notes thereto; (5) changes in the way management gathers, reports, views or considers significant operating results; (6) changes in the mix of the registrant's revenues or profit (losses); (7) changes in the registrant's relationship with customers, suppliers, and competitors; (8) changes in significant extrinsic factors (such as governmental regulations) that have or could have a significant impact on the registrant's business operations or financial condition; (9) matters that are the subject of the retention of special advisors or experts; and (10) matters deemed significant enough to be brought to the attention of the registrant's board of directors, or a committee thereof.[157]

The Commission's *Caterpillar* Release purports to be fact specific; however, the Commission emphasized certain factors in the Release as a warning to all registrants. Perhaps the most far reaching aspect of *Caterpillar* is the Commission's conclusion in a footnote that "Caterpillar did not have adequate procedures in place designed to ensure compliance with the MD&A requirements."[158] Therefore, in the future, registrants are advised to adopt comprehensive procedures to govern the drafting and review of their MD&A. Registrants may look to the MD&A standards of other firms within its

155. *Id.*

156. *Id.* at 63,056.

157. *See generally* Harvey L. Pitt, et al., *MD&A Through the Eyes of Management: A Closer Look at the SEC's Caterpillar Decision in Directors' and Officers' Liability 1933: A Satellite Program* (PLI Corp. Law & Practice Course Handbook Series No. A4-4424 1992) (closely analyzing the *Caterpillar* decision).

158. Exchange Act Release No. 30,532, *supra* note 9, at 63,055 n.8.

industry; but, whatever procedures are ultimately employed should be tailored to fit the nature of the registrant's business. Additionally, persons knowledgeable in the nuances and intricacies of securities law should design the registrant's framework for MD&A disclosure. The registrant's attorneys, management, and outside auditors should be involved in the actual drafting and reviewing of the MD&A disclosure language prior to board approval. However, the Commission has warned registrants, "[a]lthough an auditor or other third party [legal counsel] may review the MD&A section of a periodic report, the substance of the S-K Item 303 disclosure is the responsibility of management."[159] Thus, senior management and the board must carefully review and accept full responsibility for the registrant's MD&A.[160]

The *Caterpillar* decision was unique because it represented the first time the Commission used its new cease and desist powers. Utilizing this new tool, the Commission could draft a didactic opinion and order which offered meaningful guidance to registrants as to the Commission's interpretation of the MD&A disclosure requirements.

The Commission accepted Caterpillar's Offer of Settlement in which Caterpillar agreed to voluntarily "implement and maintain procedures designed to ensure compliance with the MD&A requirements."[161] However, Caterpillar had not been the subject of any prior SEC actions nor did it admit to any wrongdoing in the Offer of Settlement.[162] It is unclear what role Caterpillar's record played in the Commission's decision to utilize its new cease and desist power rather than to use its traditional remedies.

Like a fist in a velvet glove, *Caterpillar* is a message case. The *Caterpillar* Release reflects the Commission's belief in the importance of proper MD&A disclosure.[163] One can draw a strong inference that the Commission intends to subject future periodic filings to more rigorous review and where appropriate to institute administrative proceedings that advance MD&A's objective of allowing investors and other users to view the registrant "through the eyes of management." Moreover, recalcitrant registrants that fail to heed the admonitions of the Commission face the more formidable

159. Exchange Act Release No. 30,532, *supra* note 9, at 63,054 n.6.

160. *See id.* at 63,052. Interestingly, in *Caterpillar*, the MD&A was found to be inadequate even where the controller, treasurer, financial vice president, senior executive, legal counsel, the pubic affairs and economics departments, and the board had scrutinized and deliberated the propriety of the MD&A. Presumably, the error was in the quality, not the quantity of review. *Id.*

161. Exchange Act Release No. 30,523, *supra* note 9, at 63,056 (March 31, 1992).

162. Exchange Act Release No. 30,532, *supra* note 9, at 63,050-51, 63,056.

163. Ironically, the stature of Caterpillar as a well-respected public company may have been a motivating factor in the Commission's decision to institute administrative proceedings against it. By so doing, the Commission sent the message that no registrant, no matter how sophisticated and well respected, is beyond its reach when the registrant's disclosure is inadequate.

traditional remedial measures.

C. *Fraud-On-The-Market Theory and Inaccurate Prospective Disclosure*

Many commentators have attempted to draw an analogy between *Caterpillar* and an earlier case, *Wielgos v. Commonwealth Edison Co.*[164] In *Wielgos* the Commonwealth Edison Company (CEC) made inaccurate forward-looking statements regarding the cost estimates to complete several nuclear reactors.[165] The plaintiff argued that CEC should be denied the protection of the Rule 175 safe-harbor because CEC's statements were made without a reasonable basis.[166] In rejecting such an argument, Judge Easterbrook noted: "Forward-looking statements need not be correct; it is enough that they have a reasonable basis."[167] The court noted the reality that estimates are not certainties; things never go exactly as predicted.[168] Any deviation causes the future to diverge from the estimate.[169] The *Wielgos* court then embraced the fraud-on-the-market theory as the basis for finding that the predictions of CEC were made in good faith, despite their flaws.[170] The court grounded its holding on the assumption that the market was sophisticated enough to discount management's habitually inaccurate cost estimates.[171]

Caterpillar is distinguishable from *Wielgos* in at least two respects. First, *Caterpillar* was not claiming the benefit of Rule 175. The disclosure at issue in *Caterpillar* was not volitional but rather mandatory because Caterpillar reasonably expected CBSA's performance to have a future impact on its results of operations and financial condition.[172] Second, and most important, unlike in *Wielgos*, the market was unable to discount the forward-looking statements made by Caterpillar. It was common knowledge that nuclear power plant cost estimates were typically inaccurate and that Brazil was suffering from hyperinflation. Nevertheless, it was not public knowledge that CBSA accounted for twenty-three percent of Caterpillar's profits.

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164. 892 F.2d 509 (7th Cir. 1989).

165. *Id.* at 512.

166. *Id.* at 513.

167. *Id.* Judge Easterbrook further remarked:

> Issuers need not "disclose" Murphy's law or the Peter Principle, even though these have substantial effects on business . . . . Just as a firm needn't disclose that 50% of all new products vanish from the market within a short time, so Commonwealth Edison needn't disclose the hazards of its business, hazards apparent to all serious observers and most casual ones.

Id. at 515.

168. *See* 892 F.2d at 515-16.

169. *See id.*

170. *Id.* at 516; *see also infra* note 190 (discussing the fraud-on-the-market theory).

171. *See id.*

172. *See supra* notes 142-44 and accompanying text.

In *Wielgos*, the registrant used the best information available to it at the time of disclosure.[173] However, in *Caterpillar*, the registrant continued to file its SEC periodic reports on a consolidated basis with the knowledge that CBSA would have a future impact on the company as a whole — a fact not apparent on the face of the financial statements or in the footnotes thereto.[174] Thus, any attempt to draw an analogy between *Caterpillar* and *Wielgos* is misleading.

D. Other Recent MD&A Litigation

In several other recent cases, courts have strictly construed the MD&A disclosure requirements and have rejected Rule 10b-5 claims when public companies allegedly failed to disclose material information in violation of Item 303. For example, in *In re Convergent Technologies Securities Litigation*,[175] the plaintiffs, stock buyers, argued that Convergent should have disclosed its internal projections pursuant to Item 303.[176] The *Convergent* court rejected that argument, finding that internal projections were forward-looking statements and as such were expressly excluded from the disclosure requirements.[177]

In re Sun Microsystems, Inc. Securities Litigation[178] raised the question of a registrant's obligation to disclose in its Quarterly Report (Form 10-Q) MD&A the potential impact that publicly announced products of competitors would have on its business. The *Sun Microsystems* court held that the disclosure of the future impact of known trends or uncertainties that have had or that are reasonably expected to have a material impact on the registrant need only be disclosed in an Annual Report (Form 10-K), but not in a Quarterly Report (Form 10-Q).[179] Quarterly Reports are governed by other provisions of Item 303 which do not expressly require that such information be discussed.[180] The court also found no violation of the general anti-fraud provisions of the Exchange Act, because there was no MD&A violation that could give rise to a material misstatement or omission.[181]

After reviewing the MD&A materiality standard compared to the *Basic* probability/magnitude balancing test, the court in *Alfus v. Pyramid Technology*

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173. 892 F.2d 509, 513.

174. Exchange Act Release No. 30,532, *supra* note 9, at 63,055-56.

175. 948 F.2d 507 (9th Cir. 1991).

176. *Id.* at 516 (citing 17 C.F.R. § 303(a)(3)(ii) (1990)).

177. *Id.* The court based this conclusion on Instruction 7 to Item 303(a). *Id.*

178. [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,504, at 97,633 (N.D. Cal. Aug. 20, 1990).

179. *See id.* at 97,637-38.

180. *See* 17 C.F.R. § 229.303(b) (1993).

181. *In re* Sun Microsystems, Inc., Fed. Sec. L. Rep. (CCH) ¶ 95,504, at 97,637.

Corp.[182] concluded that a "demonstration of a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5."[183] A violation of Item 303 in connection with MD&A, even in an annual report, may not be actionable under Rule 10b-5 if only the MD&A materiality standard of "reasonably likely" is shown without the *Basic* standard.[184] Recall that Rule 10b-5 requires that any misstatement or omission be material before it is actionable.[185] In *Basic* the Supreme Court directed that materiality for purposes of Rule 10b-5 is to be determined by the probability/magnitude balancing test.[186] In other words, misstatements or omissions in a registrant's MD&A will violate Item 303 if it is material by reference to the standard of "reasonably likely to occur" as announced in Securities Act Release No. 6835. However, a registrant is not subject to Rule 10b-5 liability for the MD&A misstatement or omission unless the *Basic* standard is also established.

The *Alfus* court's reasoning is logically inconsistent because it is hard for one to envision a known trend, demand, commitment, event, or uncertainty found to be "reasonably likely to occur" so as to be material for purposes of MD&A that would not also satisfy the "probability" prong of the *Basic* balancing test. Likewise, it is difficult to imagine an occurrence that has a "material effect" for purposes of Item 303 disclosure that would not also satisfy the "magnitude" prong of the *Basic* balancing test. Therefore, the distinction drawn in *Alfus* is one without a difference.

Consistent with *Sun Microsystems* and *Alfus*, the court in *In re VeriFone Securities Litigation*[187] dismissed a claim for a violation of Rule 10b-5. The court stated:

> Although Item 303 specifies that the corporation is to "[i]dentify any known trends or any known demands, commitments, events or uncertainties," Instruction 7 to Item 303 [also] provides that corporations are "encouraged, but not required to, supply forward-looking information" and [that] any forward-looking information so disclosed is protected by the Rule 175 "safe-harbor."[188]

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182. 764 F. Supp. 598 (N.D. Cal. 1991).

183. *Id.* at 608.

184. *See id.* The court relied on SEC Act Release No. 6835 which stated that the probability/magnitude test of *Basic* is inapposite to disclosure under Item 303. *See supra* note 33 and accompanying text.

185. 17 C.F.R. 240.10b-5 (1993).

186. *See supra* note 31 and accompanying text.

187. 784 F. Supp. 1471 (N.D. Cal. 1992), *aff'd*, No. 92-15156, 1993 WL 469265 (9th Cir. 1993).

188. *Id.* at 1483 (quoting 17 C.F.R. § 229.3039(a)(1) & Instruction 7 (1993)).

While courts have been rather cryptic in divulging their reasoning concerning MD&A, the results reached generally appear to be sound.[189]

VIII. CONCLUSION

In summary, MD&A is the Commission's attempt to level the playing field between registrants and the public by mandating that certain information be shared in an economically efficient manner.[190] It is generally agreed that "[i]nformation is not a free good."[191] Costs are incurred to generate and disseminate accurate information,[192] and costs are associated with the absence of such information.[193] The Commission's current MD&A policy attempts to balance these cost considerations; however, its efficacy in

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189. *See, e.g.*, Ferber v. The Travelers Corp., 802 F. Supp. 698 (D. Conn. 1992); *In re* Donald J. Trump Casino Securities Litigation, 793 F. Supp. 543 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3rd Cir. 1993); *In re* VanLandingham, Exchange Act Release No. 23,249, [1982-87 AAER Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,502 (June 20, 1986); *In re* Francis, Exchange Act Release No. 23,250, [1982-87 AAER Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,503 (June 20, 1986).

190. Related to the topic of economically efficient dissemination of information is the fraud-on-the-market theory approved in principal by four justices of the Supreme Court. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 241-50 (1988). This theory maintains that information regarding a registrant's expected future value is rapidly incorporated into the company's current market price. The unspoken assumption is that at least a semi-strong, efficient market exists. Under the fraud-on-the-market-theory, liability is found where material misrepresentations cause a price of securities to deviate from the efficient market price. Persons who purchase or sell securities during the period of the deviation and suffer a financial injury are permitted to sue the responsible party without having to establish any knowledge of the material misrepresentation or omission. In essence, participants in securities market transaction are assumed to have relied on a market price free from manipulation. Thus, the fraud-on-the-market theory dispenses with the element of individual reliance in securities market fraud litigation. *See generally* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanism of Market Efficiency*, 70 VA. L. REV. 549 (1984) (discussing the interrelation of methods of disclosure and degrees of market efficiency); Jonathon R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059 (1990) (analyzing the Court's establishment of the efficient capital market hypothesis in *Basic*).

191. *In re* VeriFone, 784 F. Supp. 1471, 1483 (N.D. Cal. 1992), *aff'd*, No. 92-15156, 1993 WL 469275 (9th Cir. 1993).

192. *Id.* (citing Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 787-88 (1985)).

193. *Id.* The social costs to gather and distribute historical information by registrants is relatively low. From an efficiency standpoint, it makes sense to require registrants to produce historical information because this information is under their control. Conversely, prospective information exacts a higher social cost. Not all forecasts, projections, and other prospective information exists; this information must be created by public companies before it can be distributed. Even after the information is created, competitive reasons may dictate keeping certain information confidential. Moreover, making predictions is not the forte of most registrants. *See id.*

achieving that goal is somewhat suspect. It is noteworthy that historical or hard information, when properly reported, is rarely the subject of misinterpretation or litigation.[194] Although most registrants do a fairly good job of describing historical events, few provide useful and accurate forward-looking or prospective statements.[195] By their very nature, prospective statements are subject to the biases of management.[196] Too often, these statements are both self-serving and overly optimistic. Thus, when prospective information is disclosed, registrants tend to predict correctly positive occurrences, either ignoring or not fully disclosing negative ones.[197]

Notwithstanding the market's ability to discount predictive information,[198] it might be best to impose upon public companies the obligation to disclose hard information and leave the pure speculation to others.[199] This is not to suggest that all prognostication by public companies is, or should be, prohibited. On the contrary, the federal securities laws appropriately encourage forward-looking disclosure; a safe harbor from liability is provided in Rule 175.[200] To the public, an accurate good faith prediction made on a reasonable basis is valuable information which can be carefully considered and given its proper weight.

Attempting to improve compliance with MD&A, many public companies are adopting the strategy of disclosing unanticipated events instead of remaining silent even in the absence of a disclosure trigger. Even today, it is not uncommon for a registrant to collect and analyze the contents of the MD&A disclosure statements of similarly situated companies as a means of improving its own compliance. Additionally, many companies are establishing a board committee to oversee the entire MD&A disclosure process, while others are beginning to institute written policies and procedure for the

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194. *See In re* Verifone, 784 F. Supp. 1471, 1483 (N.D. Cal. 1992), *aff'd*, No. 92-15156, 1993 WL 469265 (9th Cir. 1993) (citing Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 674 (1984)).

195. *See* Moses L. Pava & Marc J. Epstein, *How Good Is MD&A As An Investment Tool?*, J. ACCT. (March 1993) at 51, 51-52. The authors discovered that many public companies made no prediction whatsoever. *Id.* Only 12% accurately anticipated all economic events (labor conflicts, new competition, etc.) cited by *Moody's Handbook of Common Stocks*. *Id.* at 52. Public companies as a group were more than twice as likely to correctly predict positive economic events than negative events. Further, on average, registrants were more successful at predicting company-specific events than industry-wide or economy-specific events. *Id.*

196. Roger J. Dennis, *Mandatory Disclosure Theory and Management Projections: A Law and Economics Perspective*, 46 MD. L. REV. 1197, 1211-18 (1987).

197. *Id.*

198. *See* Wielgos v. Commonwealth Edison Co., 892 F.2d 513, 515 (7th Cir. 1989).

199. *In re VeriFone Securities Litigation*, 784 F. Supp. 1471, 1482 (N.D. Cal. 1992), *aff'd*, No. 92-15156, 1993 WL 469275 (9th Cir. 1993) (citing Easterbrook & Fischel, *supra* note 194, at 703).

200. *See supra* notes 42-44 and accompanying text.

gathering, processing, and reviewing function involved in the preparation of their MD&As. Perhaps one of the most intriguing developments is that registrants and their legal counsel are compelled to engage in a due diligence review of MD&A disclosure much in the same manner as a registration statement is reviewed by underwriters and legal counsel.

As to the future of MD&A, public companies will most likely see a further gradual tightening of the federal securities laws governing disclosure, thereby limiting their ability to exercise discretion in making selective disclosure, to withhold potentially damaging information, and to make optimistic statements about the company's future. Although the increasing complexity of MD&A coupled with the ever present threat of an SEC proceeding or other litigation will continue to produce anxiety among many registrants, the public may benefit from the more forthright disclosure MD&A now compels.