

period by a specified amount, it would not provide a sufficient basis for a reader to analyze the change. If the company reports negative cash flows from operations, the disclosure provided in MD&A should identify clearly this condition, discuss the operational reasons for the condition if material, and explain how the company intends to meet its cash requirements and maintain operations. If the company relies on external financing in these situations, disclosure of that fact and the company's assessment of whether this financing will continue to be available, and on what terms, should be considered and may be required.

A company should consider whether, in order to make required disclosures, it is necessary to expand MD&A to address the cash requirements of and the cash provided by its reportable segments or other subdivisions of the business, including issues related to foreign subsidiaries, as well as the indicative nature of those results.⁵³ A company also should discuss the effect of an inability to access the cash flow and financial assets of any consolidated entities. For example, an entity may be consolidated but, because the company lacks sufficient voting interests or the assets are legally isolated, the company may be unable to utilize the entity's cash flow, cash on hand, or other assets to satisfy its own liquidity needs.

2. Financing

To the extent material, a company must provide disclosure regarding its historical financing arrangements and their importance to cash flows, including, to the extent material, information that is not included in the financial statements. A company should discuss and analyze, to the extent material:

- Its external debt financing;
- Its use of off-balance sheet financing arrangements;
- Its issuance or purchase of derivative instruments linked to its stock;
- Its use of stock as a form of liquidity; and
- The potential impact of known or reasonably likely changes in credit ratings or ratings outlook (or inability to achieve changes).

In addition to these historical items, discussion and analysis of the types of financing that are, or that are reasonably likely to be, available (or of the types of financing that a company would want to use but that are, or are reasonably likely to be, unavailable) and the impact on

the company's cash position and liquidity, should be considered and may be required. For example, where a company has decided to raise or seeks to raise material external equity or debt financing, or if it is reasonably likely to do so in the future, discussion and analysis of the amounts or ranges involved, the nature and the terms of the financing, other features of the financing and plans, and the impact on the company's cash position and liquidity (as well as results of operations in the case of matters such as interest payments) should be considered and may be required.⁵⁴

C. Debt Instruments, Guarantees and Related Covenants

There are at least two scenarios in which companies should consider whether discussion and analysis of material covenants related to their outstanding debt (or covenants applicable to the companies or third parties in respect of guarantees or other contingent obligations)⁵⁵ may be required.⁵⁶

First, companies that are, or are reasonably likely to be, in breach of such covenants⁵⁷ must disclose material information about that breach and analyze the impact on the company if material. That analysis should include, as applicable and to the extent material:

- The steps that the company is taking to avoid the breach;
- The steps that the company intends to take to cure, obtain a waiver of or otherwise address the breach;
- The impact or reasonably likely impact of the breach (including the effects of any cross-default or cross-acceleration or similar provisions) on financial condition or operating performance; and
- Alternate sources of funding to pay off resulting obligations or replace funding.

Second, companies should consider the impact of debt covenants on their

⁵⁴ We believe that disclosure satisfying the requirements of MD&A can be made consistently with the restrictions of Section 5 of the Securities Act. See, e.g., Securities Act Rules 135c [17 CFR 230.135c].

⁵⁵ See FASB Interpretation No. (FIN) 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (Nov. 2002); 2003 Off-Balance Sheet Release; and the discussion *infra*, regarding off-balance sheet arrangements.

⁵⁶ See *In the Matter of America West Airlines, Inc.*, Release No. 34-34047 (May 12, 1994) (finding that the company failed to discuss uncertainties regarding its ability to comply with covenants).

⁵⁷ Companies also must take a similar approach to discussion and analysis with respect to mandatory prepayment provisions, "put" rights and other similar provisions.

ability to undertake additional debt or equity financing. Examples of these covenants include, but are not limited to, debt incurrence restrictions, limitations on interest payments, restrictions on dividend payments and various debt ratio limits. If these covenants limit, or are reasonably likely to limit, a company's ability to undertake financing to a material extent, the company is required to discuss the covenants in question and the consequences of the limitation to the company's financial condition and operating performance. Disclosure of alternate sources of funding and, to the extent material, the consequences (including but not limited to the cost) of accessing them should also be considered and may be required.

D. Cash Management

Companies generally have some degree of flexibility in determining when and how to use their cash resources to satisfy obligations and make other capital expenditures. MD&A should describe known material trends or uncertainties relating to such determinations. For example, a decision by a company in a highly capital-intensive business to spend significantly less on plant and equipment than it has historically may result in long-term effects that should be disclosed if material. Material effects could include more cash, less interest expense and lower depreciation, but higher future repair and maintenance expenses or a higher cost base than the company would otherwise have.

V. Critical Accounting Estimates

Many estimates and assumptions involved in the application of GAAP have a material impact on reported financial condition and operating performance and on the comparability of such reported information over different reporting periods. Our December 2001 Release reminded companies that, under the existing MD&A disclosure requirements, a company should address material implications of uncertainties associated with the methods, assumptions and estimates underlying the company's critical accounting measurements.⁵⁸ In May 2002 we proposed rules, which remain under consideration, that would broaden the scope of disclosures beyond those currently required.⁵⁹

When preparing disclosure under the current requirements, companies should consider whether they have made

⁵⁸ December 2001 Release.

⁵⁹ See 2002 Critical Accounting Policies Proposal.

⁵³ See Item 303(a) of Regulation S-K [17 CFR 229.303(a)].