

From Heavy Equipment to Cyber – 30 years of MD&A Enforcement

The [announcement](#) last week that NVIDIA Corporation had [settled charges](#) involving inadequate disclosure in two of its Form 10-Q reports was a milestone of sorts and a reminder that one of the most prominent and frequent threads in enforcement proceedings brought by the Securities and Exchange Commission (“SEC”) in recent decades has been inadequate disclosure of facts, trends, and uncertainties that are known by management in Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”). The first such enforcement action after the SEC’s landmark 1989 MD&A interpretive release was *In re Caterpillar, Inc.*, SEC Release No. 34-30532 (Mar. 31, 1992), which the SEC announced a little more than 30 years ago. Although there is a big difference between heavy equipment that can weigh more than 70 thousand pounds empty and graphics processors that can have more than 50 billion transistors today, it turns out that the principles that apply to MD&A disclosure are the same.

The disclosure principle that the Division of Enforcement has repeatedly made clear over the last three decades is not complex: Item 303 of Regulation S-K requires companies to disclose in MD&A what management **currently knows** about facts, trends, and uncertainties that have had, or are reasonably likely to have, a material impact on the company’s business and financial performance. These cases do not involve complex legal theories or factual connections, such as those that insider trading or fraud-on-the-market cases sometimes present. Most of the MD&A cases that have followed *Caterpillar* are straightforward factually and legally. Further, the facts necessary for the Division of Enforcement to support its allegations are typically readily available in company emails, memoranda, and other documents.

The frequency with which the SEC initiates – and wins – enforcement actions like *Caterpillar* and *NVIDIA* should be an ongoing reminder that basic MD&A disclosure principles are important. To state a few of the most important principles:

- The company’s disclosure controls and procedures should be designed to identify the facts, trends, or uncertainties that have caused, or are reasonably likely to cause in the future, material changes or differences between financial reporting periods.
- This information should be routed to the company’s financial and business management, as well as to the board of directors and especially the audit committee, for discussion and evaluation, not just for internal business and financial planning purposes but as part of the company’s public disclosure processes.
- Management should regularly review the design and operation of the company’s disclosure controls and procedures, and ensure that the company updates them as necessary to allow the company to comply with applicable disclosure requirements.
- Management should remember that Form 10-Q MD&A disclosure is no less important than the full-year disclosure in the company’s Form 10-K reports.
- Although less significant in the *Caterpillar* and *NVIDIA* enforcement actions, other MD&A enforcement actions have made it very clear that MD&A disclosure of facts, trends, and uncertainties that have affected or may in the future affect the company’s business and financial performance must be accurate as of the filing date of the report, not just as of the end of the fiscal period covered by the report.

It is possible that companies may fail to make the disclosure that was required in *Caterpillar*, *NVIDIA* and many other similar enforcement actions because the fact, trend, or uncertainty may not yet have found its way to the bottom line of the income statement. As such, it is critical to note that SEC rules require that

MD&A discloses not just financial results but what management *currently knows* about the facts, trends, and uncertainties that have affected its financial performance or are reasonably likely to affect future financial performance. Enforcement actions like *Caterpillar*, *NVIDIA* and the many similar actions that the Division of Enforcement has brought over the past 30 years often turn on just a few very simple questions:

- What does management know right now – at the time the company is filing the Form 10-Q or Form 10-K report, not just as of the close of the relevant fiscal period – about facts, trends, or uncertainties that have recently affected the company’s products, markets, sales and net income, or are reasonably likely to do so in the near future?
- Has this information been clearly presented, with any appropriate cautions or disclaimers, in MD&A?

Caterpillar and *NVIDIA* illustrate these principles clearly. In *Caterpillar*, the SEC alleged that the company’s management knew that sales in recent quarters reflected material and historically atypical increases in sales in South America. Further, during the periods involved in the enforcement action, management knew that these increased sales were likely to decline. The company did not disclose these facts in the MD&A sections of its Form 10-Q and Form 10-K reports during the relevant periods.

NVIDIA is based on a similar factual scenario. Nvidia’s sales of graphics processing units (“GPUs”) had historically been driven by computer gaming. During the relevant periods, NVIDIA’s revenues increased materially as a result of demand for its GPU products for use in crypto-mining. Although Nvidia’s systems did not permit the company to quantify this impact exactly, management was aware of this new market demand and sought to take advantage of it. However, NVIDIA did not disclose the impact of crypto-mining sales in its Form 10-Q reports for the second and third quarters of its fiscal 2018 year; NVIDIA first disclosed the impact of these sales in its Form 10-K report for its fiscal 2018 year.

In both of these cases, the SEC simply connected the dots between subsequent disclosure of events that had affected the company’s business and financial performance and earlier reports that did not disclose known facts and trends. Thus, the question a company should continually ask itself is does its MD&A accurately reflect what management knows about what is shaping the company’s business and financial performance right now?

AUTHORS:

Sean M. Donahue
John O. Newell