

Programmatic Portfolio Company Reporting

Access Holdings

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This is a documentation of best practices for producing Management's Discussion and Analysis (MD&A) for the Access Holdings family of companies. Companies to which this applies will be small to medium sized enterprises (SME's) in the service and manufacturing sectors.

5 Steps to Quality MD&A

There are five steps involved in producing quality MD&A. Details are discussed below but the steps are outlined here for an easy reminder:

- 1) Variance analysis
- 2) Identification of proximate cause(s)
- 3) Root cause analysis
- 4) Remediation plan (for Budgets Implementation plan)
- 5) Forecast year end results (NA for budgets)

What is MD&A?

Quality MD&A is a tool that allows users of the company's financial information to understand what the information is telling them about operational issues, what they can do to create better financial results and what financial results are likely to be in future based on current results and plans to improve results.

Just to be clear, what we refer to as MD&A in our financial budgeting and reporting processes is really variance analysis. That is, we compare financial results in the current quarter to the budget for that period and explain differences or we compare our proposed budget for the year to last year's actual results and explain those differences. MD&A for public companies is very different. The Securities and Exchange Commission issued its current rule on MD&A effective commencing February 10, 2021, and the guidance provided covers 195 pages! So long as we understand the difference, MD&A is the term we will use for the process of explaining our budget and actual results.

Purpose of MD&A

The purpose of the MD&A is to provide a narrative explanation, through the eyes of management, of how a company has performed in the past, its financial condition and its future prospects. The MD&A should supplement and complement the information provided in the financial statements. It is a powerful tool for management to communicate how they have created value and how they plan to continue doing so. In combination with the financial statements, MD&A provides the opportunity for management to communicate the effectiveness of its stewardship of resources and, further, progress towards its stated strategic objectives in its three-year strategic plan.

Quality MD&A provides material information to readers that may not be fully reflected in the financial statements and supplements and complements the information in the financial statements by helping readers understand what the financial statements show and do not show. It outlines key trends and risks that have affected or could affect the current and future financial statements and provides information to aid the readers in understanding the quality of the company's earnings and cash flows.

Principles

There are underlying principles that guide preparation of MD&A

- MD&A discloses information as it is viewed by management.
- MD&A should complement, as well as supplement, the financial statements.
- MD&A should be balanced, complete and fair as well as providing information that is material to the decision-making needs of users.
- A forward-looking orientation is fundamental to useful MD&A reporting.
- MD&A should explain management's strategy for achieving short-term and long-term objectives.
- To be useful, MD&A should be understandable, relevant, comparable, verifiable and timely.
 - Understandable – MD&A focuses on material information, using plain language and avoiding boilerplate.
 - Relevant - Information is considered relevant if it has the capacity to make a difference in the decisions made by readers. Focusing on material information in the MD&A is an important aspect of providing relevant information in the MD&A
 - Comparable - Information is comparable when sufficient commentary and disclosure have been provided so that similarities and differences between periods can be understood and evaluated, (including disclosures about accounting policies and changes therein).
 - Verifiable - The use of verifiable information in the MD&A helps assure readers that the information faithfully represents what it purports to represent.
 - Timely - Timely disclosure of material information is important as it ensures that information is available to users in time to inform and influence their decisions.

Types of MD&A

In our companies we produce three types of MD&A:

- 1) Budgeting – When draft budgets are prepared and presented by management the draft budget is compared to the prior year actual results (actually they are usually compared to forecast prior year results say in November with 10 months of actual and 2 months of forecast treated as the prior year actual for MD&A purposes). The budget is usually presented in three columns (See Appendix 1), variance being the difference between budget and actual:

	Next Year's Budget	This Year's Actual	Variance
Revenue			

Cost of Sales			
Gross Margin			
Etc.			

Typically, variances are shown marked Favorable or Unfavorable (FU for short - and now you will remember this idea forever!) or color coded with red for unfavorable and black for favorable. An additional column showing percentage changes can be added.

- 2) Reporting – When management produces financial reports for the board of directors, usually on a quarterly basis, the period actual results are compared to the budget for the period (it can be for the quarter or for the year to date, or both depending on the needs of the users). The financial report is usually presented in three columns (See Appendix 1), variance being the difference between actual and budget for the period:

	Current Period		
	Actual	Budget	Variance
Revenue			
Cost of Sales			
Gross Margin			
Etc.			

Variances are again marked F or U, black or red and an additional column showing percentage changes can be added.

- 3) Forecasting – Whenever management produces a financial report on the results of operations for the board during the year, management should also provide a reforecast of what they currently expect the results of operations for the entire year to be. The closer the reporting is to year end, the more likely the forecast results will match the actual results. The financial report is usually presented in three columns (See Appendix 1), variance being the difference between forecast and budget for the year:

	Year Ended December 31		
	Forecast	Budget	Variance
Revenue			
Cost of Sales			
Gross Margin			
Etc.			

Variances are again marked F or U, black or red and an additional column showing percentage changes can be added.

The Importance of Business Drivers, KPIs, and Budget Assumptions

Quality MD&A cannot be produced in the absence of an understanding of what drives the financial performance of the business. And from this understanding management must develop measures for those drivers (Key Performance Indicators or KPIs) in order to be able to determine what is working and not working. And a good budgeting process where the assumptions that drive the budget are articulated and connected to the business drivers and KPIs is also necessary for producing quality MD&A.

MD&A gets at the story behind the numbers and these three important components make that possible. Without business drivers, KPIs and budget assumptions management might report "Revenue was 10% behind plan because we didn't sell as much as we budgeted." There is no business insight offered here, nothing that suggests what can be done differently, nothing to learn from.

Or – Our revenue budget assumed (budget assumption) that our new marketing campaign would allow us to introduce a 3% price increase with our average revenue per customer (a business driver) increasing from \$100k to \$103k (a KPI) and our total number of customers (a business driver) increasing from 2,500 to 3,000 (a KPI) resulting in an increase in our revenue by 24% from \$250m to \$309m. Actual revenue for the period was \$278m, 10% below plan. Our price increase did not stick because of significant customer resistance. We were only able to realize an average price increase of 1% instead of the 3% we budgeted. Our customer base only grew to 2,750, not the 3,000 we assumed in the budget.

Now if management stops there, we have more useful information about the business drivers that delivered this actual to budget miss. But it is not actionable, and we have no idea what it means for the future of the business. Management has to move beyond the basic math of the business drivers to the root causes of the performance. Was the introduction of the price increase delayed? Why were we unable to overcome customer objections to the price increase? Was the marketing campaign ineffective? How do we know that? Was our sales group not as productive as planned? Quality MD&A will find and articulate the root causes.

And if management stops there, we have a better understanding of why the actual to budget miss happened but still no idea about what action to take and what the impact on our whole year will be. So management needs to report on actions it will be taking to address each of the root causes and the extent to which they expect the shortfall to affect the total year or the degree to which some or all of it can be recovered (forecasting the year end). Quality MD&A includes managements plans to improve results and offers management's forecast of what the total year results will be, based on what has happened year to date and the likely results of their plans to improve results for the year.

How, Exactly, Do You Produce Quality MD&A? – The Five Steps

Start by understanding the important business drivers that determine operational success. Select KPIs that measure those business drivers and make sure that the financial reporting system can produce those KPIs routinely and accurately. Select budget assumptions that are soundly grounded in reality and address the important business drivers. And make sure all these are clearly articulated.

- 1) Step 1 Variance Analysis - Calculate the variances. Not all variances are created equal. Quality MD&A should address material variances, not all variances. And materiality is not just a matter of the current value of a variance, but also looks forward where a small variance now is a harbinger of bigger problems to come.

- 2) Step 2 Identification of Proximate Cause(s) - Do the math. Use the KPIs to break down how much of the variance is created by each of the key business drivers.
- 3) Step 3 Root Cause Analysis - Find the root causes. This is by far the most challenging part of MD&A. A deep understanding of the business, what is actually happening on the ground, what your competitors are doing to you, how well your organization is functioning – the list is long. The analysis is a combination of data, understanding, management meetings, logic – digging until we really understand what happened.
- 4) Step 4 Remediation Plan (for Budgets Implementation Plan) - Plan to fix the root causes. This is the creative part of quality MD&A. The example in Appendix 1 identified a root cause of a price increase not fully realized as resistance by new customers who had only just started with the company and who had been told in the sales process that they could expect stable prices. The plan to fix the root cause involved training sales teams to not make this promise in future and meeting with objecting customers to explain to them what is driving the price increase and to tell them that their price increase would be delayed, not eliminated, for 3 months.
- 5) Step 5 Forecast the year end results (NA for Budgets). Understanding the key business drivers, determining root causes, planning to mitigate the results all allow management to forecast the results for the whole year including the extent to which some or all of the variance can be eliminated.

Conclusion

Quality MD&A is a tool that allows users of the company's financial information to understand what the information is telling them about operational issues, what they can do to create better financial results and what financial results are likely to be in future based on current results and plans to improve results.
