Alerts & Publications

SEC Proposes Amendments to MD&A and Financial Disclosures and Issues MD&A Interpretive Guidance

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On January 30, 2020, the Securities and Exchange Commission (SEC) announced proposed amendments intended to modernize and enhance certain Regulation S-K financial and MD&A disclosure requirements. The proposed release is available here. Comments on the proposed amendments will be due 60 days after publication in the Federal Register and the SEC proposes to provide a transition period of 180 days after effectiveness of any final rule, if adopted, to provide companies with adequate time to adjust their disclosures.

Separately, the SEC has issued interpretive guidance on key performance indicators and metrics in MD&A, which is available here. The guidance is effective immediately upon its publication in the Federal Register.

Proposed Amendments

The proposed amendments are intended to promote the "principles-based nature of MD&A" and advance the SEC's goals to "revise or eliminate overlapping or unnecessary disclosure requirements, where possible, thereby reducing burdens on registrants and enhancing readability without affecting the provision of material information to investors." The proposals are part of the SEC's "Disclosure Effectiveness Initiative" and are informed by the objectives of the Fixing America's Surface Transportation Act, which, among other things, required the SEC to study ways that Regulation S-K could be modernized and simplified.

Appendix A summarizes the more significant proposed amendments to Regulation S-K, which include:

- eliminating *Item 301 (Selected Financial Data)*, which requires most companies to furnish selected financial data in comparative tabular form for each of the last five fiscal years;
- eliminating *Item 302 (Supplementary Financial Information)*, which requires disclosure of selected financial data for each quarter within the two most recent fiscal years;
- enhancing *Item 303(a)(2) (Capital Resources)* to require discussion of material cash commitments of the company, including but not limited to capital expenditures (currently the requirement is to discuss material commitments for capital expenditures only);

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- replacing *Item 303(a)(4) (Off-Balance Sheet Arrangements)*, which requires disclosures about off-balance sheet arrangements in a separately captioned section, with an instruction regarding the need to discuss such obligations in the broader context of MD&A;
- eliminating *Item 303(a)(5) (Contractual Obligations Table)*, which requires most companies to disclose in tabular format their known contractual obligations by type of obligations and overall payments due;
- amending *Item 303* to expressly require disclosure of critical accounting estimates and including an instruction specifying that the disclosure of critical accounting estimates should supplement, but not duplicate, the description of accounting policies in the notes to the financial statements; and
- amending *Item 303(b) (Interim Periods)* to permit companies to compare their most recently completed quarter to either the corresponding quarter of the prior year or the immediately preceding quarter.

Additionally, Appendix A summarizes some of the other proposed amendments to Regulation S-K, which include: adding a new Item 303(a) to state the principal objectives of MD&A; amending Item 303 to add "product lines" of the company as an example of other subdivisions that the company should discuss if appropriate to an understanding of the company's business; and clarifying that a company should discuss "*material changes*" (as opposed to only "*material increases*") from period to period in net sales and revenues and "*underlying reasons*" (rather than only the "*cause*") of material changes from period-to-period in one or more line items in quantitative and qualitative terms. The SEC also proposes eliminating current Item 303(a)(iv), which requires companies to discuss the impact of inflation and changing prices, and making other changes such as eliminating unnecessary cross-references to industry guides, eliminating certain instructions and making other conforming changes. Although not specifically described here or in Appendix A, the proposals also include certain parallel amendments to Forms 20-F and 40-F applicable to disclosures provided by foreign private issuers.

Interpretive Guidance on Key Performance Indicators and Metrics

The guidance is consistent with the SEC's previous emphasis that, when preparing MD&A, companies should consider whether disclosure of "all key variables and other factors that management uses to manage the business would be material to investors, and therefore required." [1]

As part of the interpretive guidance, the SEC notes that companies often disclose non-financial and financial metrics (which can vary significantly from company to company and industry to industry, depending on various facts and circumstances) when describing the performance or status of their business. The SEC reminds companies that, when including metrics in their disclosure, they

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should consider existing MD&A requirements and the need to include such further material information, if any, “as may be necessary in order to make the presentation of the metric, in light of the circumstances under which it is presented, not misleading.”

In considering additional disclosures, the guidance advises that companies should consider the extent to which existing regulatory disclosure frameworks apply, such as GAAP or, for non-GAAP measures, Regulation G or Item 10 of Regulation S-K, as well as what additional information may be necessary to provide adequate context for an investor to understand the metric presented. [2]

In the interpretive guidance, the SEC states that it would generally expect, depending on the facts and circumstances, that a company would accompany disclosure of key performance indicators and metrics with the following disclosures:

- a clear definition of the metric and how it is calculated;
- a statement indicating the reasons why the metric provides useful information to investors; and
- a statement indicating how management uses the metric in managing or monitoring the performance of the business.

The company should also consider whether to disclose any estimates or assumptions underlying the metric or its calculation, for the metric not to be materially misleading.

The guidance further provides that if a company changes its method of calculation or presentation of the metric from one period to another, the company should consider disclosing, to the extent material: (1) the differences in the way the metric is calculated or presented compared to prior periods; (2) the reasons for such changes; (3) the effects of any such change on the amounts or other information being disclosed and on amounts or other information previously reported; and (4) such other differences in methodology and results that would reasonably be expected to be relevant to an understanding of the company’s performance or prospects, and depending on the significance of the change(s) in methodology and results, whether it is necessary to recast prior metrics to conform to the current presentation and place the current disclosure in an appropriate context.

Additionally, the SEC reminds companies that they are required to maintain effective disclosure controls and procedures and notes their importance when disclosing material key performance indicators or metrics that are derived from the company’s own information. When key performance indicators and metrics are material to an investment or voting decision, the company should consider whether it has effective controls and procedures in place that address their consistency and accuracy.

[1] See Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8350 (Dec. 19, 2003) [68 FR 75056 (Dec. 29, 2003)] available here.

[2] Examples of metrics include: operating margin; same store sales; sales per square foot; total customers/subscribers; average revenue per user; daily/monthly active users/usage; active customers; net customer additions; total impressions; number of memberships; traffic growth; comparable customer transactions increase; voluntary and/or involuntary employee turnover rate; percentage breakdown of workforce (e.g., active workforce covered under collective bargaining agreements); total energy consumer; and data security measures (e.g., number of data breaches or number of account holders affected by data breaches).
