

## **Alert** | Capital Markets



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### **SEC Issues MD&A Disclosure Guidance and Proposes Amendments to Modernize and Enhance MD&A Financial Disclosures**

On Jan. 30, 2020, the Securities and Exchange Commission (SEC) issued (i) **guidance** regarding the disclosure of key performance indicators (KPIs) and metrics in Management’s Discussion and Analysis, or MD&A (the “Guidance”), which is effective immediately and applies to the upcoming annual reports on Form 10-K and 20-F as well as related earnings releases; and (ii) **a proposal** to eliminate duplicative disclosures required by Regulation S-K Items 301 (Selected Financial Data), Item 302 (Supplementary Financial Information), and Item 303 (MD&A), and modernize and enhance MD&A disclosures for the benefit of investors, while simplifying compliance efforts for companies (the “Proposed Amendments”). In addition, on Jan. 24, 2020, the SEC staff issued certain Compliance & Disclosure Interpretations, or C&DIs, to clarify recent changes that allow companies to omit in the MD&A the earliest of the three years in certain circumstances.

#### **MD&A Guidance Related to KPI and Metrics Disclosures**

Under existing SEC rules, the SEC has long advised companies to consider whether all key variables and factors that management uses to manage the business – those that allow investors to see the company “through the eyes of management” – are material to investors and, therefore, required to be disclosed. The SEC has encouraged companies to identify and discuss such key factors and variables, which may include KPIs and financial and non-financial metrics. The Guidance reminds companies to consider

whether existing disclosure requirements apply, such as GAAP, Regulation G, or Item 10 of Regulation S-K, and whether additional disclosures may be needed to provide adequate context for investors to understand the KPI or metric presented. The Guidance specifically notes that the SEC would generally expect to see the following disclosures accompanying the metric:

- a clear definition of the metric and the method of calculation;
- the rationale for why the metric provides useful information to investors; and
- an explanation of how the metric is applied in managing the business.

Examples of metrics to which the SEC intends the Guidance to apply include such items as operating margin, same-store sales, sales per square foot, total customers or subscribers, among others listed in the release. These metrics are generally operating and performance metrics that are not considered to be non-GAAP measures that would be subject to Regulation G or Item 10 of Regulation S-K. Companies should note that this Guidance imposes certain disclosure requirements on these metrics that are similar to what would be required for non-GAAP measures.

The Guidance also reminds companies to consider whether there are estimates or assumptions underlying the metric or its calculation, and whether disclosure of such information is necessary for the metric not to be materially misleading. In particular, if a company changes the method by which it calculates or presents the metric from one period to another, the company should discuss:

- the material differences in the way the metric is calculated or presented compared to prior periods;
- the reasons for such changes;
- the effects of such changes on the amounts or other information being disclosed currently and as previously reported; and
- other differences in methodology and results that would reasonably be expected to be relevant to an understanding of the company's performance or prospects.

Depending on the significance of the changes, the company should consider whether it is necessary to recast previously reported metrics to conform to the current presentation and place the current disclosure in context. Companies should also review the effectiveness of their disclosure controls and procedures when disclosing metrics derived from internal company data, as well as consider the need for additional or revised risk factor disclosure.

### **Proposed Amendments to MD&A Disclosures**

Building upon the SEC's prior Regulation S-K studies in December 2013, July 2016, and November 2016, as part of its Disclosure Effectiveness Initiative, the Proposed Amendments seek to continue the SEC's focus of reviewing and enhancing those rules that may have become outdated or unnecessary, or could otherwise be improved, and to continue the move to principles-based disclosure.

In summary, the key elements of the Proposed Amendments would:

- eliminate Item 301 (Selected Financial Data) and Item 302 (Supplementary Financial Data) of Regulation S-K, noting that both requirements are duplicative of other disclosure requirements contained in the financial statements;
- add a new Item 303(a), Objective, to incorporate the substantive portions of current Instructions 1, 2 and 3, and to confirm existing guidance on the principal objectives of MD&A;

- replace the Off-Balance Sheet Arrangements in Item 303(a)(4) with a principles-based instruction to prompt companies to discuss such arrangements in the broader context of MD&A;
- eliminate the Contractual Obligations table requirement in Item 303(a)(5) due to its overlap with information required in the financial statements;
- add a Critical Accounting Estimates disclosure requirement to Item 303 to clarify and codify existing SEC guidance in this area; and
- add flexibility to the interim MD&A requirement in Item 303(b) to permit companies to compare their most recently completed quarter to either the corresponding quarter of the prior year (as currently required) or to the immediately preceding quarter.

### **Item 301 – Selected Financial Data**

The SEC is proposing to eliminate Item 301, which requires registrants to provide five years of selected financial data. A few commenters to the July 2016 concept release recommended retaining this disclosure or limiting the disclosure to the two earliest years, which should be provided only when necessary to make the current financial data not misleading or to illustrate material trends. The SEC believes that such selected financial data can be obtained from prior filings and is duplicative.

### **Item 302 – Supplementary Financial Information**

The SEC is proposing to eliminate Item 302, which requires registrants to provide two years of selected quarterly financial data and disclosure of variances in these results. Previously, commenters have recommended retaining and expanding Item 302 or have noted that this information avoids having to infer the quarterly results based on the annual results, and that allows investors to understand the effects of changes to the business sooner. Although eliminating Item 302 may result in the loss of a separate presentation of certain fourth quarter information, the Proposed Amendments reflect a conclusion that most of the financial data required by Item 302 can be found in prior quarterly reports and is duplicative.

### **Item 303 – MD&A**

The Proposed Amendments include several changes to Item 303, including, among others:

- *Adding a new Item 303(a) to state the principal objectives of MD&A.* The proposal establishes a new paragraph 303(a), incorporating much of the substance of Instructions 1, 2, and 3 to emphasize the objective of MD&A for both full fiscal years and interim periods. The proposal also codifies SEC guidance that a registrant should provide a narrative explanation of its financial statements sufficient to enable investors to see a registrant “through the eyes of management.”
- *Enhancing Item 303(a)(2) to require registrants to disclose material cash requirements.* The proposal would require disclosure of commitments for capital expenditures, the anticipated source of funds needed to satisfy such cash requirements, and the general purpose of such requirements. The proposal is intended to modernize Item 303(a)(2) by specifically requiring disclosure of material cash requirements in addition to capital expenditures. The SEC recognizes that certain expenditures and cash commitments that are not necessarily capital investments in property, plant, and equipment may be increasingly important to companies, especially those for which human capital or intellectual property are key resources. These proposals, alongside the current requirement for registrants to discuss their ability to generate cash, are intended to enhance disclosure and provide greater clarity of a registrant’s ability to meet its material cash requirements.

- *Amending Item 303(a)(3)(ii) to clarify the disclosure of known trends or uncertainties by using a threshold of “reasonably likely.”* The proposal would require registrants to disclose known events that are reasonably likely to cause (as opposed to an event that will cause) a material change in the relationship between costs and revenues, such as known or reasonably likely future increases in costs of labor or materials, price increases, or inventory adjustments.
- *Amending Item 303(a)(3)(iii) to clarify that the results of operations discussion should include all material changes in net sales or revenues.* The proposal would amend Item 303(a)(3)(iii) to codify existing guidance and clarify the requirement by tying the required disclosure to “material changes” in net sales or revenues, rather than solely to “material increases” in these line items.
- *Eliminating the Item 303(a)(3)(iv) requirement to discuss the impact of inflation and changing prices.* The proposal notes that the reference to inflation and changing prices may give undue attention to the topic, and is not necessary to understand a registrant’s financial condition. Despite these proposed deletions, registrants would still be expected to discuss the impact of inflation or changing prices if they are part of a known trend or uncertainty that has had, or the registrant reasonably expects to have, a material favorable or unfavorable impact on net sales, revenue, or income from continuing operations. The SEC has also specifically encouraged registrants to consider disclosure of economic or industry-wide factors where relevant.
- *Replacing Item 303(a)(4) (Off-Balance Sheet Arrangements) with a principles-based instruction.* The proposal provides that registrants disclose off-balance sheet arrangements in a more holistic, principles-based discussion throughout the MD&A, rather than in a separately captioned section. Registrants would be required to discuss commitments or obligations arising from arrangements with unconsolidated entities that have, or are reasonably likely to have, a material current or future effect on such registrant, even when the arrangement results in no obligation being reported in the registrant’s consolidated balance sheets.
  - The SEC also proposes to amend Items 2.03 and 2.04 of Form 8-K to include the definition of “off-balance sheet arrangements” that is currently in Item 303(a)(4), but would not result in any changes in reporting obligations under either Item of Form 8-K.
- *Eliminating the Item 303(a)(5) requirement for a Tabular Disclosure of Contractual Obligations.* The proposal would eliminate the specific requirement to provide a contractual obligations table due to the overlap with information required in the financial statements and in order to promote the principles-based nature of MD&A.
- *Adding a new requirement to Item 303 for disclosure of critical accounting estimates.* The proposal is intended to eliminate disclosure that duplicates the financial statement discussion of significant accounting policies and, instead, promote enhanced analysis of measurement uncertainties. The proposal is also intended to clarify for registrants the required disclosures related to critical accounting estimates. To this end, the proposal defines a critical accounting estimate as an estimate made in accordance with GAAP that involves a significant level of estimation uncertainty and has had or is reasonably likely to have a material impact on the registrant’s financial condition or results of operations. By focusing the definition on estimation uncertainties, the proposal intends to avoid any unnecessary repetition of significant accounting policy footnotes, and should instead serve to supplement disclosure contained in the financial statements. In addition, for each critical accounting estimate, the proposed amendment would require registrants to disclose, to the extent material, why the estimate is subject to uncertainty, how much each estimate has changed during the reporting period, and the sensitivity of the reported amounts to the material methods, assumptions, and estimates underlying the estimate’s calculation.

- *Revising the interim period discussion required by Item 303(b) to allow for flexibility in comparisons of interim periods.* The proposal would allow companies to compare their most recently completed quarter to either (i) the corresponding quarter of the prior year (as currently required) or (ii) the immediately preceding quarter. Under the proposal, if a registrant elects to discuss changes from the immediately preceding sequential quarter, the registrant must provide summary financial information that is the subject of the discussion for that quarter or identify the prior EDGAR filing that presents such information so that an investor may have ready access to the prior quarter financial information being discussed. In addition, if a registrant changes the comparison from the prior interim period comparison, the registrant would be required to explain the reason for the change and present both comparisons in the filing where the change is announced.
- *Eliminating Item 303(c) (Safe Harbor) as a conforming change in light of the changes to Items 303(a)(4) and (a)(5) discussed above.* Current Item 303(c) confirms application of the statutory safe harbors to Item 303(a)(4) (Off-Balance Sheet Arrangements) and Item 303(a)(5) (Tabular Disclosure of Contractual Obligations), and states that all of the required disclosures under these two items are deemed to be “forward-looking statements” as that term is defined in the statutory safe harbors, except for historical facts. The proposal provides that the elimination of Item 303(c) is meant to be a conforming change in light of the proposed elimination of Item 304(a)(4) and (a)(5). The proposal specifically notes that forward-looking information included in off-balance sheet arrangement disclosures provided in response to proposed Instruction 8 to Item 303(b), along with disclosures regarding contractual obligations, would continue to be covered by existing safe harbors.

The Proposed Amendments include certain parallel amendments applicable to financial disclosures provided by foreign private issuers and smaller reporting companies.

### **New MD&A Compliance and Disclosure Interpretations**

In other recent action, on Jan. 24, 2020, the SEC issued [three new Compliance & Disclosure Interpretations \(C&DIs\)](#) to offer further guidance on amended Instruction 1 to Item 303(a). The new C&DIs:

- confirm that the statement identifying the location in a previous filing where the omitted disclosure may be found does not automatically incorporate that disclosure by reference into the current filing, unless the company expressly states that the information is incorporated by reference;
- confirm that a company may not omit discussion of the earliest of the three years if the company believes that discussion to be necessary to an understanding of its financial condition, changes in financial condition, and results of operations; and
- address the impact of Instruction 1 to Item 303(a) for purposes of incorporation by reference in an effective registration statement (specifically, the registration statement will only include the information from the most recent Form 10-K filing, including whether the discussion of the earliest of the three years is omitted or specifically incorporated by reference).

### **Conclusion**

As the Guidance is effective immediately upon publication in the Federal Register, companies will need to consider its applicability when preparing upcoming annual reports on Form 10-K and 20-F and related earnings releases. Companies will need to ensure that KPIs and other metrics are adequately disclosed, included methodology for calculation and the basis for inclusion and analysis by management.

Although the Commissioners have expressed different views on the appropriateness of certain aspects of the proposals,<sup>1</sup> including the lack of any specific requirements for disclosure of the impact on a company's business from the effects of climate change or other environmental, social and governance (ESG) factors, the Proposed Amendments are consistent with the SEC's attempts in recent years to simplify and update disclosure requirements for registrants, thereby reducing duplicative and burdensome disclosures, while seeking to preserve investor protections.

Comments on the Proposed Amendments are due to the SEC within 60 days after publication in the Federal Register, or approximately mid-April. However, given that the proposing release states there will be a 180-day transition period, it is likely that the final rules would not become effective until the second half of 2021.

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<sup>1</sup> See Commissioner Allison Herren Lee, "Modernizing" Regulation S-K: Ignoring the Elephant in the Room" (Jan. 30, 2020).