

# SEC Proposes to Modernize MD&A and Other Financial Disclosures

February 25, 2020

The SEC has issued a new proposal, part of the Disclosure Effectiveness Initiative, to simplify and modernize Management's Discussion and Analysis of Financial Condition and Results of Operations and the other financial disclosure requirements of Regulation S-K. Much like other recent proposals, this proposal once again tilts toward a more principles-based approach, describing the objectives of MD&A with the goal of eliciting more thoughtful, less rote analysis. Similarly, the proposal eliminates some prescriptive requirements in favor of more general disclosures that are integrated into the primary discussions. Some of the proposed changes are fairly dramatic – such as eliminating selected financial data, supplementary financial data and the table of contractual obligations. Whether the proposal, if adopted, actually leads to more nuanced, analytical disclosure remains to be seen. The proposal will be open for comment for 60 days.

Included as Appendix A is a version of the SEC's table of proposed changes.

At the same time, the SEC released guidance (new Section 501.16 of the "Codification of Financial Reporting Policies") on disclosure regarding key performance indicators.

## The proposal

### Elimination of selected financial data and supplementary financial information (items 301 and 302)

In response to commentary questioning the continued value of the five-year table of selected financial data, the SEC is proposing to eliminate the requirement. With the ready availability of data on EDGAR and trend information already required in MD&A, the table may no longer be necessary and the cost of preparation not justified.

Similarly, the SEC is proposing to eliminate the requirement to provide supplementary financial data, which comprises quarterly operating data for two years. Again, with quarterly reports available on EDGAR, this item appears unnecessary and duplicative. One of the benefits cited for maintaining the requirement was the availability of discrete results for the fourth quarter; however, the SEC observed that, to the extent that "fourth quarter results are material or there is a material retrospective change, existing requirements would still elicit this disclosure" in MD&A.

### Proposed changes to MD&A (item 303)

The changes to MD&A are intended to streamline and clarify the rule and to elicit more thoughtful and nuanced MD&A analysis.

#### Objectives of MD&A

This new item collapses some of the prior instructions and prior guidance into a new paragraph designed to provide principles-based direction regarding the objectives of MD&A. The SEC's intent is "to facilitate a thoughtful discussion and analysis, and encourage management to disclose factors specific to the registrant's business, which management is in the best position to know, and underscore materiality as the overarching

principle of MD&A." As a general principle, the discussion should include:

- Material information relevant to an assessment of the financial condition and results of operations of the registrant, including an evaluation of the amounts and certainty of cash flows from operations and from outside sources;
- Material financial and statistical data that the registrant believes will enhance a reader's understanding of the registrant's financial condition, changes in financial condition, and results of operations;
- Material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition; and
- A narrative explanation of the financial statements that enables investors to see a registrant "through the eyes of management."

### **Discussion of full fiscal years**

Overall, the SEC is seeking to elicit a thoughtful, less mechanical discussion. The proposal requires, in the context of the business as a whole, a "narrative discussion of the 'underlying reasons' for material changes from period-to-period in one or more line items in quantitative and qualitative terms, rather than only the 'cause' for material changes." The proposal also clarifies that companies should discuss material changes within a line item even when the material changes are offsetting.

### **Capital resources**

The approach taken by the SEC is again a principles-based one: instead of focusing on disclosure of material commitments only for capital expenditures, the proposal asks companies to provide "a clear picture of a registrant's ability to meet its material cash requirements." "Material cash requirements" would include funds necessary to maintain current operations, complete projects underway, and achieve stated objectives or plans, as well as commitments for capex or other expenditures. The proposal also seeks a description of the anticipated source of funds and the general purpose of the requirements.

### **Results of operations**

- **Known trends or uncertainties.** The proposed amendment requires disclosure when a company knows of events that are *reasonably likely* to cause (as opposed to *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 or price increases or inventory adjustments. The express requirement to discuss the effects of inflation would be eliminated, but inflation is still expected to be discussed if it is part of a known trend or uncertainty that could be material or otherwise contributed to a material change.
- **Net sales and revenues.** The proposed amendment provides that, to the extent there are material *changes* in net sales or revenues (not just increases, but also *decreases*), a narrative discussion is required of the extent to which the changes are attributable to changes in prices, the amount of goods or services being sold, or to the introduction of new products or services. As noted above, the narrative must include a discussion of the "underlying reasons" for the changes.

### **Off-Balance sheet arrangements**

The proposal eliminates the current prescriptive definition of off-balance sheet arrangement and the related requirement for disclosure under a separately captioned section, replacing it with a principles-based instruction to Item 303 and examples of off-balance sheet items. The instruction requires a discussion of "material matters of liquidity, capital resources, and financial condition as they relate to off-balance sheet arrangements." The objective is to reduce the amount of boilerplate and encourage more integration of material off-balance sheet arrangements disclosure within MD&A disclosures, particularly the discussion of financial condition.

### **Contractual obligations table**

The SEC is proposing to eliminate the prescriptive contractual obligations table, given that the capital resources proposal mandates discussion of material cash requirements, including material contractual obligations, as does the discussion in the notes to the financial statements.

### **Critical accounting estimates**

In prior guidance, the SEC has said that, in addition to discussing critical accounting *policies* in MD&A, companies should address the material implications of uncertainties associated with critical accounting *estimates*. The disclosure was supposed to supplement the policies discussion, but often just duplicated it. To eliminate this duplication and promote enhanced analysis of measurement uncertainties, the proposal amends Item 303(a) to explicitly require disclosure of critical accounting estimates. The instruction makes clear that the disclosure should supplement, not duplicate, disclosure in financial statements. The intent is to further understanding of amounts reported in the financials "by providing greater insight on the uncertainties involved in creating and applying an accounting policy and how significant accounting policies of registrants faced with similar facts and circumstances may differ."

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." The proposal requires disclosure, to the extent material, of "why the estimate is subject to uncertainty, how much each estimate has changed during the reporting period, the sensitivity of the reported amounts to the material methods, assumptions, and estimates underlying the estimate's calculation."

### **Discussion of interim periods**

The proposal is intended to provide companies with more flexibility in their discussions of interim periods by permitting comparison of the most recently completed quarter to either the corresponding quarter of the prior year (as is currently required) *or* to the immediately preceding quarter. The objective is to allow companies to provide an analysis that they view as most illuminating. For example, businesses that are not seasonal may find a sequential quarter analysis to be more relevant than a comparison to the corresponding quarter of the prior year. Under the proposal, if the company opts to provide a sequential quarter analysis, the company must provide summary financial information for that preceding quarter or identify the relevant prior EDGAR filing. In addition, if a company changes the comparison from the prior interim period comparison (e.g., provides sequential quarter analysis after previously providing analysis of the corresponding quarter of the prior year), the company would be required to explain the reason for the change and present both comparisons in the filing.

### **Application to foreign private issuers**

The proposal also includes certain parallel amendments applicable to financial disclosures provided by foreign private issuers. The corresponding proposed amendments apply to FPIs using Form 20-F or Form 40-F, as well as to current Instruction 11 to Item 303, which specifically applies to FPIs that choose to file on domestic forms.

### **Compliance date**

The proposed compliance date is 180 days after effectiveness of any final rule, although companies could comply early upon effectiveness.

## **Observations and commentary**

- The commissioners' views of the proposal reflect the continuing debate about the advisability of prescriptive regulation relative to a principles-based approach. In the SEC's 2016 [Concept Release](#) on disclosure simplification and modernization, the SEC explained that "principles-based" rules "articulate a disclosure objective and look to management to exercise judgment in satisfying that objective," while some requirements "prescribe" specific parameters and quantitative thresholds to minimize uncertainty in determining materiality and to identify when disclosure is required. Although principles-based rules are necessarily imprecise, may be difficult to apply and can result in a loss of comparability among reporting entities, they can help to eliminate irrelevant information by permitting tailored responses that focus on information that is material to the particular business and are more flexible and adaptable as circumstances change. Prescriptive standards can help promote comparability, consistency and completeness of disclosure, but they can sometimes be circumvented and may not address or capture all the important information.

[Commissioner Allison Lee](#) voted against issuing the proposal in part because of the proposal's emphasis on a "principles-based approach rather than balancing the use of principles with line-item disclosure." She expressed her concern "that the increased flexibility and discretion that this approach affords company executives may result in significant costs to investors—both if materiality is misapplied and through the loss of important comparability in disclosure." On the other side,

Commissioner Hester Peirce, who supported the proposal, was appreciative that its "principles-based disclosure framework provides management with the flexibility to tailor effectively its disclosure to provide the information about its specific financial condition that is material to an investment decision. Such flexibility is possible because of the concept of materiality, which is the longstanding touchstone of our disclosure regime."

- Although the SEC did not hold an open meeting to consider the proposal, several of the Commissioners issued statements that addressed, for the most part, not what was in the proposal, but rather, what wasn't – standardized disclosure requirements related to climate change. Whether or not to adopt some type of standards for climate-related disclosure appears to be a matter of some debate at the SEC. In his statement, SEC Chair Jay Clayton discussed at length his continued belief that the SEC's regulatory commitment on sustainability and climate should remain "disclosure-based and rooted in materiality, including providing investors with insight regarding the issuer's assessment of, and plans for addressing, material risks to its business and operations." Commissioner Lee, however, viewed climate change regulation as the "elephant in the room" that the new proposal was ignoring: "investors are overwhelmingly telling us, through comment letters and petitions for rulemaking, that they need consistent, reliable, and comparable disclosures of the risks and opportunities related to sustainability measures, particularly climate risk. Investors have been clear that this information is material to their decision-making process, and a growing body of research confirms that. And MD&A is uniquely suited to disclosures related to climate risk; it provides a lens through which investors can assess the perspective of the stewards of their investment capital on this complex and critical issue." Peirce was pleased that, faced with "repeated calls to expand our disclosure framework to require ESG and sustainability disclosures regardless of materiality" from "an elite crowd pledging loudly to spend virtuously other people's money," the SEC did "not bow to demands for a new disclosure framework, but instead support[ed] the principles-based approach that has served us well for decades."

# Guidance on key performance indicators

Contemporaneously with the new MD&A rule proposal, the SEC also issued new companion guidance on the disclosure of key performance indicators and other metrics in MD&A. There has been an increase in investor interest in disclosure of KPIs and similar metrics, as part of MD&A and especially outside of MD&A, for example, in connection with sustainability reporting.

## KPIs

In general, a KPI is a quantitative measure used to demonstrate performance of a business or operational objective. These metrics may be financial or non-financial, relate to external or macro-economic matters, be company-specific or industry-specific, or combine external and internal information. Examples of KPIs might include operating margin, same-store sales, sales per square foot, traffic growth, monthly active users or employee turnover rate. To the extent that KPIs are material to an understanding of MD&A, the SEC believes that they should be disclosed; as the SEC has previously stated, "companies should identify and address those key variables and other qualitative and quantitative factors that are peculiar to and necessary for an understanding and evaluation of the individual company. Such information could constitute key performance indicators and other metrics."

## KPI disclosure requirements

The guidance recommends that, when including KPIs in disclosure, companies look to the "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." To that end, companies will need to first examine whether any existing regulation, such as GAAP or Reg G or Item 10 of Regulation S-K, may apply, providing requirements for calculation of the metric (if the metric is a GAAP metric) and minimum elements of disclosure. Outside of those parameters, companies have more flexibility but also less direction. The guidance advises that the company "should consider what additional information may be necessary to provide adequate context for an investor to understand the metric presented." What does the metric tell you about the company's performance? More specifically, depending on the facts and circumstances, the SEC expects to see:

- 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.

In addition, the company should "consider whether there are estimates or assumptions underlying the metric or its calculation, and whether disclosure of such items is necessary for the metric not to be materially misleading." In the guidance, the SEC cautioned that, because prior guidance instructs a company to "provide a narrative that enables investors to see a company 'through the eyes of management,' so these metrics *should not deviate materially from metrics used to manage operations or make strategic decisions.*" [Emphasis added.]

## Changes in the method of calculation

If a company changes the method of calculation or presentation of the KPI, the guidance advises that the company consider the need to disclose, 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."

The guidance also recommends that companies consider the need to "recast prior metrics to conform to the current presentation and place the current disclosure in an appropriate context," depending on the significance of the change.

## Disclosure controls and procedures

The guidance also emphasizes the importance of maintaining effective *disclosure controls and procedures* in connection with the "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 to process information related to the disclosure of such items to ensure consistency as well as accuracy."

## Observations and commentary

- At a December 2018 meeting of the SEC's Investor Advisory Committee, SEC Chair Jay Clayton indicated that, with regard to KPIs, he would like to see a clear tie-back to GAAP (presumably, where possible) and period-to-period consistency for each company. In addition, he indicated, these types of metrics should track how management *looks at* its business, not just how management *wants to present* its business.
- It's worth noting that the SEC has not been reluctant to take enforcement action against companies that have misled investors by inflating KPIs, such as subscriber counts, revenue-per-subscriber, number of vehicles sold monthly, net new customers added, and even backlog. Most recently, the SEC brought an action against a producer of liquor, wine and beer for failure to disclose known trends and uncertainties. The company's omission resulted in materially misleading disclosures regarding its financial results and material inflation of key performance indicators – organic net sales growth and organic operating profit growth. These types of metrics – outside of the financial statements – are metrics on which investors rely to assess performance, and companies have been held to account if their presentations are inaccurate or misleading or the related controls are inadequate.
- In the guidance, the SEC observes that companies also use KPIs in describing environmental or other sustainability factors, such as human capital. For example, the [Task Force on Climate-related Financial Disclosures](#) recommends, in addition to disclosure of the key targets used by the company to manage climate-related risks and opportunities, disclosure about performance against targets, KPIs and methodologies. And some have suggested that more expansive use of KPIs, together with quantitative results, could go a long way toward enhancing disclosure. In a recent [study of human capital disclosures](#), the EY Center for Board Matters suggested that some disclosures could have been improved by identifying KPIs and quantifying results. For example, with regard to culture initiatives, some of the KPIs mentioned related to diversity hires, employee engagement, turnover and issues escalation resolution. However, with "limited exceptions, the companies did not provide quantitative results for their disclosed KPIs." Similarly, with regard to health and safety, "KPIs included recordable injury rates and the number of employees participating in certain health and wellness programs. However, only a handful of companies

provided quantitative results for their disclosed KPIs." Although the SEC's guidance applies specifically in the context of MD&A, companies should consider the guidance when disclosing KPIs in other contexts as well.

## Appendix A – SEC table of proposed changes

Current item or issue	Summary description of proposal	Principal objective(s)	FPI change(s)?
Item 301, <i>Selected financial data</i>	Registrants would no longer be required to provide 5 years of selected financial data.	Modernize disclosure requirement in light of technological developments and simplify disclosure requirements.	Yes
Item 302(a), <i>Supplementary financial information</i>	Registrants would no longer be required to provide 2 years of selected quarterly financial data.	Reduce repetition and focus disclosure on material information. Modernize disclosure requirement in light of technological developments	N/A
Item 303(a), <i>MD&amp;A</i>	Clarify the objective of MD&A and streamline the fourteen instructions.	Simplify and enhance the purpose of MD&A.	Yes
Item 303(a)(2), <i>Capital resources</i>	Registrants would disclose material cash requirements, including commitments for capital expenditures, as of the latest fiscal period, the anticipated source of funds needed to satisfy such cash requirements, and the general purpose of such requirements.	Modernize and enhance disclosure requirements to account for capital expenditures that are not necessarily capital investments.	Yes

<p>Item 303(a)(3) (ii), <i>Results of operations</i></p>	<p>Registrants would disclose known events that are reasonably likely to 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 or price increases or inventory adjustments.</p>	<p>Clarify item requirement by using a disclosure threshold of "reasonably likely," which is consistent with the Commission's interpretative guidance on forward-looking statements.</p>	<p>Yes</p>
<p>Item 303(a)(3) (iii), <i>Results of operations</i></p>	<p>Clarify that a discussion of the <i>reasons</i> underlying material <i>changes</i> in net sales or revenues is required.</p>	<p>Clarify MD&amp;A disclosure requirements by codifying existing Commission guidance.</p>	<p>Yes</p>
<p>Item 303(a)(3) (iv), <i>Results of operations</i> Instructions 8 and 9 (Inflation and price changes)</p>	<p>The item and instructions would be eliminated. Registrants would still be required to discuss these matters 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, or revenue, or income from continuing operations.</p>	<p>Encourage registrants to focus on material information that is tailored to a registrant's businesses, facts, and circumstances.</p>	<p>Yes</p>

<p><b>Item 303(a)(4), <i>Off- balance sheet arrangements</i></b></p>	<p>The item would be replaced by a new instruction added to Item 303. Under the new instruction, registrants would be required to discuss commitments or obligations, including contingent obligations, arising from arrangements with unconsolidated entities or persons that have, or are reasonably likely to have, a material current or future effect on such registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, cash requirements, or capital resources even when the arrangement results in no obligation being reported in the registrant's consolidated balance sheets.</p>	<p>Prompt registrants to consider and integrate disclosure of off-balance sheet arrangements within the context of their MD&amp;A.</p>	<p>Yes</p>
<p><b>Item 303(a)(5), <i>Contractual obligations</i></b></p>	<p>Registrants would no longer be required to provide a contractual obligations table.</p>	<p>Promote the principles-based nature of MD&amp;A and simplify disclosures by reducing redundancy.</p>	<p>Yes</p>
<p><b>Instruction 4 (Material changes in line items)</b></p>	<p>Incorporate a portion of the instruction into proposed Item 303(b). Clarify that where there are material changes in a line item, including where material changes within a line item offset one another, disclosure of the underlying reasons for these material changes in quantitative and qualitative terms is required.</p>	<p>Enhance analysis in MD&amp;A. Clarify MD&amp;A disclosure requirements by codifying existing Commission guidance on the importance of analysis in MD&amp;A.</p>	<p>Yes</p>

<p><b>Item 303(b), Interim periods</b></p>	<p>Registrants would be permitted to compare their most recently completed quarter to either the corresponding quarter of the prior year or to the immediately preceding quarter. Registrants subject to Rule 3-03(b) of Regulation S-X would be afforded the same flexibility.</p>	<p>Allow for flexibility in comparison of interim periods to enhance the disclosure provided to investors.</p>	<p>N/A</p>
<p><b>Critical Accounting Estimates</b></p>	<p>Explicitly require disclosure of critical accounting estimates.</p>	<p>Facilitate compliance and improve resulting disclosure. Eliminate disclosure that duplicates the financial statement discussion of significant policies. Promote meaningful analysis of measurement uncertainties.</p>	<p>Yes</p>

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