WILLKIE FARR & GALLAGHER LLP

CLIENT ALERT

SEC Proposes MD&A Amendments that Continue Shift to Principles-Based Disclosure

Companion Guidance Encourages Disclosure of Key Performance Metrics

February 6, 2020

AUTHOR

Jeffrey S. Hochman

As part of its ongoing disclosure modernization program, the Securities and Exchange Commission recently proposed changes to the rules governing Management's Discussion and Analysis ("MD&A") and certain related financial disclosures.[1] The proposed changes, together with companion guidance[2] encouraging the use of key performance metrics in MD&A disclosures, seek to improve the quality and readability of financial information through the enhancement of MD&A disclosures and the deletion of duplicative disclosures, while simplifying registrants' compliance efforts. The proposal also includes parallel changes for foreign private issuers ("FPIs").

Both the proposed amendments and the guidance move the SEC disclosure regime further toward a principles-based approach for MD&A. In the guidance, the SEC noted that it had previously emphasized that a registrant should focus on "disclosure of all key variables and other factors that management uses to manage the business" and provide a narrative that "enables investors to see the company 'through the eyes of management.' "[3]

1 See SEC Release No. 33-10750, *Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information* (January 30, 2020), available here.

2 See SEC Release No. 33-10751, *Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations* (January 30, 2020), available here.

3 See SEC Release No. 33-8350, *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations* (December 19, 2003), available here.

Consistent with this principles-based approach, no new requirements for specific disclosures regarding the impact of climate change are proposed; as Chairman Jay Clayton noted, disclosure should be "rooted in materiality." Commissioner Allison Herren Lee criticized this approach, noting that the "proposal is most notable for what it does not do: make any attempt to address investors' need for standardized disclosure on climate change risk."

Attached to this memorandum as Annex A is an outline of the proposed amendments; the significant changes are summarized below.

The proposal includes 87 questions, many with various subparts, soliciting feedback on the proposed amendments. Comments on the proposal are due 60 days after publication in the Federal Register.

Item 301, Selected Financial Data

Item 301 of Regulation S-K currently requires registrants to furnish selected financial data in comparative tabular form for each of the registrant's last five fiscal years, including, for example, net sales or revenues, income (loss) from continuing operations and total assets. The proposal would delete Item 301 in its entirety as duplicative of the information readily available in the financial statements. However, the SEC reminds registrants that a tabular presentation of the relevant financial information may be useful in discussing material trends required in MD&A under Item 303.

Item 302(a), Supplementary Financial Information

Item 302(a) requires disclosure of selected quarterly financial data and variances in these results from the amounts previously reported in a registrant's Form 10-Q. As most of the financial data can be found in (or calculated from) prior reports, the SEC proposes to eliminate this requirement.

Item 302(b), Information about Oil and Gas Producing Activities

Item 302(b) mandates disclosures regarding oil and gas producing activities. U.S. GAAP currently mandates similar disclosures, which are proposed to be expanded to include the period-specific disclosures required by Item 302(b). The SEC has proposed to eliminate Item 302(b) subject to this proposed amendment to U.S. GAAP being adopted.

Item 303, Management's Discussion and Analysis of Financial Condition and Results of Operations

The proposal reorganizes Item 303 of Regulation S-K and streamlines its requirements in order to "enhance the MD&A disclosures for investors while reducing the compliance burdens for registrants." Instruction 4 to Item 303(a) would be amended to clarify the requirement for a discussion of the underlying reasons for material changes between periods for line items in both quantitative and qualitative terms, as opposed to only noting the cause of such changes. Revised instructions would also explicitly require that registrants discuss material changes that offset each other within a line item.

The proposed changes also include:

Objective of MD&A

Item 303(a) would be amended to add a new section that summarizes the objective of MD&A, which is for a registrant to "provide a narrative explanation of its financial statements that enables investors to see a registrant 'through the eyes of management.' " In the SEC's view, this principles-based guidance would elicit disclosure about complex and often rapidly evolving areas, without imposing bright-line requirements that may require frequent updating.

Amended Item 303(a) would incorporate current MD&A instructions that the discussion and analysis focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of the registrant's future operating results or financial condition.

Capital Expenditures

The proposal would amend current Item 303(a)(2), which requires a registrant to discuss material commitments for capital expenditures as of the end of the latest fiscal period, the purpose of such commitments and the source of funds to fulfill them. Material trends related to a registrant's capital resources are also required to be discussed. Given the importance of capital resources to a company's prospects, the SEC has proposed that registrants be required to "broadly disclose material cash commitments, including but not limited to capital expenditures" and specifically, their material cash requirements. The SEC noted that it left "capital resources" undefined to preserve flexibility for tailored, business-specific discussion of the topic.

Results of Operations

The proposal would amend Item 303(a)(3)(ii) to change required disclosure of events that are ***reasonably likely*** to cause a material change in the relationship between costs and revenues, from the current standard of those that ***will*** cause such a change. Item 303(a)(3)(iii) would be clarified to require disclosures for material ***changes*** in net sales or revenues instead of material ***increases***. The express requirement in Item 303(a)(3)(iv) and related instructions to disclose the impact, to the extent material, of changing prices or inflation on a registrant's information would be dropped, so as not to give undue attention to this specific (somewhat vestigial) issue, instead relying on the principles-based requirement to discuss material trends, if applicable.

Off-Balance Sheet Arrangements

Instead of the current separately captioned requirement for a discussion of off-balance sheet arrangements under Item 303(a)(4), the SEC would add a new instruction to Item 303(b) that would require a registrant to discuss commitments or obligations arising from arrangements with unconsolidated entities that have, or are reasonably likely to have, a material effect on a registrant's financial condition or results. "Off-balance sheet arrangements" would not be defined. The SEC notes that this new instruction would enhance the existing requirement in Item 302(a) "that specifically requires consideration of off-balance sheet financing arrangements as part of the capital resources discussion," resulting in greater integration of these arrangements with the other MD&A disclosure.

Contractual Obligations Table

As proposed, the current requirement under Item 303(a)(5) for a table summarizing the registrant's contractual obligations, including payments due and time periods, would be eliminated. The proposal notes that much of such information currently required to be presented overlaps with U.S. GAAP and other disclosure requirements under Regulation S-K.

Critical Accounting Estimates

In previous guidance, the SEC reminded registrants that they should address material uncertainties associated with the methods, assumptions and estimates underlying their critical accounting measurements.[4] The proposed amendments would expressly require disclosure of critical accounting estimates.

As proposed, a critical accounting estimate would be defined as "an estimate made in accordance with generally accepted accounting principles 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." As stated in a related instruction, this disclosure of critical accounting estimates is intended to supplement, but not duplicate, the description of accounting policies contained in the financial statements.

For each critical accounting estimate, a registrant would be required 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.

The SEC further noted that, despite some overlap, the proposed requirement to disclose critical accounting estimates should not be conflated with the discussion of critical audit matters ("CAMs")[5] required in auditor reports, commencing this year for large accelerated filers.

Interim Period Comparisons

The proposal would amend Item 303(b) to provide registrants with the flexibility to compare the most recently completed quarter to either the corresponding quarter of the prior year or the immediately preceding quarter. If a registrant decides to discuss changes as compared to the immediately preceding quarter, it must reference the EDGAR filing of such previous quarter's discussion. If it decides to change the manner of quarterly comparison from that in the previous interim comparison, it would have to disclose the rationale for the change and present both comparisons in the filing where the change is disclosed.

Form 20-F and Foreign Private Issuers

Corresponding changes are proposed for FPIs as they relate to Form 20-F. Most of the above-described amendments to Regulation S-K would apply to FPIs, except that the specific requirement to disclose any material impact of inflation on an FPI's financial statements (and similar disclosure regarding hyperinflation, if applicable) would be retained.

Guidance on Key Performance Indicators and Metrics

In a companion release, the SEC issued new guidance encouraging the disclosure in MD&A of key performance indicators and metrics to analyze the registrant's financial results and trends in its business, to help investors see the

---

[4] See SEC Release No. 33-8040, *Cautionary Advice Regarding Disclosure* (December 12, 2001), available here. The proposed rules requiring this disclosure of critical accounting estimates were never adopted. See SEC Release No. 33–8098, *Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies* (May 10, 2002), available here.

[5] For more information on CAMs, see our client memorandum *Preparing Your Form 10-K – 2019 Updates* (January 2, 2020), available here.

company “through the eyes of management.” Such indicators would depend on the company’s particular industry and circumstances and could include, for example, such metrics as same-store sales or revenue per subscriber.

The SEC generally expects the following information to accompany a metric:

- 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.

If a registrant changes the method by which it calculates or presents a metric between reporting periods, the registrant should discuss the rationale behind the changes and how the methods differ from those previously utilized. Registrants should make sure that their disclosure controls and procedures apply to any performance metrics included in their SEC reports.

If you have any questions regarding this client alert, please contact the following attorney or the Willkie attorney with whom you regularly work.

Jeffrey S. Hochman
212 728 8592
jhochman@willkie.com

Annex A
SEC Summary of Proposed MD&A Amendments

Current Item or Issue	Summary Description of Proposal	Principal Objective(s)	Corresponding FPI Change(s)?
Item 301, *Selected financial data*	• 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), *Supplementary financial information*	• 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), *MD&A*	• Clarify the objective of MD&A and streamline the fourteen instructions	• Simplify and enhance the purpose of MD&A.	Yes
Item 303(a)(2), *Capital resources*	• 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
Item 303(a)(3)(ii), *Results of operations*	• 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	• Clarify item requirement by using a disclosure threshold of "reasonably likely," which is consistent with the Commission's interpretative guidance on forward-looking statements.	Yes
Item 303(a)(3)(iii), *Results of operations*	• Clarify that a discussion of the reasons underlying material changes in net sales or revenues is required.	• Clarify MD&A disclosure requirements by codifying existing Commission guidance.	Yes
Item 303(a)(3)(iv), *Results of operations* **Instructions 8 and 9 (Inflation and price changes)**	• 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.	• Encourage registrants to focus on material information that is tailored to a registrant's businesses, facts, and circumstances.	Yes
Item 303(a)(4), *Off-balance sheet arrangements*	• 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	• Prompt registrants to consider and integrate disclosure of off-balance sheet arrangements within the context of their MD&A.	Yes

Current Item or Issue	Summary Description of Proposal	Principal Objective(s)	Corresponding FPI Change(s)?
	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.		
Item 303(a)(5), *Contractual obligations*	• Registrants would no longer be required to provide a contractual obligations table.	• Promote the principles-based nature of MD&A and simplify disclosures by reducing redundancy.	Yes
Instruction 4 (Material changes in line items)	• 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.	• Enhance analysis in MD&A. • Clarify MD&A disclosure requirements by codifying existing Commission guidance on the importance of analysis in MD&A.	Yes
Item 303(b), *Interim periods*	• 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.	• Allow for flexibility in comparison of interim periods to enhance the disclosure provided to investors.	N/A
Critical Accounting Estimates	• Explicitly require disclosure of critical accounting estimates.	• Facilitate compliance and improve resulting disclosure. • Eliminate disclosure that duplicates the financial statement discussion of significant policies. • Promote meaningful analysis of measurement uncertainties.	Yes