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SEC Proposes Amendments to MD&A Requirements and Provides Guidance on use of Metrics in the MD&A

On January 30, the U.S. Securities and Exchange Commission (the “SEC”) published proposed amendments (the “Proposed Amendments,” [available here](#)) to modernize, simplify and enhance certain financial disclosure requirements set forth in Regulation S-K. The Proposed Amendments cover Item 301 (Selected Financial Data), Item 302 (Supplementary Financial Data) and Item 303 (Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”). Concurrently, the SEC also published separate guidance (the “MD&A Guidance,” [available here](#)) highlighting certain disclosure considerations when including performance indicators or other metrics in an MD&A.

The Proposed Amendments and the MD&A Guidance follow on from a series of recommendations in the SEC staff’s Report on Review of Disclosure Requirements in Regulation S-K ([available here](#)), mandated under Section 108 of the Jumpstart Our Business Startups Act. The modifications and recommendations reflected in the Proposed Amendments and the MD&A Guidance aim to improve “the quality and accessibility of registrant’s presentation of financial results and performance metrics” with the goal of assisting investors’ capital allocation decisions, while reducing registrant’s compliance burden and costs. The Proposed Amendments include conforming amendments to Forms 20-F and 40-F, as appropriate (since these Forms do not cross-reference Regulation S-K as do the Forms for domestic registrants).

In a related development, we note that the SEC also had published, on January 24, three new Compliance and Disclosure Interpretations (“C&DIs”) ([available here](#)) addressing issues that can arise by virtue of recent modifications to the MD&A requirements.

Finally, we take note of three Public Statements issued on January 30 by SEC Chairman Clayton, “Proposed Amendments to Modernize and Enhance Financial Disclosures; Other Ongoing Disclosure Modernization Initiatives; Impact of the Coronavirus; Environmental and Climate-Related Disclosure” ([available here](#)), which addresses ongoing disclosure initiatives and also singles out two disclosure themes – one new (the coronavirus) and one that dates back to 2010 (environmental and climate-related securities law disclosures), and by Commissioner Hester M. Peirce, “Statement on Proposed Amendments to Modernize and Enhance Financial Disclosures” ([available here](#)), and Commissioner Allison Herren Lee, “Modernizing’ Regulation S-K: Ignoring the Elephant in the Room” ([available here](#)), both of which address environmental and climate-related securities law disclosure themes.

Summary of the Proposed Amendments

Item 301. The SEC has proposed to eliminate Item 301, which requires registrants to provide selected financial data in a table that compares the last five fiscal years and any additional fiscal years necessary to keep the information from being misleading. The SEC notes that, following the elimination of Item 301, registrants could continue to provide, on a voluntary basis, a tabular presentation of relevant financial or other information in the MD&A if they believe that such presentation would enhance investors' understanding of the disclosure.

Item 302. Similarly, the SEC proposes to eliminate Item 302, which calls for disclosure of selected quarterly financial data of specified operating results as well as of variances in these results from amounts previously reported on Form 10-Q. The SEC believes that eliminating this prescriptive requirement would help registrants provide more principles-based disclosure of information required under this Item in other parts of their filings, such as the MD&A. There is no corresponding requirement for foreign private issuers ("FPIs"), and in fact this requirement does not apply to first-time registrants conducting an initial public offering. However, consistent with market practice, for example for Chinese issuers for which it is common to include on a voluntary basis six or eight quarters of condensed financial information in registration statements used for initial public offerings, this information may continue to be provided by FPIs on a voluntary basis for initial public offerings.

The SEC notes that removal of Item 302(a) would eliminate presentation of fourth quarter information, but that if that information is material, it would be covered by the MD&A, and that Item 101(c)(1)(v) requires disclosure of the extent to which a business is seasonal.

Item 303. The following key amendments to Item 303 would be made in order to further¹ streamline and improve MD&A disclosures:

- **Addition of new Item 303(a), Objective** – a new Item 303(a) would be added that would require registrants to state and describe the principal objectives of the MD&A. The SEC views this new principles-based approach to disclosure as best suited to ensuring that management discloses factors that are most specific to the registrant's business, resulting in clearer, more focused and thoughtful discussion and analysis. To most accurately describe the objectives of the MD&A, the Proposed Amendments would incorporate portions of current Instructions 1, 2 and 3 to Item 303(a), requiring registrants to provide the following disclosure:

¹ Prior amendments to the MD&A requirements allow registrants that provide financial statements covering three years in a filing to omit discussion of the earliest of the three years if such discussion was already included in the registrant's prior filings on EDGAR.

- 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.
- The 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.
- **Additional changes to Item 303(a)** – in connection with the addition of new Item 303(a), the Proposed Amendments would re-caption current Item 303(a) as Item 303(b) and current Item 303(b) as Item 303(c), and would eliminate Items 303(c) and (d). In connection with the elimination of Item 303(c), which provides safe harbours for forward-looking information supplied in response to Items 303(a)(4) and 303(a)(5), the SEC clarifies that, to the extent that forward-looking information included in disclosure relating to off-balance sheet arrangements and contractual obligations provided in response to new proposed Instruction 8 in Item 303(b) is provided, such information would continue to be covered by existing safe harbours.

The following additional modifications are proposed in renumbered Item 303(b):

- Current Item 303(a)(2), *Capital resources*, would be modified to specifically require a discussion of material cash requirements, in addition to the current capital expenditures disclosure. The proposal would add a requirement for a registrant to describe its material cash requirements, including commitments for capital expenditures, the anticipated sources of funds needed to satisfy such cash requirements and the general purpose of such requirements. Depending on the registrant, this could include items such as: funds necessary to maintain current operations, complete projects underway or achieve stated objectives or plans, or commitments for capital or other expenditures. The SEC notes that certain expenditures and cash commitments that are not traditional capital expenditures in fixed assets may be increasingly important, particularly those for which human capital or intellectual property are key resources. This expanded disclosure, together with current requirements regarding the ability to generate cash, is intended to enhance disclosure as to a registrant's ability to meet its material cash requirements.
- Current Item 303(a)(3)(ii), *Results of operations*, would be amended to clarify that a registrant should disclose reasonably likely changes in the relationship between costs and revenues. Examples could include future increases in costs of labor or materials, or inventory adjustments.
- Current Item 303(a)(3)(iii), *Results of operations*, and Instruction 4 to Item 303(a) would be clarified to ensure that a registrant includes in its MD&A a 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 address only the “cause” of material changes. The SEC also proposes to clarify that registrants should discuss material changes within a line item even when such material changes offset one another.

- Current Item 303(a)(3)(iv), *Results of operations*, which requires registrants to discuss the impact of inflation and changing prices where material, along with the related Instructions 8 and 9 to Item 303(a), would be deleted in order to ensure that MD&A disclosures focus on material information that is tailored to the relevant facts and circumstances. 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, or revenue, or income from continuing operations.
- **Modifications to Item 303(a)(4), *Off-balance sheet arrangements*** – the Proposed Amendments would replace current Item 303(a)(4), which requires registrants to disclose off-balance sheet arrangements in a separately captioned section, with an instruction that emphasizes the importance of discussing these obligations in the broader context of MD&A disclosure when such obligations have, or are reasonably likely to have, a material current or future effect on a registrant’s financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, cash requirements or capital resources.
- **Elimination of Item 303(a)(5), *Tabular disclosure of contractual obligations*** - registrants would no longer be required to provide disclosure of contractual obligations in tabular form with the aim of reducing redundancy, given the overlap of this requirement with information required in the financial statements and the SEC’s proposed expansion of the requirement to address capital resources.
- **Modification to Item 303, *Critical accounting estimates*** – the Proposed Amendments would explicitly require disclosure of critical accounting estimates. The proposed change is intended to eliminate the current practice of duplicating disclosure of the significant accounting policies already discussed in notes to the financial statements and to promote improved analysis of measurement uncertainties. The SEC would define a critical accounting estimate 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.” The focus on “estimation uncertainty” is intended to avoid repetition of the financial statement note on significant accounting policies. To highlight this intention, an instruction would be added specifying that disclosure of critical accounting estimates shall supplement, but not duplicate, the description of accounting policies or other disclosures in the notes to the financial statements.

For each critical accounting estimate, registrants 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. It is interesting to note that the SEC proposed more detailed rules for critical accounting estimates in 2002, but those proposals were never adopted.

The SEC notes that it does not believe that this requirement overlaps with auditor communications of critical accounting matters under PCAOB Standard AS 3101.

- **Revisions to Item 303(b), *Interim periods*** – Item 303(b), which currently requires MD&A disclosure for interim periods that allows investors to review material changes in financial condition and results of operations of the registrant between certain specified periods, would be simplified to afford registrants additional flexibility to provide analysis that they believe is most relevant to an understanding of the frequency and amplitude of past business cycles, while also ensuring that investors have appropriate information to assess the comparisons being presented. As such, registrants would be able to compare their most recently completed quarter to either the corresponding quarter of the prior year (as is currently required) or to the immediately preceding quarter.

If a registrant chooses to discuss changes from the immediately preceding sequential quarter, the registrant would be required to include summary financial information that is the subject of the discussion for that quarter or identify the prior EDGAR filing that presents such information in order to facilitate easy access to the prior quarterly financial information being discussed. Moreover, if a registrant changes the comparison from the prior interim period comparison, it would be required to explain the reason for the change and present both sets of comparisons in the filing where the change is announced.

- **Key changes to Form 20-F, affecting foreign private issuers** – the Proposed Amendments include several corresponding modifications to Form 20-F to ensure that the existing MD&A requirements for FPIs mirror the substantive MD&A requirements in Item 303. The key amendments are highlighted below.
 - Elimination of Item 3.A of Form 20-F, which requires FPIs to disclose selected financial data for the most recent five financial years, in line with the elimination of Item 301 of Regulation S-K. The trend information required by this Item would instead be provided in response to Item 5 of Form 20-F. FPIs would continue to be able to include a tabular presentation of the relevant financial information discussed in the MD&A, to the extent they believe such a presentation would be useful to an understanding of the disclosure.
 - Modifications to Item 5 of Form 20-F, *Operating and Financial Review and Prospects*, in order to align it with the proposed revisions to Item 303 of Regulation S-K, include:
 - Incorporation into Item 5 of Form 20-F of portions of current Instructions 1 and 3 to Item 303(a) that specify the purpose of MD&A.
 - Codification, in the forepart of Item 5, of SEC guidance that states that a registrant should provide a narrative explanation of its financial statements that enables investors to see a registrant “through the eyes of management.”

- Revisions to the forepart of Item 5 to state that, in addition to providing information relating to all separate segments, FPIs must also provide information relating to other subdivisions, such as geographic areas or product lines.
- Revisions to the liquidity and capital resources requirement in Item 5.B to specify that a registrant must broadly disclose material cash commitments, including but not limited to capital expenditures.
- Replacement of Item 5.E, which covers off-balance sheet arrangements, with a principles-based instruction.
- Elimination of Item 5.F, which covers tabular disclosure of contractual obligations.
- Elimination of Item 5.G, which acknowledges application of the statutory safe harbour and specifically and exclusively applies to Item 5.E and Item 5.F.
- Modification to Item 5 to explicitly require disclosure of critical accounting estimates.
- Modification to the portion of Item 5.A.2 that would eliminate the requirement to discuss the impact of inflation, if material.
- Amendment to Item 5.D, which currently requires FPIs to identify “the most significant recent trends,” to instead require disclosure of “material trends,” consistent with Item 303 of Regulation S-K and the MD&A’s focus on materiality.

Summary of the MD&A Guidance

An SEC registrant is required, under Item 303(a) of Regulation S-K, to (i) disclose information not specifically referenced in this Item if it believes the information is necessary to an understanding of its financial condition, change in financial condition and results of operations, and (ii) provide discussion and analysis of other statistical data that, in the registrant’s view, would assist investors to better understand the MD&A. The MD&A Guidance builds upon prior statements from the SEC, which has encouraged registrants preparing MD&A disclosure to “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” and, if so, “to 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.”

The SEC has published the MD&A Guidance to remind registrants (both domestic and foreign), when using non-financial and financial performance indicators and other metrics to describe their businesses,² that

² The SEC notes that performance indicators and other metrics can vary significantly from registrant to registrant and industry to industry, depending on various facts and circumstances. For example, some of these metrics relate to external or macro-economic matters, some are company- or industry-specific, and some are a combination of external and internal information. Some registrants voluntarily disclose specialized, company-specific sales metrics, such as same-store sales or revenue per

they will need to consider existing MD&A requirements and reflect any additional information that may be necessary to ensure that the presentation of performance indicators or other metrics, in light of the circumstances under which they are presented, is not misleading. In this regard, registrants should consider taking the following two-step approach:

- Step One – consider the extent to which an existing regulatory disclosure framework (*e.g.*, generally accepted accounting principles (“GAAP”) or, for non-GAAP financial measures, Regulation G or Item 10 of Regulation S-K) applies.
- Step Two – consider any additional information that may need to accompany the performance indicator or other metric to provide investors with the adequate context for the metric’s review. The SEC would expect any such additional information, based on facts and circumstances, to include:
 - a clear definition of the performance indicator or other metric and how it is calculated;
 - an explanation as to why the registrant believes the performance indicator or other metric is useful for investors; and
 - an explanation as to how the performance indicator or other metric assists management in managing and monitoring the performance of the registrant’s business.

Additionally, the registrant should consider whether there are estimates or assumptions underlying the performance indicator or other metric and its calculation, and whether disclosure of such estimates or assumptions is necessary to ensure that the performance indicator or other metric is not misleading.

The MD&A Guidance further provides that any change in the way in which the registrant calculates or presents the performance indicator or other metric from one period to another or otherwise will necessitate the following disclosures, to the extent they are material:

- variations in the performance indicator or other metric’s presentation between periods and the reasons for such variations;
- the effect of any such change on the amount and other information previously or currently being disclosed; and
- variations in methodology and results that would reasonably be expected to be relevant to an understanding of the registrant’s performance or prospects.

subscriber. Some registrants also voluntarily disclose environmental metrics, including metrics regarding the observed effect of prior events on their operations.

Depending on the extent of the change(s) in methodology and results, registrants may need to recast prior metrics to conform to the current presentation, in order to provide investors with the context necessary to understand the current disclosure.

Finally, the SEC reminds registrants of the requirements to maintain effective disclosure controls and procedures in connection with disclosure of material key performance indicators and other metrics in order to ensure consistency and accuracy.

Summary of the New C&DIs

The SEC has recently added the following new C&DIs on MD&A in order to address certain queries regarding the 2019 amendments to Regulation S-K Item 303 that allow the omission of the earliest year from the period-to-period comparisons of financial results. The new C&DIs are described below:

- **Question 110.02** - when a registrant omits a discussion of the earliest of three years in the MD&A and includes the required statement that identifies the location of such discussion in a prior filing, such statement does not incorporate such disclosure into the filing unless the registrant expressly states that the information is incorporated by reference.
- **Question 110.03** - if a registrant believes that a discussion of the earliest of the three years is necessary to an understanding of its financial condition, changes in financial condition and results of operations, then the registrant cannot omit such discussion in reliance on Instruction 1 to Item 303(a). The registrant must assess its information about the earliest of the three years and, if it is required by Item 303(a), include it in the current disclosure or expressly incorporate by reference its discussion from a previous filing.
- **Question 110.04** - if a registrant has an effective registration statement that incorporates by reference its Form 10-K and it subsequently incorporates into the registration statement a new Form 10-K that only includes a discussion of its results for the most recent two financial years (and omits the earliest year), then the filing of the new Form 10-K will operate as the Section 10(a)(3) update to the registration statement, establishing a new effective date for the registration statement. As a result, in order for the registration statement to be viewed as incorporating by reference the discussion of the results for the earliest fiscal year, such information must be expressly incorporated by reference.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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