SEC & FASB Developments

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Agenda

- Amendments to MD&A and Financial Disclosures
- SEC Staff Comments on MD&A
- Regulation S-K and Form 10-K
- Statistical Disclosure Requirements for Banking Registrants

Amendments to MD&A and Financial Disclosures

Amendment to MD&A and Related Disclosures

- On November 19, 2020, the SEC:
  - Amended Item 303 of Regulation S-K (Management's Discussion and Analysis of Financial Condition and Results of Operations, or MD&A), and
  - Revised or eliminated several other requirements of Regulation S-K
- The SEC adopted these changes to:
  1. Eliminate duplicative disclosures, and
  2. Modernize and enhance MD&A disclosures for the benefit of investors, while simplifying compliance efforts for registrants

New Paragraph 303(a) – Objective

- New paragraph (a) to Item 303 clarifies the objective of MD&A by incorporating much of prior Instructions 1, 2, and 3
  - Emphasizes the objective of MD&A for both full fiscal years and interim periods
  - Disclosure generally is expected to better allow an investor to view the company from management's perspective
  - Prior Items 303(a) and (b) have now been recaptioned as Items 303(b) and (c), respectively

Results of Operations
(Reflected in Item 303(b)(2)(ii))

- Companies must disclose known events or trends 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
  - Price increases
  - Inventory adjustments
- Companies must disclose the reasons underlying material changes in net sales or revenues

Results of Operations
(Reflected in Item 303(b)(2)(ii)) *(cont'd.)*

- Elimination of specific disclosure with respect to the impact of inflation and changing prices
  - Companies are still required to discuss these matters if they are part of a known trend or uncertainty that has had, or is reasonably likely to have, a material impact on net sales or revenue
  - This allows companies to focus on material disclosure that is tailored to their business, facts and circumstances

Off-Balance Sheet Arrangements

- Prior requirement is eliminated
- Companies should consider off-balance sheet arrangements within the broader context of their MD&A
- Instruction 8 requires companies to discuss commitments and obligations arising from arrangements with unconsolidated entities or persons that have, or are reasonably likely to have, a material current or future effect on their:
  - Financial condition,
  - Changes in financial condition,
  - Revenues or expenses,
  - Results of operations,
  - Liquidity,
  - Cash requirements, or
  - Capital resources.

Tabular Disclosure of Contractual Obligations

- Eliminated this disclosure requirement previously contained in paragraph (a)(5)
- Item 303(b) now requires disclosure of material cash requirements from known contractual and other obligations as part of the liquidity and capital resources discussion
- The adopting release explains that the "amendments are intended to focus only on material disclosures and specifically, disclosure of those periods where the cash requirements or reasonably likely effect of these cash requirements on liquidity and capital resources is material"

Regulation S-K — MD&A
Liquidity disclosure requirements

Transition	Effective date for all domestic registrants	Early adoption?
Prospective	Fiscal years ending after 9 August 2021	Yes, with all of Item 303

- Disclose **all** reasonably likely material cash requirements, including:
  - Contractual obligations that are recognized as liabilities
  - Contractual obligations that are not recognized as liabilities
  - Other reasonably likely material cash requirements (even if not contractual and not recognized as liabilities)
    - *Examples*: human capital (such as payroll and training expenses), intellectual property development, research activities, variable lease payments
- Discuss ability to generate and obtain adequate amounts of cash to meet requirements
- Describe short-term (1 year from balance sheet date) and long-term periods
- Include qualitative and quantitative information

Line Item Changes and Critical Accounting Estimates

- If line item changes are material, disclose the underlying reasons for these material changes in quantitative and qualitative terms
- Disclosure of critical accounting estimates explicitly required
  - Qualitative and quantitative information necessary to understand
    - The estimation uncertainty
    - Impact the critical accounting estimate has or is reasonably likely to have on financial condition or results of operations

Regulation S-K — MD&A
Critical accounting estimates

Codifies old guidance and clarifies requirements to enhance disclosures

Provide information necessary to understand the estimation uncertainty and the effect on the financial condition and results of operations

- Disclose for each critical accounting estimate:
  - Why the estimate is subject to high uncertainty
    - For example: multiple acceptable valuation approaches, significant subjective inputs
  - How much the estimate or assumption has changed over the relevant periods
  - The sensitivity of the reported amounts to the methods, assumptions and estimates underlying the estimate’s calculation
- Provide both quantitative and qualitative information
- Supplement and refer to (but not repeat) the description of significant accounting policies in the notes to the financial statements

Regulation S-K — MD&A

Example critical accounting estimate disclosure

Allowance for loan losses (ALL) *(extract of footnote as of 31 December 2020)*

1 We used a number of economic variables in our scenarios to estimate the ALL, with the most significant drivers being GDP growth and unemployment rate.

2 GDP growth rate

In our 31 December 2020 estimate, we assumed that GDP will grow at 3.0% per year over the next five years. This is an increase relative to our GDP assumption at 30 September 2020 of 2.8%, but a decrease relative to our GDP assumption of 3.2% at December 30, 2019.

A 0.5% change in the GDP growth would result in the following estimates for the ALL:

3

Scenario	Assumed GDP growth rate	ALL at 31 December 2020
Lower end of estimate range	2.5%	$30,000
Recorded ALL	3.0%	$25,000
Upper end of estimate range	3.5%	$18,000

Quarterly Periods
(Reflected in New Item 303(c))

- Companies can compare their most recently completed quarter to either:
  - The corresponding quarter of the prior year, or
  - The immediately preceding quarter
- If comparison from the prior interim period comparison changes:
  - Explain the reason for the change, and
  - Present both comparisons in the filing where the change is announced

Supplementary Financial Information and Selected Financial Data

- S-K Item 301 (Selected Financial Data) eliminated
- S-K Item 302 (Supplementary Financial Information) amended
  - Replaced requirement to provide two years of tabular selected quarterly financial data with a principles-based requirement requiring disclosure only when there are one or more specified retrospective changes that that, individually or in the aggregate, are material
  - Disclosure could involve a single quarter in which the material retrospective change applies, or it may flow through to subsequent quarters during the relevant look-back period

Early Adoption

Effective and Compliance Dates

- Effective Date: **February 10, 2021**
- Mandatory Compliance Date
  - Beginning with first fiscal year ending on or after August 9, 2021
  - Companies must apply the amended rules in a registration statement and prospectus that on its ***initial filing date*** is required to contain financial statements for a period on or after the mandatory compliance date
- Voluntary Early Compliance
  - Allowed at any time after the effective date, as long as disclosure is responsive to an amended item in its entirety

Early Adoption

- Expect registrants' MD&A disclosures to generally reflect the substance of the SEC's amendments
- Remove the five-year summary and only include quarterly information if it has been materially, retrospectively adjusted
  - If a company decides it wants to keep the five-year summary, there is no longer a Form 10-K Item 6, as it is now "reserved." Company that wants to keep the five-year summary would have to include it in the MD&A.
- Example of an Annual Report on Form 10-K that implemented the SEC's new rules early: **Lumen Technologies 2020 Form 10-K**

Early Adoption *(cont'd)*

- *In November 2020, the SEC issued Release No. 33-10890, "Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information" which will become fully effective on August 9, 2021, with voluntary compliance permitted on or after February 10, 2021. This release was adopted to modernize, simplify, and enhance certain financial disclosure requirements in Regulation S-K. Specifically, the SEC eliminated the requirement for selected financial data, only requiring quarterly disclosure when there are retrospective changes affecting comprehensive income, and amending the matters required to be presented under Management's Discussion and Analysis ("MD&A") to, among other things, eliminate the requirement of the contractual obligations table. With our early adoption of this release, we have eliminated from this document the items discussed above that are no longer required. Information on our contractual obligations is still disclosed in a narrative within the "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 of Part II of this report.*

SEC Staff Comments on the MD&A Section

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Frequent Areas of SEC Comment on MD&A

- The number of SEC Staff comment letters on Exchange Act reports declined approximately 20% in 2020, compared to the previous year, continuing the downward trend of recent years. However, we may see more comments on topics addressed in the MD&A amendments in the future.
- MD&A topics that frequently received SEC Staff comments included:
  - Results of Operations
  - Critical Accounting Estimates
  - Liquidity and Capital Resources
  - COVID-19 Trends
  - Climate Change

Results of Operations

- Registrants are frequently requested to explain the results of their operations with greater specificity.
- SEC Staff comments included:
  - Requiring registrants to provide a narrative of the underlying reasons for material changes in financial statement line items in quantitative and qualitative terms.
  - Asking for greater specificity, including identifying underlying drivers for each material factor that affected earnings.
  - Elaborating on significant components of expenses.
  - Describing any unusual or infrequent events or transactions, or any significant economic changes, that materially affected income.
  - Providing insight into significant components of revenue or expense necessary to understand the results of operations.

Results of Operations *(cont'd)*

Example SEC Staff comment:

> *Where a material change is attributed to two or more factors, including any offsetting factors, the contribution of each identified factor should be described in quantified terms. For example, you disclose revenue growth is primarily attributable to contributions from new service centers, increased sales of advisory services, service fee increase and acquisitions, but do not quantify these factors. Please consider quantifying the factors in tabular form with the remaining written narrative focused on analyzing the reasons for such changes. In addition, please avoid vague terms such as "primarily" or "partially offset."*

Critical Accounting Estimates

- Registrants are frequently requested to expand disclosure on the quality and variability of management's judgments and assumptions as it relates to critical accounting estimates
- MD&A disclosure should provide a more robust analysis than what is in the significant accounting policies note to the financial statements
  - Consider including in MD&A a cross-reference to the footnote disclosure about significant accounting policies instead of repeating the same information
- Address why the accounting estimate or assumption bears the risk of change
- Consider whether an illustrative sensitivity analysis would be useful

Critical Accounting Estimates *(cont'd)*

Example SEC Staff comment:

> *We note that a sharp decline in your stock price resulted in a significant decline in your market capitalization; however, you concluded that goodwill was not impaired for any business unit but did not provide a discussion of the methodology used to estimate fair value. Tell us how you reconciled and evaluated your market capitalization to the fair value of your reporting units and describe the reasons for significant differences, if any. Please also provide the method(s) you used to estimate the fair value of your reporting units. In this regard, please provide qualitative and quantitative descriptions of the material assumptions and factors (e.g., stock prices) used to support each reporting unit's fair value determination and describe the degree of uncertainty associated with your key assumptions.*

Liquidity and Capital Resources

- SEC Staff comments typically focus on the sources and uses of a registrant's cash and the availability of cash to fund its required and proposed capital commitments
- Provide additional information on alternative sources of funding and material debt covenants
- Expand disclosure to include a meaningful analysis of any variability in cash flows and discuss the material components
- Explain how disclosed trends are likely to impact the registrant's short-term and long-term liquidity needs
- Disclosure should be expanded if there is heightened risk of default

Liquidity and Capital Resources *(cont'd)*

Example SEC Staff comment:

> *It appears from the statement of cash flows that changes in assets and liabilities, which include working capital items, are the substantial cause of the increase in operating cash flows compared to the prior year. Please revise your disclosure to discuss the material items and the associated underlying factors contributing to the variance. Quantify all factors cited and address the material drivers underlying those factors. Additionally, define what you consider to be your working capital and please note that merely citing changes in working capital items and other items identified in the statement of cash flows may not provide a sufficient basis to understand how operating cash between comparative periods changed.*

COVID-19 Trends

- Since the onset of the COVID-19 pandemic, the SEC Staff has issued many comments on registrants' accounting and disclosures related to COVID-19
- Registrant's disclosure should include the impact of the COVID-19 impact in the MD&A section
- Do not just provide general statements about uncertainties created by the pandemic; instead provide disclosure tailored to the registrant's particular facts and circumstances
- Registrants that want to adjust GAAP results as a result of the effects of the COVID-19 pandemic should limit non-GAAP adjustments to those that are clearly related to the pandemic

COVID-19 Trends *(cont'd)*

Example SEC Staff comment:

> *We note that the majority of your sales are in domestic markets and your most significant customer operates primarily in [Location X]. Given the continued rise in COVID-19 cases throughout the United States, including [Location X], please ensure that your MD&A disclosures in your upcoming Form 10-Q for the period ended June 30, 2020, address the matters described in CF Disclosure Guidance: Topic 9A. Please similarly revise your risk factor and financial statement disclosures as appropriate.*

Regulation S-K and Form 10-K

Risk Factors

As part of the SEC modernization amendments to Regulation S-K, amendments to Item 105 regarding risk factors were adopted:

- Requirement of a summary of not more than two pages in the “forepart” of the annual report if the discussion exceeds 15 pages;
- Change to the disclosure standard from “most significant” risks to “material” risks;
- Required organization of risks under relevant headings; and
- Requirement that generic risks (not specifically relevant to a company’s investors) be placed at the end of the discussion under a heading entitled “General Risk Factors”.

Business

- Amendments to Item 101(c), including specific amendments
- Human capital disclosures
  - Human capital resources; and
  - Human capital resources that the company focuses on in managing its business.
- Government regulations – not just environmental; and
- Other prescriptive disclosure items – any item that is material to investment and voting decisions, rather than current quantitative thresholds.

Legal Proceedings

- The amendments to legal proceedings disclosure (Item 103) also raise the threshold for disclosure of environmental proceedings to which a governmental authority is a party from $100,000 to $300,000, with the flexibility for the company to select a different threshold, so long as such threshold:
  - Is reasonably designed to disclose any material proceeding;
  - Does not exceed the lesser of (**i**) $1 million or (**ii**) 1% of the current assets of the company and its subsidiaries on a consolidated basis; and
  - Is disclosed, together with any changes, in **each** annual **and** quarterly report.

2020 Form 10-Ks

- The first year of annual reports on Form 10-K did not include very robust disclosures responsive to the principles-based disclosure requirement for a discussion of human capital
- Most registrants included the standard disclosures related to number of employees, locations, general functions, whether employees were unionized, and the registrants' relationship with their employees
- These disclosures were, in some instances, supplemented by discussions regarding reliance on part-time workers, consultants, or seasonal workers
- As reported in numerous surveys, including Intelligize's survey, the disclosures were inconsistent—ranging from general discussions of diversity and inclusion (though with few registrants including detailed breakdowns of personnel by EEO reporting characteristics) to discussions of the types of measures employed by registrants to attract, retain, and develop personnel (training and other learning resources)
- There were many registrants that focused their disclosures on COVID-19 related topics, including workplace safety, work from home measures, and return to work

2021 Form 10-Ks

Areas of enhanced disclosure focus for 2021:

- COVID-19
- Human capital disclosures: The SEC's rulemaking agenda indicates, and the SEC Chair has indicated, that there will be additional rulemaking on human capital. We can expect more prescriptive disclosure requirements. The SEC's Investor Advisory Committee had put forward recommendations for human capital disclosures.
- IBOR transition and related risks and associated planning: Chair Gensler has been quite vocal regarding support for SOFR as the LIBOR successor rate, and has expressed concerns regarding alternative rates.
- Brexit: For many issuers, especially in regulated industries, a discussion of Brexit related impacts may still be material to their business and results of operations.

2021 Form 10-Ks *(cont'd)*

- Cybersecurity: The SEC's Division of Enforcement has taken enforcement action against several registrants related to failures to disclose cybersecurity breaches—evidencing the SEC's continuing focus on cyber disclosures, and especially risk disclosures that disclosures that are hypothetical when the registrant has experienced actual breaches. Also included in the SEC's rulemaking agenda is a rule to enhance issuer disclosures regarding cybersecurity risk governance.
- ESG/Climate Change: The SEC requested public comment in March 2021, regarding climate-related disclosures. The SEC intends to propose rules that would establish a framework for climate risk disclosures. In the meantime, the SEC Staff has shared comments the Staff has issued on Forms 10-K.
- Holding Foreign Companies Accountable Act: Issuers that are "covered issuers" will be required to make certain additional disclosures ("Disclosure Regarding Foreign Jurisdictions that Prevent Inspections")

SEC Staff Sample Comment Letter

- On September 22, 2021, the Staff published a sample comment letter on climate change disclosures that included comments that have been issued in connection with Form 10-K filings and address the following topics:
  - Disclose considerations the company has given to providing the same type of climate-related disclosure in SEC filings as corporate sustainability reports
  - Identify and quantify any material past and/or future capital expenditures for climate-related initiatives
  - To the extent material, quantify or discuss the significant physical effects of climate change on the company’s property or operations
  - To the extent material quantify any material compliance costs related to climate change, including compliance costs associated with environmental regulations

SEC Staff Sample Comment Letter *(cont'd)*

- Disclose any material litigation risks related to climate change and the potential impact to the company
- Disclose the material effects of transition risks related to climate change that may affect the company's business, financial condition and results of operations, such as policy and regulatory changes that could impose operational and compliance burdens, market trends that may alter business opportunities, credit risks or technological changes
- To the extent material, disclose the company's purchase or sale of carbon credits or offsets and any material effects on the company's business, financial condition and results of operations

Statistical Disclosure Requirements for Banking Registrants

Subpart 1400 of Regulation S-K

- The SEC rescinded Industry Guide 3, Statistical Disclosures by Bank Holding Companies, and replaced requirements with a new subpart 1400 of Regulation S-K
- The rules become applicable for calendar year companies for annual reports for the year ending December 31, 2021
- The final rules eliminate overlaps in old Guide 3 disclosure requirements with GAAP/IFRS disclosures
- Applies to bank holding companies, bank and savings and loan registrants
- Applies to domestic and foreign issuers

Subpart 1400 of Regulation S-K *(cont'd)*

- Item 1402 (Item I of Guide 3): Item 1402 essentially carries forward all of the disclosures required by Item 1 of Guide 3, and also requires further disaggregation of the categories of interest-earning assets and interest-bearing liabilities
- Item 1403 (Item II of Guide 3): Codifies the weighted average yield disclosure for each range of maturities by category of debt securities currently required by Guide 3 but for those securities required in the registrant's financials. Item 1403 does not codify most of the Guide 3 investment portfolio disclosures.
- Item 1404 (Item III of Guide 3): Codifies the maturity by loan category. Certain Guide 3 loan category disclosure requirements were not carried forward.

Subpart 1400 of Regulation S-K *(cont'd)*

- Item 1405: Codifies Guide 3 requirement for ratio of net charge-offs to average loans outstanding (based on loan categories used in financials); as well as requires additional credit ratios—these include: allowance for credit losses to total loans (on a consolidated basis); nonaccrual loans to total loans (on a consolidated basis); and allowance for credit losses to nonaccrual loans (on a consolidated basis)

- Item 1406 (Item V of Guide 3): Codifies most of the requirements of Item V of Guide 3 with modest revisions

Additional Resources

Read:

- 2022 Proxy and Annual Report Season: The Time to Get Started Is Now
- MD&A Tune-Up
- SEC Issues MD&A Guidance

Watch:

- MB Microtalk: MD&A

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