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Legal Update

SEC Issues MD&A Guidance

On January 30, 2020, the US Securities and Exchange Commission (SEC) provided guidance[1] (MD&A Guidance) regarding the disclosure of key performance indicators and metrics used in the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) section of SEC filings. This commission-level guidance, which reflects the SEC's interpretation of existing MD&A requirements, becomes effective on the date of its publication in the *Federal Register*, which will make it applicable to annual reports on Form 10-K and Form 20-F that are currently being prepared. In addition, on January 24, 2020, the SEC's Division of Corporation Finance issued three MD&A compliance and disclosure interpretations (C&DIs).[2]

Commission-Level MD&A Guidance

For some time now, SEC representatives have expressed concerns regarding the use of key performance indicators, or KPIs, concerns which are similar to those raised by the SEC with respect to the use of non-GAAP financial measures.[3] The SEC's Division of Enforcement also has taken action in recent years against companies relating to the use of misleading key performance metrics. The MD&A Guidance describes how Item 303(a) of Regulation S-K and comparable requirements of Forms 20-F and 1-A apply to key performance indicators and metrics. Item 303(a) not only specifies particular items for disclosure in the MD&A (such as liquidity, capital resources and results of operations), it also requires discussion of "such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations." In addition, Instruction 1 to Item 303(a) requires discussion of "statistical data that the registrant believes will enhance a reader's understanding of its financial condition, changes in financial condition, and results of operations."

The MD&A Guidance observes that some companies disclose non-financial and financial metrics when describing the performance or the status of their business. These metrics vary by company and industry, and some metrics include company- or industry-specific matters. These metrics may reflect external or macro-economic matters, or they may be a combination of external or internal information.

The MD&A Guidance reminds each registrant that uses metrics in its MD&A that, under existing requirements, it "need[s] 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." According to the MD&A Guidance, a registrant must consider whether an existing regulatory disclosure framework—such as Generally Accepted Accounting Principles (GAAP) or, for non-GAAP financial measures, Regulation G or Item 10 of Regulation S-K—applies in the context of the metrics it uses and assess what "additional information may be necessary to provide adequate context for an investor to understand the metric presented."

Based on the facts and circumstances, the MD&A Guidance states that the SEC generally expects that a metric be accompanied by the following disclosure:

- 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.

According to the MD&A Guidance, a registrant needs to consider whether there are underlying estimates or assumptions for a metric or its calculation that need to be disclosed in order for the metric not to be materially misleading. And, if a company changes the calculation method or presentation of a metric from one period to another or otherwise, it should consider disclosing, to the extent material:

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

Depending on significance, following a change in methodology or presentation, it may be necessary to recast prior metrics to conform to the current presentation and place the current disclosure in the appropriate context.

The MD&A Guidance emphasizes the importance of disclosure controls and procedures in the context of key performance indicators and metrics that are derived from the company's own information. If these indicators and metrics are material to either an investment decision or a voting decision, the MD&A Guidance states that "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."

The MD&A Guidance contains the following non-exclusive list of examples of metrics to which this guidance applies:

- operating margin;
- same store sales;
- sales per square foot;
- total customers/subscribers;
- average revenue per user;
- daily/monthly active users/usage;
- active customers;
- net customer additions;
- total impressions;
- number of memberships;
- traffic growth;
- comparable customer transactions increase;
- voluntary and/or involuntary employee turnover rate;

- percentage breakdown of workforce (e.g., active workforce covered under collective bargaining agreements);
- total energy consumed; and
- data security measures (e.g., number of data breaches or number of account holders affected by data breaches).

At the same time that the SEC issued the MD&A Guidance, it proposed amendments to the current MD&A, selected financial data and supplementary financial information rules.[4] We will issue a separate Legal Update on those proposed amendments.

MD&A Compliance and Disclosure Interpretations

As a result of amendments to the MD&A that became effective in May 2019, companies are permitted to omit a discussion of the earliest of three years in a filing that includes financial statements covering three years to the extent that the discussion of that earlier year was already included in an SEC filing and such presentation identifies the location in the prior filing where the omitted disclosure may be found. The SEC's Division of Corporation Finance issued three new C&DIs to provide guidance in connection with that change.

C&DI 110.02 clarifies that a "statement merely identifying the location in a prior filing where the omitted discussion can be found does not incorporate such disclosure into the filing unless the registrant expressly states that the information is incorporated by reference."

C&DI 110.03 explains that a company may not omit the discussion of the earliest of the three years if it believes it "necessary to an understanding of its financial condition, changes in financial condition and results of operations."

C&DI 110.04 addresses the situation where a company files a Form 10-K in which the discussion of the earliest of the three years of financial statements is omitted from the MD&A and that Form 10-K thereupon becomes incorporated into a registration statement that is already effective. According to this C&DI, the filing of a Form 10-K for a newly completed fiscal year establishes a new effective date for the registration statement, and, as of the new effective date, the registration statement incorporates by reference only the latest Form 10-K, which does not contain the company's discussion of results for the earliest of the three years unless, as indicated in C&DI 110.02, the information is expressly incorporated by reference.

Practical Considerations

A registrant should assess whether it currently uses, or plans to use, any key performance indicators or metrics. If the answer is yes, a registrant should consider whether there is additional information that should be disclosed and develop the presentation for that new disclosure.

Because the MD&A Guidance becomes effective as soon as it is published in the *Federal Register*, it will be applicable to the MD&A that a calendar year-end company is drafting for its upcoming annual report. As a result, each such company should promptly assess whether it needs to make any changes to the MD&A to reflect the new guidance.

The MD&A Guidance is not limited to annual reports. It applies to other SEC filings containing MD&A, including quarterly reports and certain registration statements. Therefore, every company subject to the SEC's MD&A requirements should review this guidance now in order to prepare to apply it in the next MD&A to the extent necessary.

A company that discloses performance indicators and metrics in its MD&A section that are derived from the company's own information should review its disclosure controls and procedures to be sure these are effective with respect to the calculation of

these indicators and metrics. The review should also include a discussion with the audit committee. The audit committee should understand the performance indicators that are used—what their purpose is, whether they are well-understood and well-defined, what the methodology is for their calculation and whether there have been any significant changes in the indicators presented by the company or in their calculation methodology. This review and any update of disclosure controls and procedures should be completed before the company files its next annual report on Form 10-K or quarterly report on Form 10-Q.

Often, a company will use key performance indicators in its investor presentations, including in its earnings releases. The same level of review and care should be undertaken in relation to the preparation of these presentations and the use of performance indicators in these materials.

Companies that are considering omitting the discussion of the earliest of three years of financial statements from their MD&A should carefully review Instruction 1 to Item 303(a), which sets forth the requirements for doing so, and the recently issued C&DIs for the appropriate way to proceed. In particular, before omitting all or any part of such discussion, companies must conclude that they would not be excluding any information that they believe is necessary to the understanding of their financial position.

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Endnotes

[1] https://www.sec.gov/rules/interp/2020/33-10751.pdf

[2] https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm

[3] See, for example, remarks by then-Commissioner Kara Stein addressing KPIs, available at https://www.sec.gov/news/speech/speech-stein-102318

[4] https://www.sec.gov/rules/proposed/2020/33-10750.pdf