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MD&A TUNE-UP

In 2020, the SEC issued new guidance on MD&A in light of COVID-19. The authors discuss this guidance in detail, as well as recent amendments to Item 303 of Regulation S-K, and guidance on key performance indicators. They then turn to discussions of disclosure obligations relating to cybersecurity and the SEC's focus on MD&A in comment letters.

By Laura D. Richman and Christine M. McDevitt *

Management's discussion and analysis of financial condition and results of operations (MD&A) is a very important portion of a public company's filings with the Securities and Exchange Commission, enabling investors to see the company through the eyes of management. As such, companies should revisit their MD&A disclosure each time they prepare an SEC filing that requires it. This is especially true at this time because of both the ongoing need to describe the various effects of the global outbreak of COVID-19, and recent rule changes and guidance impacting MD&A disclosure.

CF DISCLOSURE GUIDANCE: TOPIC NO. 9

In connection with COVID-19, the SEC's Division of Corporation Finance issued CF Disclosure Guidance: Topic No. 9 (CF #9) on March 25, 2020.[1] This guidance addresses two areas that are particularly relevant to MD&A: assessing and disclosing the evolving impact of COVID-19 and reporting earnings and financial results, including non-GAAP financial measures. In addition, CF #9 discusses insider trading in a company's securities before material non-public information relating to COVID-19 has been disseminated.

Assessing and disclosing the evolving impacts of COVID-19

CF #9 includes a list of questions that companies should consider when assessing and disclosing the effects of COVID-19 on their specific circumstances. The list is not exhaustive. Companies should certainly consider these questions when assessing the impacts of COVID-19 and drafting the related disclosures of such impacts. Even if not all of the questions are relevant to a particular company, they provide insight into the type of information the SEC is looking for. The suggested questions may prompt parallel lines of inquiry for companies to think about. Moreover, in line with the principles-based disclosure system of the federal securities laws, the Division encourages companies to provide disclosure that is tailored and provides material information about the impact of COVID-19 to investors and market participants. Thus, disclosure that provides rote answers to each question may not be appropriate or desirable. But, information that is material to investment and voting decisions should be disclosed even if there is no "line-item" disclosure requirement.

[1] Coronavirus (COVID-19), Division of Corporation Finance, Securities and Exchange Commission, CF Disclosure Guidance: Topic No. 9, *available at* https://www.sec.gov/corpfin/coronavirus-covid-19.

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FORTHCOMING

- ***EXCHANGE ACT DISCLOSURE IN A COVID-19 PANDEMIC ENVIRONMENT***

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The non-exhaustive list of questions in CF #9 includes consideration of the following:

- How has COVID-19 impacted your financial condition and results of operations? How do you expect COVID-19 to impact future operating results and near- and long-term financial condition?

- How has COVID-19 impacted your capital and financial resources, including your overall liquidity position and outlook?

- How do you expect COVID-19 to affect assets on your balance sheet and your ability to timely account for those assets?

- Do you anticipate any material impairments, increases in allowances for credit losses, restructuring charges, other expenses, or changes in accounting judgments that have had or are reasonably likely to have a material impact on your financial statements?

- Have COVID-19-related circumstances, such as remote work arrangements, adversely affected your ability to maintain operations, including financial reporting, internal controls over financial reporting, and disclosure controls and procedures?

- Have you experienced challenges in implementing business continuity plans?

- Do you expect COVID-19 to materially affect the demand for your products or services?

- Do you expect a material adverse impact on your supply chain or the methods used to distribute your products or services?

- Will your operations be materially impacted by any constraints or other impacts on your human capital resources and productivity.

- Are travel restrictions and border closures expected to have a material impact on your ability to operate and achieve your business goals?

The Division acknowledges in CF #9 that it may be difficult for companies to assess or predict with precision the broad effects of COVID-19, and that the actual impact will depend on many factors beyond a company's control and knowledge. At the same time, the Division observes that certain facts are known, such as the effects that COVID-19 already has had on a company, what management expects its future impact will be, how management is responding, and how the company is planning for COVID-19-related uncertainties. These facts can be material to both investment and voting decisions, and thus companies should consider the need for disclosure in the context of the principles-based disclosure system. The Division encourages companies to provide disclosure that allows investors to evaluate the impact of COVID-19 on the company through the eyes of management.

CF #9 reminds companies that they can present forward-looking information in a manner that would allow companies to avail themselves of statutory safe harbors.[2] It is helpful for discussions of COVID-19's future impact to be drafted in a way that takes advantage of the safe harbors for forward-looking statements. For example, when the company is providing forward-looking information in discussing COVID-19 matters, consider clearly stating that actual results could differ materially from those contained in the forward-looking statements because the impact of COVID-19 is uncertain and could be materially different than management's current expectations. Identify forward-looking remarks with words such as "believe" or "expect." If a company's safe harbor language includes a list of factors that could impact actual results, add the uncertain effects of COVID-19 to the list.

MD&A must include information that a company "believes to be necessary to an understanding of its financial condition, changes in financial condition, and results of operations."[3] In addition, MD&A must specifically address any known trends or any known demands, commitments, events, or uncertainties that will

[2] Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934.

[3] Regulation S-K, Item 303(a).

result in, or that are reasonably likely to result in, the company's liquidity increasing or decreasing in any material way. MD&A should discuss COVID-19 as a known trend or uncertainty, and give management's perspective on the type and extent of COVID-19's effect on the company, to the extent material. There are many possible questions for companies to consider when assessing what is material in the COVID-19 context as they prepare their MD&A, including the questions contained in CF #9. For example, if a company has experienced supply chain issues, are they anticipated to be ongoing? How has COVID-19 affected liquidity? Has the company drawn down on bank facilities for any reason, including because it has not been able to finance in the capital markets? Is there a material risk that the company may not meet covenants in its credit or other agreements? Is the company able to service its debt and other obligations? Has the company needed to close any locations? Does the company operate any facilities where there has been a significant outbreak of COVID-19? Has there been any reduction in productivity or other consequences as a result of employees working from home? Is the company party to contracts with force majeure provisions that have been, or may be, triggered by the COVID-19 pandemic and, if so, is there a material impact on the company's business? Is the company having a dispute with its insurance carrier regarding business continuity coverage?

Human capital is increasingly becoming a topic of disclosure consideration. Before the COVID-19 pandemic, aspects of human capital had been discussed in the environmental, social and governance ("ESG") context, with issues such as board and workplace diversity, and pay equity receiving greater attention. The COVID-19 pandemic heightened the already-growing interest in human capital matters, with investors focusing on topics such as protecting the health and safety of employees and customers, remote working issues, succession planning, and the impact of these matters on business continuity. Moreover, amendments to Item 101 of Regulation S-K that became effective on November 9, 2020, expressly provide that a description of the company's human capital resources must be discussed as part of a company's business description, if material.[4] It is against this backdrop that companies should consider possible MD&A disclosure, in particular in response to the question in CF #9 regarding whether operations will be materially impacted by constraints or other impacts on human capital resources and productivity.

While some MD&A disclosure by its nature needs to wait until the period results become available, not all of it does. For example, companies are already aware of how they are being impacted by COVID-19, how management is responding, and how the company is planning for COVID-19-related uncertainties. Many companies have been adversely affected by COVID-19, but in some cases the pandemic has provided opportunities. Companies can start framing how their upcoming quarterly and annual MD&A disclosures will discuss the affects that COVID-19 has had. Given the time it takes to prepare MD&A — including assessing what should be discussed, drafting the disclosure, and having the disclosure reviewed by internal and external advisors, as well as the audit committee and/or full board of directors — it is not too early to begin the MD&A drafting process, even before results are fully known.

Because the pandemic is affecting so many aspects of business, and with many employees working remotely during 2020, consideration should also be given to whether any changes to the company's disclosure controls and procedures are needed. For example, companies might make the potential impacts of COVID-19 an express part of disclosure controls and procedures. Also consider reaching out to business units or other areas within the business that may not typically be part of the disclosure controls process to ascertain whether anything is happening that could require disclosure.

Companies may also need to assess whether COVID-19 is having any impact on their internal control over financial reporting. Think about whether the increase in remote working has affected internal control. Although addressing potential shortcoming in this area may be a sensitive topic, keep in mind that the principal executive officer and principal financial officer must certify to these control disclosures.[5]

Non-GAAP disclosure

In its discussion regarding reporting earnings and financial results, CF #9 provides guidance related to the presentation of non-GAAP financial measures. Companies that will present a non-GAAP measure that adjusts for or explains the impact of COVID-19, either in an earnings release or in MD&A, should explain why

[4] Release Nos. 33-10825; 34-89670 (2020); *see also* Mayer Brown Legal Update, "*SEC Amends Business, Legal Proceedings and Risk Factor Disclosures*," August 31, 2020, *available at* https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/08/sec-amends-business-risk-and-legal-proceedings-disclosure.pdf.

[5] Rule 13a-15 and Rule 15d-15.

the measure is useful to management and how it helps investors assess the impact of COVID-19 on the company. CF#9 explains that it is not appropriate to present non-GAAP financial measures or metrics solely to present a more favorable view of the company. Rather, companies should use and report non-GAAP measures with a COVID-19 adjustment for the purpose of sharing with investors how management and the board of directors are analyzing the current and potential impacts of COVID-19 on the company.

CF #9 states that where GAAP financial measures are not available at the time of an earnings release because the measure may be impacted by COVID-19-related adjustments that are not currently available, the Division will not object if companies reconcile a non-GAAP measure to preliminary GAAP results or a range of reasonably estimable GAAP results. But, this relief does not apply to filings where GAAP financial statements are required, such as filings on Form 10-K and Form 10-Q. Accordingly, non-GAAP measures presented in MD&A must be reconciled to GAAP results.

Enforcement

Be aware that the SEC's Division of Enforcement has its eye on disclosures during this time of COVID-19. Around the same time the Division issued CF #9, the Co-Directors of Enforcement issued a statement emphasizing "the importance of maintaining market integrity and following corporate controls and procedure," and stating that "the Enforcement Division is committing substantial resources to ensuring that our Main Street investors are not victims of fraud or illegal practices in these unprecedented market and economic conditions."[6] The SEC has already instituted and settled cease-and-desist proceedings against one public company for material misstatements regarding the impact of COVID-19 on its business operations and financial condition.[7] In the press release announcing the settlement, the current Director of Enforcement stated that the "Enforcement Division, including the Coronavirus Steering Committee, will continue to scrutinize COVID-related disclosures."[8] In that case, the disclosures appeared in press releases furnished on Forms 8-K by the company. Expect the SEC to also be reviewing MD&A disclosures and related controls and procedures carefully.

CF DISCLOSURE GUIDANCE: TOPIC NO. 9A

On June 23, 2020, the Division supplemented CF #9 by issuing CF Disclosure Guidance: Topic No. 9A ("CF #9A").[9] This guidance provides additional views on companies' ongoing assessment of the impact of COVID-19, including operations, liquidity, and capital resources disclosures that companies should consider related to COVID-19-related disruptions. CF #9A notes that companies are making a diverse range of operational adjustments to respond to the pandemic, such as the transition to telework, supply chain and distribution adjustments, and suspension or modification of certain operations to comply with health and safety guidelines. CF #9A indicates that these types of adjustments could impact a company in a way that would be material to an investment or voting decision, triggering disclosure obligations.

CF #9A also recognizes that companies are undertaking a diverse and sometimes complex range of financing activities in response to the pandemic — including, for example, the entry into, or entry into amendments to, credit facilities and public and private financings — each of which may have novel terms and structures. CF #9A reminds companies to provide robust and transparent disclosure regarding short- and long-term liquidity and funding risks, especially new risks or uncertainties. The Division notes that companies have made some of these disclosures in their earnings releases and encourages companies to evaluate whether such information, in light of its potential materiality, should also be discussed in MD&A.

CF #9A suggests that companies consider a broad, non-exclusive range of questions as they evaluate the impacts of COVID-19, including:

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[6] Statement from Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, Regarding Market Integrity, March 23, 2020, *available at* https://www.sec.gov/news/public-statement/statement-enforcement-co-directors-market-integrity (Statement from Enforcement).

[7] In the Matter of the Cheesecake Factory Incorporated, Securities Exchange Act Release No. 90565 / December 4, 2020, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, *available at* https://www.sec.gov/litigation/admin/2020/34-90565.pdf.

[8] SEC press release 2020-306, December 4, 2020, *available at* https://www.sec.gov/news/press-release/2020-306.

[9] Coronavirus (COVID-19) – Disclosure Considerations Regarding Operations, Liquidity, and Capital Resources, Division of Corporation Finance, Securities and Exchange Commission, CF Disclosure Guidance: Topic No. 9A, *available at* https://www.sec.gov/corpfin/covid-19-disclosure-considerations.

- What are the material operational challenges that management and the board of directors are monitoring and evaluating?

- How is the company's overall liquidity position and outlook evolving?

- Have COVID-19-related impacts affected the company's ability to access traditional funding sources on the same or reasonably similar terms as were available to it in recent periods?

- Is the company at material risk of not meeting covenants in its credit and other agreements?

- Is the company able to timely service its debt and other obligations?

- Have capital expenditures been reduced and if so, how?

- Have terms with customers been altered?

- Is the company relying on supplier finance programs to manage its cash flow?

- Has the company considered whether disclosure is required of subsequent events in the financial statements and known trends or uncertainties in MD&A?

Companies should discuss with their accountants whether COVID-19-related disclosure is needed as part of their financial statement footnotes, including a subsequent event footnote. In addition, CF #9A reminds companies to consider whether there is substantial doubt about the company's ability to continue as a going concern. As it relates to MD&A disclosure, CF #9A notes that the following questions should be considered:

- Are there conditions and events that give rise to the substantial doubt about the company's ability to continue as a going concern? For example, have you defaulted on outstanding obligations? Have you faced labor challenges or a work stoppage?

- What are your plans to address these challenges? Have you implemented any portion of those plans?

AMENDMENTS TO ITEM 303 OF REGULATION S-K (MD&A)

On November 19, 2020, the SEC adopted amendments to Item 303 of Regulation S-K (the item setting forth the MD&A requirements) for both full fiscal years and interim periods, as well as to several other items of Regulation S-K.[10] The amendments are intended to modernize, simplify, and enhance MD&A disclosure for investors while reducing compliance burdens for companies. The amendments became effective on February 10, 2021. Companies must comply with the amended rules for their first fiscal year ending on or after August 9, 2021. Companies may choose to comply early any time after the effective date. But if a company chooses to comply early, it must provide disclosure that is responsive to an amended item in its entirety, and it must begin providing such disclosure in any applicable future filings.

Although the mandatory compliance date for the MD&A amendments will occur after the Form 10-K filing in 2021 for many companies, it is worthwhile for a company to carefully review the amendments at this time to assess how it will apply the amendments and to determine whether it wants to voluntarily adopt the provisions earlier than required. The SEC's commentary in the proposing release and adopting release are also instructive as companies draft their current disclosure. For example, the SEC highlights that the general purpose of MD&A disclosure is to provide both a historical and prospective analysis of the company's financial condition and results of operations, with particular emphasis on the company's prospects for the future.[11] The SEC notes the importance of materiality and trend disclosures to a thoughtful MD&A.[12]

New Item 303(a) – objective

The amendments add a new paragraph (a) to Item 303 that sets out the objective of MD&A for both full-year and interim periods by incorporating much of substance of current Instructions 1, 2, and 3 to the Item. In addition, this new paragraph specifies that disclosure responsive to the objective of MD&A "is expected to better allow investors to view the registrant from

[10] Management's Discussion and Analysis, Selected Financial Data and Supplementary Financial Information, Release No. 33-10890; 34-90459 (November 19, 2020), *available at* https://www.sec.gov/rules/final/2020/33-10890.pdf (MD&A Adopting Release); *see also* Management's Discussion and Analysis, Selected Financial Data and Supplementary Financial Information, Release No. 33-10750; 34-88093 (proposed January 30, 2020), *available at* https://www.sec.gov/rules/proposed/2020/33-10750.pdf (MD&A Proposing Release).

[11] MD&A Proposing Release at 38.

[12] MD&A Adopting Release at 31.

management's perspective," codifying existing SEC guidance that states that a company should explain its financial statements in a way that enables investors to see the company "through the eyes of management."[13] Current Item 303(a) has been recaptioned as Item 303(b), and current Item 303(b) as Item 303(c).

New Item 303(b) – full fiscal years

The existing introductory paragraph to Item 303(a) (recaptioned as Item 303(b)) largely retains its current language. The amendments add "product lines" as an example of other subdivisions, in addition to a company's reportable segments, that should be discussed where necessary to understand the company's business. In addition, the changes move to new Item 303(b) the portion of current Instruction 4 that requires companies to describe the "cause" for material changes from period-to-period in one or more line items. The amendments, however, require companies to disclose the "underlying reasons" for material changes, rather than the "cause," and expressly require that the description provide both quantitative and qualitative analysis. These changes are intended to improve the quality of analysis in MD&A, including by encouraging companies to provide a more meaningful discussion of the underlying reasons that may be contributing to material changes in line items. The amendments also clarify that material changes in a line item should be discussed even when they offset each other. These changes codify existing SEC MD&A guidance.[14]

New Item 303(b)(1) – liquidity and capital resources

The amendments move current Items 303(a)(1) (related to liquidity) and 303(a)(2) (related to capital resources) under a new lead-in paragraph titled "Liquidity and Capital Resources." This new lead-in paragraph (new Item 303(b)(1)) requires companies to discuss their ability to meet their cash requirements in the short-term (i.e., in the next 12 months) and the long-term (i.e., beyond 12 months), and to analyze material cash requirements from known contractual and other obligations. This discussion must specify the type of obligation and the relevant time period for the related cash requirements. This addition was intended to address concerns that information may be lost with the elimination of the tabular disclosure of contractual obligations, discussed below.

Current Item 303(a)(1) (related to liquidity) remains unchanged other than being recaptioned as Item 303(b)(1)(i).

Current Item 303(a)(2) (related to capital resources) has been expanded to require companies to describe not only material commitments for *capital expenditures* but the company's material *cash requirements*, including commitments for capital expenditures, the anticipated source of funds needed to satisfy the cash requirements, and the general purpose of the cash requirements. These changes are reflected in new Item 303(b)(1) and amended Item 303(b)(1)(ii). The objective behind this change is to revise the disclosure requirements to account for capital expenditures that are not necessarily capital investments, recognizing that expenditures for human capital or intellectual property have become increasingly important for some companies.

New Item 303(b)(2) – results of operations

The amendments make three changes to Item 303(a)(3) (related to results of operations), recaptioned as Item 303(b)(2). First, companies must disclose known 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. Using a disclosure threshold of "reasonably likely" is consistent with the SEC's guidance on forward-looking disclosure in MD&A.[15]

Second, the SEC requires companies to discuss material "changes" (as opposed to "increases") in net sales or revenues. This amendment codifies existing SEC MD&A guidance that the discussion of results of operations should describe not only increases but also decreases.[16]

Third, the amendments eliminate the current requirement to disclose the impact of inflation and changing prices, which the SEC finds may give undue attention to a topic that might not be necessary to an understanding of the company's financial condition.

[13] Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operation, Release No. 33-8350 (Dec. 19, 2003) (2003 MD&A Interpretative Release) at 75056; Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Release No. 33-6835 (May 18, 1989) (1989 Interpretative Release), at 22428.

[14] 1989 MD&A Interpretive Release; 2003 MD&A Interpretive Release.

[15] 1989 MD&A Interpretive Release at 22430.

[16] 1989 MD&A Interpretive Release at n. 36.

Companies are still required to discuss these matters if they are part of a known trend or uncertainty that has had, or the company reasonably expects to have, a material impact on net sales, revenue, or income from continuing operations. This change is intended to allow companies to focus on material disclosure that is tailored to their business, facts, and circumstances.

Deletion of current Items 303(a)(4) (off-balance sheet arrangements) and 303(a)(5) (tabular disclosure of contractual obligations)

The amendments eliminate current Item 303(a)(4) (related to off-balance sheet arrangements) which requires a separately captioned section discussing the company's off-balance sheet arrangements. The amendments replace this requirement with an instruction to Item 303 that 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, even when the arrangements result in no obligation being reported in the consolidated balance sheet. This change moves from a prescriptive requirement to a principles-based instruction, and is intended to emphasize the importance of discussing off-balance sheet arrangements in the broader context of MD&A disclosure.

The amendments also eliminate the tabular contractual disclosure requirement currently in Item 303(a)(5). However, as noted above, the amendments to Item 303(b) specifically require disclosure of material cash requirements from known contractual and other obligations as part of a liquidity and capital resources discussion. The SEC notes in the adopting release that this change should not result in the loss of material information and 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."[17]

New Item 303(b)(3) – critical accounting estimates

In addition, the amendments add a new paragraph to current Item 303(a) (new Item 303(b)(3)) to explicitly require disclosure of critical accounting estimates. This change is intended to codify existing SEC MD&A guidance.[18] It is also intended to eliminate disclosure that duplicates the financial statement discussion of significant policies and, instead, promote enhanced analysis of measurement uncertainties. This amendment requires companies to provide qualitative and quantitative information necessary to understand the estimation uncertainty and the impact the estimate has had, or is reasonably likely to have, on the company's financial condition or results of operations. This information, however, must be provided only to the extent material *and* reasonably available. In addition, this disclosure should include why each critical accounting estimate is subject to uncertainty and, to the extent material and reasonably available, how much each estimate and/or assumption has changed over a relevant period, and the sensitivity of the reported amount to the methods, assumptions, and estimates underlying its calculation. The amendments and the adopting release clarify that the "reasonably available and material" qualifier applies "to all information about a critical accounting estimate that has had or is reasonably likely to have a material impact on financial condition or results of operations, whether qualitative or quantitative, including whether the information relates to sensitivity of the reported amount or how much the estimate has changed."[19] Thus, companies are not required to provide disclosure that is impracticable to provide or that is not material.

New Item 303(c) – interim periods

The current MD&A rules related to interim period disclosure (current Item 303(b), recaptioned as Item 303(c)) remain largely unchanged except for one significant change. The amendments allow companies 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. This change gives companies the flexibility to choose the best presentation for them and it is intended to allow companies to provide the most relevant information about the company to market participants. If a company changes the comparison from the prior interim period comparison, it must explain the reason for the change and present both comparisons in the filing where the change is announced.

In light of the amendments, in particular the deletions of current Items 303(a)(4) and 303(a)(5), the amendments delete current Item 303(c) (related to the safe harbor for the forward-looking statements) and Item

[17] MD&A Adopting Release at 61–65.

[18] 2003 MD&A Interpretive Release.

[19] MD&A Adopting Release at 74.

303(d) (related to smaller reporting companies), which refer exclusively to disclosure requirements that are deleted by the amendments.

KEY PERFORMANCE INDICATORS

On January 30, 2020 the SEC provided commission-level guidance regarding the disclosure of key performance indicators and metrics ("KPIs") in MD&A.[20] This guidance was not a surprise. SEC representatives had previously expressed concerns regarding the use of KPIs, which raise issues that are similar to those raised by the use of non-GAAP financial measures. Companies' use of non-GAAP financial measures has of course been the focus of rule-making and interpretive guidance by the SEC and is often a topic raised by the SEC in comment letters.[21]

KPIs in MD&A

The KPI guidance describes how MD&A rules apply to KPIs. Item 303(a) of Regulation S-K not only specifies particular items for disclosure in 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." And the KPI guidance reminds companies that, when including metrics in their disclosure, they should consider explicit MD&A requirements, as well as the need to disclose such further information as may be necessary in order to make the presentation of a metric, in light of the circumstances under which it is presented, not misleading.[22]

The KPI 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.

According to the KPI guidance, a company 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."[23]

Many types of metrics can be KPIs. For example, same store sales, active customers, number of account holders affected by data breaches, and employee turnover rate are just some of the performance indicators mentioned specifically in the KPI guidance. KPIs are not GAAP-prescribed measures and they often are highly customized. Therefore, it makes sense that the KPI guidance expressly provides only a non-exclusive list of examples of metrics to which this guidance applies. Companies will need to give thought to whether metrics or indicators that they use are KPIs that fall within the KPI guidance, whether or not such metric is expressly mentioned in the KPI guidance.

Although the final determination will depend on the company's particular facts and circumstances, the SEC generally expects a KPI to be accompanied by a clear definition of the metric and a statement of:

- how the metric is calculated;
- what assumptions or estimates are used;
- why the metric provides useful information to investors; and
- how management uses the metric in managing or monitoring the company's business.

[20] Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations, Release Nos. 33-10751; 34-88094; FR-87, effective February 25, 2020 (KPI Guidance).

[21] Regulation G; Item 10(e) of Regulation S-K; Item 2.02 of Form 8-K; Release Nos. 33-8176, 34-47226; Release Nos. 33-8145, 34-46788; Release Nos. 33-8039, 34-45124; C&DIs covering non-GAAP financial measures, most recently updated April 4, 2018, *available at* https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm; *see also* Deloitte, A Roadmap to SEC Comment Letter Considerations, Including Industry Insights, November 2020, *available at* https://dart.deloitte.com/USDART/ov-resource/c0c78948-e20b-11e8-8992-71b1f00939dc.pdf (citing non-GAAP measures as the #2 topic in SEC comment letters); PwC SEC comment letter trends, *available at* https://www.pwc.com/us/en/cfodirect/publications/sec-comment-letter-trends.html (citing non-GAAP measures as the #1 topic in SEC comment letters).

[22] KPI Guidance at 3 (citing Rule 408(a) and Rule 12b-20).

[23] KPI Guidance at 4.

The KPI guidance instructs companies to consider whether there are underlying estimates or assumptions for a metric or its calculation that must be disclosed in order for the metric not to be materially misleading. If so, any such underlying estimates or assumptions must be disclosed.[24]

Often, a company will use KPIs in investor presentations and earnings releases. The same level of review and care should be undertaken in relation to the preparation and use of KPIs in these materials as is taken in SEC filings. In addition, KPIs used in earnings releases or other presentations may also need to be disclosed in MD&A. It likely will be expected, and their absence in such circumstances could give rise to SEC comment.

Changes to KPIs

If a company changes the calculation method or presentation of a KPI, from one period to another or otherwise, it should consider whether such changes are material. If the changes are material, the company should disclose the following, 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.

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. Whether a company should recast prior metrics will depend on the significance of the change in methodology and results.

Disclosure Controls

The KPI guidance emphasizes the importance of disclosure controls and procedures in the context of KPIs that are derived from the company's own information. If these indicators and metrics are material to either an investment or a voting decision, the KPI 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."[25] Moreover, if a metric is customized, a company should have in place a process by which the calculation is documented.

Especially if the company is disclosing KPIs in its MD&A that are derived from the company's own information, the company should review its disclosure controls and procedures to be sure they are effective with respect to the calculation of the KPIs. This review should include a discussion with the audit committee of the company's board of directors. The audit committee should understand the performance indicators that are used. In particular, the audit committee should understand: What is the purpose of the KPI? Is the KPI well-understood and well-defined? What is the methodology for calculation of the KPI? Have there been any significant changes in the KPIs presented by the company or in their calculation methodology as compared to previous disclosure?

MD&A COMPLIANCE AND DISCLOSURE INTERPRETATIONS

Also noteworthy as you tune up your MD&A are three MD&A Compliance and Disclosure Interpretations (C&DIs) issued by the Division in January 2020.[26] These C&DIs provide guidance in connection with the May 2019 amendments to Regulation S-K. Those amendments, among other things, amended Instruction 1 to Item 303 to permit companies to omit a discussion in MD&A of the earliest of three years in a filing that includes financial statements covering three years if (1) that discussion was already included in the company's prior SEC filings and (2) the company includes a statement that identifies the location in the prior filing where the omitted discussion appears.[27] Two of the C&DIs (110.02 and 110.03) provide drafting-related guidance, and the third (110.04) clarifies how the 2019 amendments affect what information will be incorporated into an already effective registration statement.

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[24] *Supra* note 22.

[25] KPI Guidance at 5 (citing Rule 13a-15 and Rule 15d-15 and describing the required disclosure controls and procedures and related principal executive officer and principal financial officer certifications).

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

[27] Instruction 1 to Item 303(a) of Regulation S-K.

C&DI 110.02 clarifies that the statement required by Instruction 1 identifying the location in the prior filing where the omitted discussion appears alone does not incorporate that disclosure into the current filing. To do so, the company must expressly state that the information is incorporated by reference.

C&DI 110.03 addresses the question of whether a company may omit a discussion of the earliest of the three years if that discussion is necessary to an understanding of the company's financial condition, changes in financial condition, and results of operations. In this case, C&DI 110.03 clarifies that the company must include the information, *but* it has two options for doing so: it can either include the discussion in its current disclosure or expressly incorporate by reference the discussion from a previous filing. As noted in C&DI 110.02, the statement identifying the location in the previous filing where the discussion appears is not enough to incorporate that discussion by reference; express incorporation by reference language must be included.

Thus, companies can take advantage of the 2019 amendments to avoid repeating the discussion of the earliest of three years in their current disclosure. But companies should be sure to include the required statement identifying the location in the prior filing where the omitted discussion appears. Moreover, if the discussion of the third year is necessary to an understanding of the company's financial condition, changes in financial condition, and results of operations, companies may still take advantage of the 2019 amendments to avoid repetition. But, in that case, the company must include the necessary information by expressly incorporating by reference the prior disclosure into the current filing.

CYBERSECURITY

In February 2018, the SEC published commission-level interpretive guidance to assist public companies in preparing disclosures about cybersecurity risks and incidents, updating, and expanding SEC staff guidance that was issued in 2011.[28]

With respect to MD&A, this guidance identifies the costs of ongoing cybersecurity efforts, the costs and other consequences of cybersecurity incidents, and the risks of potential cybersecurity incidents as items to be considered when preparing MD&A disclosure. The guidance notes that the costs associated with cybersecurity issues could include loss of intellectual property, the immediate costs of the incident, preventative measures, maintaining insurance, responding to litigation and regulatory investigations, and addressing harm to reputation. The guidance specifies that the SEC expects companies to consider the impact of cybersecurity incidents on each of their reportable segments.

In determining disclosure obligations related to cybersecurity risks and incidents, the guidance notes that companies generally weigh, among other things, the potential materiality of any identified risks and, in the case of incidents, the importance of any compromised information and of the impact of the incident on the company's operations. Companies should consider whether their risk profile for cybersecurity incidents has changed due to COVID-19, and whether the corresponding disclosures in their MD&A or otherwise need to be updated. For example, does the work-from-home environment create heightened risk for the company? The SEC notes that it does not expect detailed disclosure, for example, of technical information about a company's cybersecurity systems, that could compromise a company's cybersecurity efforts. Nevertheless, the SEC does expect appropriate disclosure of a cybersecurity incident or risk that would be material to inventors, including any associated financial, legal, or reputational consequences.

Remember also that companies may have a duty to correct prior disclosure that was untrue when made, or a duty to update disclosure that becomes materially inaccurate after it is made.[29] The cybersecurity guidance states that, for example, when the original statement is still being relied on by reasonable investors, a duty to update might exist. Consider whether you need to revisit

[28] Commission Statement and Guidance on Public Company Cybersecurity Disclosures, Release No. 33-10459 (Feb. 26, 2018), *available at* https://www.sec.gov/rules/interp/2018/33-10459.pdf (Cybersecurity Guidance).

[29] Cybersecurity Guidance at 12 (citing *Backman v. Polaroid Corp.*, 910 F.2d 10, 16-17 (1st Cir. 1990) (en banc) (finding that the duty to correct applies "if a disclosure is in fact misleading when made, and the speaker thereafter learns of this"), *id.* at 17 (describing the duty to update as potentially applying "if a prior disclosure 'becomes materially misleading in light of subsequent events'"), and, for the alternative position, *Higginbotham v. Baxter Intern., Inc.*, 495 F.3d 753, 760 (7th Cir. 2007) (rejecting duty to update before next quarterly report); *Gallagher v. Abbott Laboratories*, 269 F.3d 806, 808-11 (7th Cir. 2001) (explaining that securities laws do not require continuous disclosure)).

and update previous disclosure, including in connection with an investigation of a cybersecurity incident.

COMMENT LETTERS

MD&A is a key part of companies' disclosure in interim and annual reports. Indeed, the SEC staff continues to focus on MD&A topics in its comment letters, with MD&A ranking as or among the topics receiving the most SEC comments.[30] Recently, the staff has issued comments on topics such as COVID-19 as a known trend and uncertainty; results of operations, including the description and quantification of unusual or infrequent events or significant economic changes, including the impacts of COVID-19; critical accounting policies and estimates, in particular estimates that management used in valuations; and liquidity and capital resources, including discussion of drivers of cash flows, and the trends and uncertainties related to meeting known or reasonably likely future cash requirements.[31] In addition, SEC comments have questioned whether KPIs should be discussed in the company's MD&A. When drafting MD&A, it is worthwhile to keep in mind these areas in which the SEC staff has expressed interest through the comment letter process.

Comments related to COVID-19 disclosure include requesting discussion of COVID-19 as a known trend and uncertainty and including the company's expectations of the impact of COVID-19 on operating results and financial conditions. For example, see the following sample SEC comment:

> On your first quarter earnings call, you indicate that you currently anticipate second quarter revenue to be down as much as 50% to 60% with approximately 80% of your global business having been closed since . . . , 2020. Revise your future periodic filings to disclose known trends and uncertainties related to COVID-19. For example, disclose how you expect COVID-19 to impact your future operating results and near- and long-term financial condition, and how that compares to the current period.

In addition, comments have sought analysis of how changes in accounting estimates have impacted results of operations, as set forth in this comment:

> Please discuss and analyze the results of operations for your business as a whole, including the impact of changes in accounting estimates on your results of operations. Your three changes in accounting estimates in 2019 increased earnings per share by $0.98 per share and your primary and diluted earnings by over 24%. Your change in accounting estimate in 2018 increased earnings per share by $0.26 per share and your primary and diluted earnings by 5%. Please refer to Item 303(a) of Regulation S-K.

Also related to results of operations, comment letters highlight the requirement to disclose the extent to which increases in net sales or revenue are related to increases in price or to increases in volume sold, which requirement remains an explicit part of Item 303 after the recent amendments described in this article. For instance, see this comment:

> You disclose several different types of revenue streams such as product sales, pharmacy prescriptions, laboratory services, and management services. Please revise to provide the following or tell us why additional disclosure is not required:
>
> …
>
> - additional disclosure in Management's Discussion and Analysis quantifying each significant factor that resulted in significant changes in revenue and the extent to which the change relates to price vs. volume. Refer to item 303(a)(3) of Regulation S-K.

Comment letters have requested enhanced disclosure and user-friendly presentation of trends and uncertainties related to meeting known or reasonably likely future cash requirements, such as in this comment:

> We note your disclosure regarding the . . . grounding and your recognition of a . . . liability for potential concessions and other considerations to customers for disruptions related to the grounding. In future filings, please provide enhanced disclosures to better clarify the nature and amounts of the various concessions you are providing. It appears your concessions may be in the form of cash, in-kind consideration, and other forms of concessions. Please consider providing a tabular presentation of the concessions by type, so that investors can better understand

[30] Deloitte, A Roadmap to SEC Comment Letter Considerations, *supra* note 21 (citing MD&A as the #1 topic in SEC comment letters); PwC SEC comment letter trends, *supra* note 21 (citing MD&A as the #3 topic in SEC comment letters).

[31] *Id.*

the expected impacts to your cash flows and operating results.

In addition, staff comments may go beyond the filing being reviewed to cite the company's earnings releases or even information that can be found in news sources to request updates to MD&A disclosure, as reflected in the following comments:

> We note from various news sources that you have experienced significant commercial . . . order cancellations in fiscal year 2020. We further note your response to our prior comment number two in your letter dated . . . , 2019. As it appears order cancellations are now at significant levels, please be sure to include robust quantified and narrative disclosure of the expected impacts to your backlog, results of operations and cash flows in your future filings.
>
> If two or more factors contribute to material changes in revenue, please provide disclosure demonstrating the relative magnitude of each factor, such as the percentage or dollar increase in revenue due to onboarding of new customers versus usage from existing customers. In this regard, it appears from your most recent earnings releases that such information is readily available.

The staff has also issued comments related to whether KPIs referred to in earnings calls should be included in MD&A under Instruction 1 to Item 303(a), which requires discussion of statistical data that the company believes will enhance a reader's understanding of its financial condition, changes in financial condition, and results of operations. Two such comments include the following:

> During your quarterly earnings calls you refer to certain key performance indicators. To the extent that measures such as broadcast subscribers, unique users, or broadcast churn, are key performance indicators used in managing your business, please consider revising to include a discussion of the measures in your MD&A section, along with comparative period amounts, or explain why you do not believe this disclosure is necessary. Refer to Section III.B.1 of SEC Release No. 33-8350 and SEC Release 33-10751.
>
> We note in your earnings calls that you discuss net revenue per client . . . and inventory turnover. If these metrics are used by management to manage the business, and promote an understanding of the company's operating performance, they should be identified as key performance indicators and discussed pursuant to Instruction 1 of paragraph 303(a) or Regulation S-K and Section III.B.1 of SEC Release No. 33-8350. Please tell us your consideration of disclosing these metrics, or other key performance indicators used.

CONCLUSION

As always, it is important for public companies to provide disclosure responsive to requirements of the federal securities laws that is tailored to their particular facts and circumstances in order to keep investors and other market participants informed of material information about the company.[32] This is particularly true for MD&A disclosure. In light of developments over the last year, now is the perfect time for companies to review and tune up their MD&A. ■

[32] CF #9A ("The cornerstone of this system is disclosure of material information that is widely disseminated."); Statement from Enforcement ("We similarly urge public companies to be mindful of their established disclosure controls and procedures, insider trading prohibitions, codes of ethics, and Regulation FD and selective disclosure prohibitions to ensure to the greatest extent possible that they protect against the improper dissemination and use of material nonpublic information.").