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Alert

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Key Financial Reporting Tips For Form 10-K Drafters

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This Alert focuses on the 2021 Form 10-K for calendar-year end companies that must now comply with the SEC's amended MD&A and related rules and calls attention to "hot topics" and likely areas of SEC comment in 2022, such as climate change and other ESG matters, along with the transition away from LIBOR. The Alert also revisits familiar topics that continue to be the focus of the SEC and its staff, such as cybersecurity and non-GAAP financial measures. Throughout this Alert, we highlight key tips and takeaways for Form 10-K drafters.

Reminders re: Amendments to Rules Requiring MD&A and Related Financial Disclosures

Turning first to the recently effective MD&A rules, the SEC shifted to a principles-based narrative approach centered on materiality. While not as prescriptive, there are still specific disclosures the SEC emphasizes in the adopting release, available here. Calendar year-end reporting companies must disclose the following in the MD&A:

- Based on a new statement of the "objective" of MD&A, an "evaluation of the amounts and certainty of cash flows from operations and from outside sources," as well as material events and uncertainties known to management based on what is "reasonably likely" to cause a company's results not to be indicative of future results.
- To account for capital expenditures that are not necessarily capital investments, disclosure of material cash requirements, including but not limited to capital expenditure commitments, as of the latest fiscal period, the anticipated source of funds needed to meet them and the general purpose of these requirements.
- Known trends and/or uncertainties that are reasonably likely to cause a change in the relationship between costs and revenues, such as known or reasonably likely increases in the costs of labor or materials, price increases or inventory adjustments.
- Material change disclosure, including decreases as well as increases in sales or revenue. The amended rules require disclosure of the underlying reasons in quantitative and qualitative terms for material changes.
- Price changes and inflation if part of a known trend or uncertainty that has had, or the company reasonably expects to have, a material favorable or unfavorable impact on net sales, revenue or income from continuing operations.

- Streamlined disclosure of material off-balance sheet arrangements that eliminates the Sarbanes-Oxley era caption and reduces GAAP redundancy while retaining obligations to disclose such arrangements in Form 8-K.
- Narrative rather than tabular disclosure of material contractual commitments, both short- and long-term, which must be integrated into the enhanced discussion and analysis of liquidity and capital resources. We do not believe the staff would object to the continued use of the table to illustrate the required narrative disclosure, provided the narrative itself complies with the amended rule.
- Disclosure of "critical accounting estimates" (CAE), which, as codified, focuses on estimates made in accordance with GAAP "that involve a significant level of estimation and uncertainty and that have had or are reasonably likely to have a material impact on the financial condition or results of operations." Both quantitative and qualitative information must be analyzed and disclosed if material and, if material and reasonably available, the company must explain "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."

> Tips & Takeaways: Have support for materiality judgments made in preparing your Form 10-K, which may be second-guessed by SEC staff. As discussed further below, the SEC staff may ask for management's Staff Accounting Bulletin No. 99 analysis supporting the company's materiality judgments. Sensitivity analyses also may be requested with respect to the now-mandatory CAE disclosures.

Turning next to the changes to S-K rules regarding selected financial data and supplementary financial information, the amended rules:

- Dispense entirely with disclosure of comparative selected financial data for each of the last five fiscal years (with companies marking Part II, Item 6 of Form 10-K as "Reserved"). Material trend information that predates the periods presented in the financial statements nevertheless should be disclosed in order to promote investors' understanding of financial condition and results of operations.
- Replace the formerly required two years of tabular selected quarterly financial data with disclosure of certain material quarterly retrospective changes that pertain to the statement of comprehensive income. Explain the reasons for material changes and disclose summarized financial information for each affected quarterly period and the fourth quarter of the affected year.

Evolving COVID-19 Disclosures

- Companies must continue to disclose the effects and risks of COVID-19 on their businesses, financial condition and results of operation. The disclosure should reflect the changing circumstances and uncertainties as the impact of COVID-19 evolves over time. For example, evolving topics have included impacts of vaccine mandates and supply chain shortages, COVID-19 recovery, variant disclosures and a return to remote work.
- For the most part, companies have not and should not have excluded the impact of COVID-19 from their GAAP measures. To the extent exclusion would be appropriate, be mindful of non-GAAP considerations discussed below.

> Tips & Takeaways: In June and March of 2020, the SEC staff raised questions for management to consider in preparing disclosure of the impact of COVID-19, which are still very useful. See CF Disclosure Guidance: Topic Nos. 9A, here, and 9, here.

Disclosures around “spring loading” or equity grants while aware of material non-public information (MNPI)

- New Staff Accounting Bulletin No. 120 requires certain disclosures in MD&A (and financial statement footnotes) regarding the estimation of the fair value of equity grants made when the company or its insiders are aware of MNPI. For example, at a minimum, a company that has granted options or other securities tied to the company’s common stock while aware of MNPI must determine whether its evaluation of factors, such as consideration of future events in estimating expected volatility, resulted in an estimate that involves a significant level of estimation uncertainty and has had or is reasonably likely to have a material impact on the financial condition or results of operations of the company.
- While the focus of SAB 120 is on MNPI regarding future positive changes in a company’s stock price, the concepts in the SAB could just as easily be applied to future release of negative market news that might drive down the stock price.

Tips & Takeaways: While the example above and in the SAB dealt with stock options, the SEC staff noted in a footnote of the SAB that the guidance is not limited to stock options and applies to all instruments including, for example, restricted stock units.

ESG Disclosures

Because ESG-related disclosure is front and center for the SEC, careful drafting of required 10-K disclosures in this broad area is critical. Below, we use three examples of environmental, social and governance matters that are likely to be the focus of SEC staff comment and/or enforcement actions.

Example of “E” in “ESG” – Climate Change

Corporate employees preparing the 2021 Form 10-K for filing should keep in mind existing SEC rules requiring climate change disclosure, even as the agency considers expanding or otherwise modifying those rules in 2022 via the rulemaking process. In September 2021, for example, the Division of Corporation Finance published a Sample Comment Letter, highlighting comments addressing the following disclosure topics drawn from a 2010 SEC Interpretive Release:

- the impact of pending or existing climate-change related legislation, regulations and international accords;
- the indirect consequences of regulation or business trends; and
- the physical impacts of climate change

Specific potential disclosure targets described in the Sample Letter are: (1) General – explain the differences between climate-related disclosures made in CSR reports vs. those in SEC filings; (2) Risk Factors (such as material effects of material litigation risks or transition risks, such as policy and regulatory changes, market trends, credit risks or technological changes); and (3) MD&A, such as:

- material pending or existing climate change-related legislation, regulations and international accords and any material effect on the business, financial condition and results of operations;
- material past and/or future capital expenditures for climate-related projects – to be quantified, if material; and
- the indirect consequences of climate-related regulation or business trends (with specific examples included in the Sample Comment Letter, e.g. decreased demand for goods or services that produce significant greenhouse gas emissions or are related to carbon-based energy sources).

Tips & Takeaways: If a company responds to an SEC staff comment on climate change by stating that climate change risks are not material to the company, it should be prepared for more comments asking for support; that is, consistent with our discussion below of the staff asking for SAB 99 memos in other contexts, the staff is unlikely to accept a conclusory response regarding materiality without delving further into the company's analysis.

Although not mentioned in the Sample Letter, companies also should consider the impact of ESG on the financial statements. In a March 2021 White Paper, FASB pointed out that ESG factors can have a direct impact (e.g. recognition and measurement of compensation expense); indirect effect (e.g. reputational damage from environmental contamination that results in reduced sales); or be an input into an accounting analysis (e.g. material impairment of long-lived asset or goodwill). The White Paper included many examples of these impacts, but we present just a few below:

- Going Concern: increased costs related to enacted emission regulations
- Inventory: regulatory change that renders inventories obsolete; a significant weather event that causes a physical change to inventories; an increase in completion costs because of raw material sourcing constraints
- Impairment: changes in hazardous waste management regulations

Beware of the possibility that, depending on the particular facts and circumstances, the Division of Corporation Finance might share information gathered during the staff review and comment on a company's Form 10-K with members of the Climate & ESG Task Force in the Enforcement Division. Formed in early March 2021, the task force has been charged with identifying material misstatements or omissions that appear in public company filings.

Example of "S" in "ESG" – Human Capital

Corporate personnel now drafting the business description section of Form 10-K should keep in mind that disclosure is required of certain workforce-related matters in addition to the number of employees, collectively referred to as human capital management (HCM) in the SEC's adopting release. Because the SEC has not yet defined this term, companies have taken a variety of approaches to compliance in 2021 that may offer useful guideposts to drafters of the 2021 Form 10-K due this year. According to a survey of Form 10-K's filed in 2021, available here, the following categories of information – both quantitative and qualitative – were disclosed: geographic distribution of workforce; turnover and attrition; diversity; hiring and promotion practices; health and safety; leadership development; compensation and benefits; COVID-19 health measures; talent development; pay equity; engagement; collective bargaining agreements; and principles and values.

Tips & Takeaways: On August 18, 2021, SEC Chair Gary Gensler tweeted that the next human capital rulemaking project could include a number of metrics, such as workforce turnover, skills and development training, compensation, benefits, workforce demographics including diversity, and health and safety. No timeline has been set to date for this project in the agency's latest rulemaking agenda, available here.

Example of "G" in "ESG" – Oversight of Cybersecurity Disclosure

- Drafters of this year's Form 10-K should pay careful attention to the 2018 Interpretive Release and the Division's tips on compliance to prepare meaningful cybersecurity disclosure that satisfies the federal securities laws. This is particularly critical in this era of ransomware, industrial espionage and a COVID-19 surge induced return to remote work. It is important not to couch these risk factors in terms of "vulnerabilities" (e.g. "we may experience breaches") when a company already has experienced a breach that must be assessed for materiality. It is also important to cover in a company's risk factor those risks resulting from storage of data in the cloud as well as outsourcing to third parties.
- Should a cyber-breach occur despite the company's best prevention efforts, there should be effective procedures in place to ensure timely transmission of this information from the employees who detect the breach to the senior management personnel ultimately responsible for making tough materiality and disclosure decisions on behalf of the company. The trading window likely should be shut down while materiality of the breach is being assessed by responsible members of management.

Tips & Takeaways: Careful drafting of ESG disclosure is necessary and lessons can be gleaned from our observations of court decisions. Courts generally have found aspirational statements, using such words as "expected to" or "designed to," to not be actionable (unless allegations are directly at odd with statements). However, courts generally have found actionable statements (i) made to assure investors that nothing is wrong (such as in response to a controversy); (ii) that are repeated and/or touted; (iii) on subjects that are core to a company's business; and (iv) that are objectively verifiable. Please note that, while these observations may prove useful, this is an evolving area of law and context is key.

Areas of SEC Accounting-Related Interest

During the December 2021 AICPA & CIMA Conference, the SEC's senior accounting staff outlined their views on a wide variety of financial reporting topics in written and oral remarks that offer helpful insights into the staff's thinking in the event a company's Form 10-K or other 2022 filing is selected for review and comment. We address below four accounting-related topics that members of the staff of the Office of the Chief Accountant and the Division of Corporation Finance highlighted at the conference: (1) use of non-GAAP financial measures and key performance indicators; (2) segments; (3) the demise of LIBOR; and (4) the correction of material errors in the financial statements via restatement.

Non-GAAP Financial Measures and Key Performance Indicators

SEC staffers continue to focus on three areas in particular relating to the use of non-GAAP financial measures: failure of companies to make GAAP measures more prominent than non-GAAP measures; mislabeling of non-GAAP measures; and confusing non-GAAP financial measures with key performance indicators. Tips on dealing with these issues drawn from staff remarks and relevant compliance and disclosure interpretations, available here, are as follows:

- ***Prominence:*** Emphasize to your company's in-house financial reporting team that GAAP should be the focal point of your disclosure. Re-familiarize yourself with the SEC's non-GAAP compliance and disclosure interpretations. A lack of prominence is problematic – and potentially misleading – even when a corresponding GAAP measure is presented but overshadowed by the non-GAAP measure. Reconciliations of non-GAAP measures must give equal or greater prominence to the most directly comparable GAAP measure.

- ***Mislabeling:*** Review non-GAAP measures to ensure that the title and any relevant description of why management believes it is useful align with the nature of the adjustment(s) made to GAAP. For example, "core earnings" is an inappropriate title when the adjustment is material costs of revenue or other business operation expenses, such as a bank excluding the provision for loan losses. Additionally, a lack of transparency regarding the actual adjustments made may cause similarly titled non-GAAP measures to vary greatly among companies.
- ***Distinguishing between measures and metrics:*** Provide the appropriate description of a measure or metric and the related disclosures. Both non-GAAP measures and metrics must be used consistently inside and across SEC filings, and companies must maintain effective disclosure controls and procedures and internal control over financial reporting surrounding their use. For help in distinguishing between non-GAAP measures and key performance indicators or metrics, we suggest reviewing the SEC's 2020 interpretive guidance, available here.

LIBOR Transition

In a December 7, 2021 Statement, available here, the SEC staff reminded companies that, at a minimum, disclosure should inform investors about material anticipated impacts of the LIBOR transition throughout the Form 10-K disclosure, including sections titled MD&A, Risk Factors, Qualitative & Quantitative Disclosures on Market Risk and Financial Statements, cross-referencing between various parts of the 10-K to each place LIBOR is discussed, and that companies should consider showing more recent impacts in a Recent Developments section. Specifically, the SEC staff suggested the following disclosures relating to the end of LIBOR on December 31, 2021:

- Notional value of contracts referencing LIBOR extending past December 31, 2021 or June 30, 2023, as applicable
- Steps company is taking to address LIBOR exposure (risk identification and mitigation), such a renegotiating contracts or refinancing the obligations
- Significant matters yet to be addressed (avoiding boilerplate and focusing on company specific disclosure)
- Timeline for further efforts
- Impact of transition efforts on the company

Segment Reporting

The SEC accounting staff continues to monitor management's segment reporting, paying close attention to identification of operating segments and how they are aggregated. In this connection, the staff looks at the information that the chief operating decision maker considers and may compare what company representatives say about the performance of the company's lines of business on earnings calls with the disclosure appearing in SEC filings for the relevant period. At the AICPA & CIMA Conference, senior accounting staff noted that this should be an evolving process depending on the relevant facts and circumstances, which could run the gamut from significant acquisitions or dispositions to changes in the organization or its leadership. Be on the lookout for upcoming new disclosure requirements to be adopted by FASB relating to segment expenses.

Restatements

Qualitative factors may not be sufficient to overcome materially large quantitative factors

As the SEC's Acting Chief Accountant Paul Munter pointed out in written remarks to the AICPA & CIMA Conference: "If an error is identified in the financial statements, management must determine whether the error is material based on what is important to the user" in accordance with Staff Accounting Bulletin No. 99. Division of Corporation Finance Chief Accountant Lindsay McCord separately elaborated on Mr. Munter's message, citing two specific situations involving large quantitative errors spotted by the staff during this year's review and comment process. Each issuer had argued that qualitative factors served essentially to counter the materiality of large quantitative errors for SAB 99 analytical purposes. Ms. McCord said that while qualitative factors could be relevant to the SAB 99 analysis depending on the surrounding facts and circumstances, the Division's staff had rejected each issuer's argument that, due to the passage of time, current investors would not find material large numerical errors in the historical financial statements. She explained that this was contrary to what the staff has heard from investors themselves. After evaluating the total informational mix in light of each issuer's SAB 99 assessment, the staff determined that qualitative factors were not sufficient to overcome the materiality of the large quantitative accounting errors. Ms. McCord further indicated that the staff had requested copies of each issuer's SAB 99 memo, which you should anticipate if the Division staff selects your company's 2021 10-K for review/comment in 2022.

A material restatement often leads to a material weakness in internal control over financial reporting

Ms. McCord went on to echo Mr. Munter's linkage of restatements to disclosure of a material weakness in internal control over financial reporting (ICFR). The stakes of mischaracterizing a control deficiency in a 10-K or other SEC filing are high because the financial information contained in such reports is subject to certification by each of the CEO (PEO) and CFO (PFO) under Sarbanes Oxley. As Mr. Munter observed (emphasis added):

> "We also emphasize the importance of identifying and communicating material weaknesses in ICFR **before** they become evident in the form of a restatement and reissuance [of historical financial statements]. We encourage ongoing attention, including audit committee participation, regarding the adequacy of and basis for a company's effectiveness assessments, particularly where there are 'close calls' in the assessment of whether a deficiency is a significant deficiency (and reported to the audit committee) or a material weakness (and also reported to investors)."

Conclusion

The SEC through its various pronouncements has commanded companies to connect the dots, for disclosure purposes, between costs, impacts, risks, opportunities and liabilities that flow through the various sections of the Form 10-K. As you work on your drafting assignments, keep the lines of communication open between and among those handling the financial statement, risk factor and MD&A disclosure – as well as those personnel drafting disclosure that will be incorporated by reference from the proxy statement into Part III of the Form 10-K – to ensure that the full story is told in your annual report. Consistency in how your company tells its story within and outside the four corners of your SEC filings is also important. Finally, buckle your seat belts as we expect more prescriptive rules in the future based on the SEC's ambitious rulemaking agenda for 2022.

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