CLIENT ALERT

SEC Adopts MD&A Amendments that Continue Shift to Principles-Based Disclosure

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AUTHOR

Jeffrey S. Hochman

As part of a flurry of recent activity prior to the upcoming change in administration, last week the Securities and Exchange Commission adopted changes to the rules governing Management's Discussion and Analysis ("MD&A") and certain related financial disclosures.[1] The amendments, which were adopted largely as proposed,[2] seek to improve the quality and readability of financial information through the enhancement of MD&A disclosures and the deletion of duplicative disclosures, while simplifying registrants' compliance efforts. The amendments also include parallel changes for foreign private issuers ("FPIs").

The amendments, part of the SEC's disclosure modernization program, incorporate, to a great extent, existing SEC guidance and move the SEC disclosure regime further toward a principles-based approach for MD&A. In guidance[3] that was released with the initial proposal, the SEC noted that it had previously emphasized that a registrant should focus on

[1] *See* SEC Release No. 33-10890, *Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information* (November 19, 2020), available here.

[2] *See* SEC Release No. 33-10750, *Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information* (January 30, 2020), available here, and our related client memorandum *SEC Proposes MD&A Amendments that Continue Shift to Principles-Based Disclosure* (February 6, 2020), available here.

[3] *See* SEC Release No. 33-10751, *Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations* (January 30, 2020), available here.

"disclosure of all key variables and other factors that management uses to manage the business" and provide a narrative that "enables investors to see the company 'through the eyes of management.'"[4]

Consistent with this principles-based approach, no new specific disclosure requirements regarding the impact of climate change were adopted; as Director of the Division of Corporation Finance William Hinman recently noted, "I believe that our principles-based requirements, which articulate an objective and allow companies to satisfy the objective by providing disclosure appropriately tailored to their facts and circumstances, in most cases are the ones that provide investors with the most meaningful information."[5] However, Commissioners Caroline A. Crenshaw and Allison Herren Lee, while supporting many of the changes, dissented from the final rule, objecting, in particular, to the amendments' complete failure to address climate risk, relying instead solely on the principles-based approach, as well as opposing the elimination of the contractual obligations table (discussed below).[6]

Attached to this memorandum as Annex A is an outline of the amendments; the significant changes are summarized below.

Effective Date; Transition Period

The amendments become effective 30 days after publication in the Federal Register. Registrants will be required to follow the amended rules for their first fiscal year ending on or after the date 210 days after publication in the Federal Register (the "mandatory compliance date"), or in their annual report for the year ending December 31, 2021 for calendar-year companies. Registrants will be required to apply the amended rules in a registration statement or prospectus that on its initial filing date is required to contain financial statements for a period on or after such mandatory compliance date. Although registrants will not be required to apply the amended rules until their mandatory compliance date, they may voluntarily provide disclosure consistent with the amendments any time following the effective date, so long as they provide disclosure responsive to an amended item in its entirety.

Item 301, Selected Financial Data

Item 301 of Regulation S-K currently requires registrants to furnish selected financial data in comparative tabular form for each of the registrant's last five fiscal years, including, for example, net sales or revenues, income (loss) from continuing operations and total assets. The amendments delete Item 301 in its entirety as duplicative of the information readily available in the financial statements. However, the SEC reminds registrants that a tabular presentation of the relevant financial information, particularly as part of an introductory section or overview, still may be useful in discussing material trends required in MD&A under Item 303.

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4 *See also* SEC Release No. 33-8350, *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations* (December 19, 2003), available here.

5 *See The Regulation of Corporate Finance – A Principles-Based Approach*, William Hinman, Director, Division of Corporation Finance (November 18, 2020), available here.

6 *See Joint Statement on Amendments to Regulation S-K: Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information,* Commissioners Caroline A. Crenshaw and Allison Herren Lee (November 19, 2020), available here.

Item 302(a), Supplementary Financial Information

Item 302(a) currently requires disclosure of selected quarterly financial data and variances in these results from the amounts previously reported in a registrant's Form 10-Q. As most of the financial data can be found in (or calculated from) prior periodic reports, the SEC has largely eliminated this requirement. Registrants will now be required to disclose selected quarterly financial data *only* when there are retrospective changes that pertain to the statements of comprehensive income, for any quarters within the two most recent fiscal years and any subsequent interim period for which financial statements are included, that are material in the aggregate. Registrants will be required to provide an explanation of the reasons for such material changes and the earnings per share reflecting such changes.

Item 302(b), Information about Oil and Gas Producing Activities

Item 302(b) requires disclosures regarding oil and gas producing activities. U.S. GAAP currently mandates similar disclosures, which are proposed to be expanded to include the period-specific disclosures required by Item 302(b). The SEC had proposed to eliminate Item 302(b), subject to this proposed amendment to U.S. GAAP being adopted. As the U.S. GAAP amendment has not yet been adopted, the SEC has retained Item 302(b) in the final rule, but may reconsider the proposal in the future.

Item 303, Management's Discussion and Analysis of Financial Condition and Results of Operations

The amendments reorganize Item 303 of Regulation S-K and streamline its requirements in order to "enhance the MD&A disclosures for investors while reducing the compliance burdens for registrants." Instruction 4 to Item 303(a) has been amended to clarify the requirement for a broader discussion of the "reasons underlying" material changes between periods for line items in both quantitative and qualitative terms, as opposed to only noting the "causes" of such changes. The revised instructions also explicitly require that registrants discuss material changes, even if they offset each other within a line item.

The changes also include:

Objective of MD&A

Item 303(a) has been amended to clearly set forth the objective of MD&A, incorporating existing instructions and previous SEC guidance. As stated in new Item 303(a), the purpose of MD&A is for a registrant to "provide a narrative explanation of its financial statements that enables investors to see a registrant 'through the eyes of management.'" In the SEC's view, this principles-based guidance is the best way to elicit disclosure about complex and often rapidly evolving areas, without imposing bright-line requirements that may require frequent updating.

Under Item 303(a), a registrant should disclose in its MD&A:

- Material information relevant to an assessment of its financial condition and results of operations, including an evaluation of the amounts and certainty of cash flows from operations and from outside sources.

- Material events and uncertainties known to management that are reasonably likely to cause reported financial information not to be indicative of future operating results or of its future financial condition. This includes descriptions and amounts of matters that have had a material impact on reported operations as well as matters that are reasonably likely, based on management's assessment, to have a material impact on future operations.
- The material financial and statistical data that it believes will enhance a reader's understanding of its financial condition, cash flows and other changes in financial condition, and results of operations.

These new objectives "emphasize a registrant's future prospects and highlight the importance of materiality and trend disclosures to a thoughtful MD&A." The SEC advises registrants to regularly revisit these objectives in Item 303(a) as they prepare their MD&A and consider ways to enhance the quality of the analysis provided.

Capital Expenditures

Current Item 303(a)(2) requires a registrant to discuss material commitments for capital expenditures as of the end of the latest fiscal period, the purpose of such commitments and the source of funds to fulfill them. Material trends related to a registrant's capital resources are also required to be discussed. Given the importance of capital resources to a company's prospects, the SEC amended Item 302(a)(2) to require that registrants "broadly disclose material cash commitments, including but not limited to capital expenditures" and specifically, their material cash requirements. The SEC noted that it left "capital resources" undefined to preserve flexibility for tailored, business-specific discussion of the topic.

Results of Operations

The SEC has amended Item 303(a)(3)(ii) to require disclosure of events that are ***reasonably likely*** to cause a material change in the relationship between costs and revenues, from the current standard of those that ***will*** cause such a change. Item 303(a)(3)(iii) has also been clarified to require disclosures for material ***changes*** in net sales or revenues instead of just material ***increases***. The express requirement in Item 303(a)(3)(iv) and related instructions to disclose the impact, to the extent material, of changing prices or inflation on a registrant's information have been dropped so as not to give undue attention to this specific (somewhat vestigial) issue, instead relying on the principles-based requirement to discuss material trends, if applicable.

Off-Balance Sheet Arrangements

Instead of the current separately captioned requirement for a discussion of off-balance sheet arrangements under Item 303(a)(4), the SEC has added a new principles-based instruction to Item 303(b) that requires a registrant to discuss commitments or obligations (including contingent obligations) arising from arrangements with unconsolidated entities that have, or are reasonably likely to have, a material effect on a registrant's financial condition or results. The SEC notes that this new instruction enhances the existing requirement in Item 302(a) "that specifically requires consideration of off-balance sheet financing arrangements as part of the capital resources discussion," resulting in greater integration of these arrangements with the broader MD&A disclosure of liquidity and capital resources.

Contractual Obligations Table and Material Cash Requirements

The SEC has eliminated the current requirement under Item 303(a)(5) to include a table summarizing the registrant's contractual obligations, including payments due and time periods. The SEC noted that much of such information currently required to be presented overlaps with U.S. GAAP and other disclosure requirements under Regulation S-K. However, in response to comments received, the SEC also amended Item 303(b) to specifically require disclosure of material cash requirements from known contractual and other obligations as part of the liquidity and capital resources discussion. The changes to Item 303(b), among other things, (x) specifically require discussion of material cash requirements and obligations on both a short-term and long-term basis, (y) include a new instruction that describes what types of contractual obligations such discussions might include and (z) include an additional instruction stating that "analysis of Item 303(b) should be in a format that facilitates easy understanding and does not duplicate disclosure already provided in [a] filing."

Critical Accounting Estimates

In previous guidance, the SEC reminded registrants that they should address material uncertainties associated with the methods, assumptions and estimates underlying their critical accounting measurements.[7] New Item 303(b)(3) expressly requires disclosure of critical accounting estimates.

Under Item 303(b)(3), critical accounting estimates are defined as "estimates made in accordance with generally accepted accounting principles that involve a significant level of estimation uncertainty and have had or are reasonably likely to have a material impact on the registrant's financial condition or results of operations." As stated in a related instruction, this disclosure of critical accounting estimates is intended to supplement, but not duplicate, the description of accounting policies contained in the financial statements.

For each critical accounting estimate, a registrant must disclose, to the extent material:

- why the estimate is subject to uncertainty;
- how much each estimate has changed during the relevant period; and
- the sensitivity of the reported amounts to the material methods, assumptions and estimates underlying the estimate's calculation.

The SEC further noted that, despite some overlap, the requirement to disclose critical accounting estimates should not be conflated with the discussion of critical audit matters ("CAMs")[8] required in auditor reports, which commenced this year for large accelerated filers (and will be required in the upcoming Form 10-K for most other companies other than emerging growth companies).

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[7] *See* SEC Release No. 33-8040, *Cautionary Advice Regarding Disclosure* (December 12, 2001), available here. The proposed rules requiring this disclosure of critical accounting estimates were never adopted. *See* SEC Release No. 33–8098, *Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies* (May 10, 2002), available here.

[8] For more information on CAMs, see our client memorandum *Preparing Your Form 10-K – 2019 Updates* (January 2, 2020), available here.

Interim Period Comparisons

Item 303(b) has been amended to provide registrants with the flexibility to compare the most recently completed quarter to ***either*** the corresponding quarter of the prior year (as is currently required) or the immediately preceding quarter. If a registrant decides to discuss changes as compared to the immediately preceding quarter, it must include the prior quarter's summary financial information or, alternatively, reference the EDGAR filing that presents such previous quarter information. If it decides to change the manner of quarterly comparison from that in the previous interim comparison, it has to disclose the rationale for the change and present both comparisons in the filing where the change is disclosed.

Form 20-F and Foreign Private Issuers

Corresponding changes for FPIs as they relate to Form 20-F were also adopted. Most of the above-described amendments to Regulation S-K similarly apply to FPIs, except that the specific requirement to disclose any material impact of inflation on an FPI's financial statements (and similar disclosure regarding hyperinflation, if applicable) has been retained.

If you have any questions regarding this client alert, please contact the following attorney or the Willkie attorney with whom you regularly work.

Jeffrey S. Hochman
212 728 8592
jhochman@willkie.com

Annex A
SEC Summary of MD&A Amendments

Current Item or Issue	Summary Description of Amendments	Principal Objective(s)
Item 301, *Selected financial data*	• Registrants will no longer be required to provide 5 years of selected financial data.	• Modernize disclosure requirement in light of technological developments and simplify disclosure requirements.
Item 302(a), *Supplementary financial information*	• Registrants will no longer be required to provide 2 years of selected quarterly financial data. The item will be replaced with a principles-based requirement for material retrospective changes.	• Reduce repetition and focus disclosure on material information. Modernize disclosure requirement in light of technological developments.
Item 303(a), *MD&A*	• Clarify the objective of MD&A and streamline the fourteen instructions.	• Simplify and enhance the purpose of MD&A.
Item 303(a)(2), *Capital resources*	• Registrants will need to disclose material cash requirements, including commitments for capital expenditures, as of the latest fiscal period, the anticipated source of funds needed to satisfy such cash requirements, and the general purpose of such requirements.	• Modernize and enhance disclosure requirements to account for capital expenditures that are not necessarily capital investments.
Item 303(a)(3)(ii), *Results of operations*	• Registrants will need to disclose known events 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 or price increases or inventory adjustments.	• Clarify item requirement by using a disclosure threshold of “reasonably likely,” which is consistent with the SEC’s interpretative guidance on forward-looking statements.
Item 303(a)(3)(iii), *Results of operations*	• Clarify that a discussion of *material changes* in net sales or revenues is required (rather than only material *increases)*.	• Clarify MD&A disclosure requirements by codifying existing SEC guidance.
Item 303(a)(3)(iv), *Results of operations* **Instructions 8 and 9 (Inflation and price changes)**	• The item and instructions will be eliminated. • Registrants will still be required to discuss these matters if they are part of a known trend or uncertainty that has had, or the registrant reasonably expects to have, a material favorable or unfavorable impact on net sales, or revenue, or income from continuing operations.	• Encourage registrants to focus on material information that is tailored to a registrant’s businesses, facts, and circumstances.
Item 303(a)(4), *Off-balance sheet arrangements*	• The item will be replaced by a new instruction added to Item 303. • Under the new instruction, registrants will be required to discuss commitments or obligations, including contingent obligations, arising from	• Prompt registrants to consider and integrate disclosure of off-balance sheet arrangements within the context of their MD&A.

Current Item or Issue	Summary Description of Amendments	Principal Objective(s)
	arrangements with unconsolidated entities or persons that have, or are reasonably likely to have, a material current or future effect on such registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, cash requirements, or capital resources even when the arrangement results in no obligation being reported in the registrant's consolidated balance sheets.	
Item 303(a)(5), *Contractual obligations*	• Registrants will no longer be required to provide a contractual obligations table.	• Promote the principles-based nature of MD&A and simplify disclosures by reducing redundancy.
Instruction 4 (Material changes in line items)	• Incorporate a portion of the instruction into proposed Item 303(b). Clarify that where there are material changes in a line item, including where material changes within a line item offset one another, disclosure of the underlying reasons for these material changes in quantitative and qualitative terms is required.	• Enhance analysis in MD&A. Clarify MD&A disclosure requirements by codifying existing SEC guidance on the importance of analysis in MD&A.
Item 303(b), *Interim periods*	• Registrants will be permitted to compare their most recently completed quarter to either the corresponding quarter of the prior year or to the immediately preceding quarter. Registrants subject to Rule 3-03(b) of Regulation S-X would be afforded the same flexibility.	• Allow for flexibility in comparison of interim periods to help registrants provide a more tailored and meaningful analysis relevant to their business cycles.
Critical Accounting Estimates	• Registrants will explicitly be required to disclose critical accounting estimates.	• Facilitate compliance and improve resulting disclosure. Eliminate disclosure that duplicates the financial statement discussion of significant policies. Promote meaningful analysis of measurement uncertainties.