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SEC amends rules to modernize MD&A and other financial disclosures

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On November 19, 2020, the U.S. Securities and Exchange Commission (SEC) adopted amendments intended to modernize and enhance Management's Discussion and Analysis (MD&A) and other financial disclosure requirements. The amendments to Regulation S-K, which are a further step in the SEC's Disclosure Effectiveness Initiative, reflect the same principles-based, company-specific approach to disclosure seen in other recent amendments to Regulation S-K. The amendments are intended to improve disclosure by enhancing its readability, discouraging repetition, and eliminating immaterial information.

More specifically, the amendments eliminate the requirement for Selected Financial Data, streamline the requirement to disclose Supplementary Financial Information, and update MD&A requirements to reduce duplicative disclosures and codify certain existing SEC guidance.

Selected Financial Data (Item 301)

The amendments eliminate Item 301 of Regulation S-K, which requires companies to furnish selected financial data in comparative tabular form for each of the company's last five fiscal years and any additional fiscal years necessary to keep the information from being misleading. While acknowledging concerns expressed by some commenters that the elimination would have a negative impact on trend disclosure, the SEC noted that elimination of this requirement will reduce duplicative disclosures because such historical financial information is readily available through prior filings in the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. In addition, Item 303 requirements for MD&A, as discussed below, should continue to elicit material trend disclosure. However, where a company determines that inclusion of historical financial information for periods preceding those included in the financial statements of a particular filing is advisable or would be useful to investors, it will want to consider presenting such information in tabular format in the introductory or overview section of MD&A.

Supplementary Financial Information (Item 302)

Current Item 302(a) of Regulation S-K requires certain companies to disclose (i) selected financial data for each quarter of the last two completed fiscal years and any subsequent interim period, and (ii) variances of those results from amounts previously reported on Form 10-Q. Instead of eliminating Item 302(a) as proposed, the amendments adopt a principles-based approach and streamline its requirements to require disclosure only when there is one or more retrospective change (such as correction of an error, disposition of a business that is accounted for as a discontinued operation, reorganization of entities under common control, or change in an accounting principle) that pertain to a company's statements of comprehensive income for any of the quarters within the two most recent fiscal years and any subsequent interim period for which financial statements are included or required to be included by Article 3 of Regulation S-X, and that, individually or in the aggregate, are material. Amended Item 302(a) also requires disclosures of an explanation of the reasons for the material retrospective changes and provides certain summarized financial information for each affected quarterly period and the fourth quarter in the affected year.

The affected quarters may include, depending on the facts and circumstances, a single quarter in which the material retrospective change applies or may flow through to subsequent quarters during the relevant look-back period. The amended Item 302(a) will refer to amended Rule 1-02(bb)(ii) of Regulation S-X for summarized financial information related to the statements of comprehensive income, providing companies flexibility in the line items presented.

The amendments retain Item 302(b) of Regulation S-K, disclosure of oil-and-gas–producing activities, but the SEC may reconsider its elimination in the future if the Financial Accounting Standards Board finalizes amendments to U.S. GAAP that would require incremental disclosure called for by Item 302(b).

Management's Discussion and Analysis (Item 303)

Item 303 of Regulation S-K requires disclosure of information relevant to assessing a company's financial condition, changes in financial condition, and results of operations. The amendments to Item 303 include these updates: (1) adding a new statement of the principal objectives of MD&A disclosure and streamlining instructions; (2) clarifying that MD&A requires a narrative discussion of the "reasons underlying" material changes; (3) amending the current disclosure requirements for liquidity and capital resources and results of operations; (4) adding a new requirement to provide disclosure regarding critical accounting estimates disclosures; (5) replacing current disclosure requirements for off-balance sheet arrangements with an instruction to include relevant discussion of such obligations within MD&A; (6) eliminating the currently required tabular disclosure of contractual obligations; and (7) amending the current disclosure requirements for interim period reporting to allow greater flexibility in the comparison of interim periods.

Objectives of MD&A

New Item 303(a) provides a broad statement of the SEC's views of the purpose of MD&A and calls for the following disclosure to better allow investors to view the company from management's perspective:

- Material information relevant to assessing the financial condition and results of operations of the company, including an evaluation of the amounts and certainty of cash flows from operations and 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 future financial condition, including descriptions and amounts of matters that have had a

material impact on reported operations, as well as matters that are reasonably likely to be based on management's assessment to have a material impact on future operations; and

— Material financial and statistical data that the company believes will enhance a reader's understanding of the company's financial condition, cash flows, and other changes in financial condition and results of operations.

These objectives, which "emphasize a registrant's future prospects and highlight the importance of materiality and trend disclosures to a thoughtful MD&A," apply throughout amended Item 303. The SEC encouraged companies to revisit these objectives regularly to provide enhanced analysis in MD&A disclosure that encompasses short-term results, as well as future prospects, as seen from the eyes of management.

Reasons underlying Material Changes; Segment Information

In light of the addition of the objective statement in new Item 303(a), current Item 303(a) becomes new Item 303(b) and is amended to clarify that MD&A requires a narrative discussion of the "reasons underlying," rather than "causes for," material changes, even when material changes within a line item offset each other. These underlying reasons for material changes must be in quantitative and qualitative terms. The SEC noted that despite specific instructions in the current rules, the MD&A discussion should not merely repeat numerical data contained in the consolidated financial statements, many companies simply recite the amounts of changes from year to year that are readily available from their financial statements. The intent of amended Item 303(b) is to encourage companies to provide a more meaningful discussion of the underlying reasons that may be contributing to material changes in line items.

Current Item 303(a) also requires companies to focus on each relevant "reportable" segment and/or other subdivision when a discussion of segment information and/or other subdivision is appropriate to an understanding of such business, in the company's judgment. The amendments require companies to focus the discussion and analysis on each reportable segment and/or other subdivision (such as geographic areas and product lines), as well as on the company as a whole.

Additionally, consistent with a materiality-focused, principles-based approach to disclosure, amended Item 303(a) updates disclosure requirements for liquidity and capital resources, results of operations, off-balance sheet arrangements, and contractual obligations, as further discussed below.

Liquidity and Capital Resources

Codifying the SEC's 2003 MD&A Interpretive Release, the amendments to current Item 303(a)(2), renumbered as Item 303(b)(1), specify that a company should describe its material cash requirements, including but not limited to commitments for capital expenditures as of the end of the latest fiscal period, the anticipated source of funds needed to satisfy such cash requirements, and the general purpose of such requirements. The SEC does not expect that companies would have to deviate substantially from current practices of assessing material cash requirements because the amendments reflect current SEC guidance and resulting disclosure practices.

Results of Operations — Known Trends or Uncertainties

The amendments provide that when a company knows of 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 increase in costs of labor or materials or price increases or inventory adjustments, the reasonably likely change must be disclosed.

The SEC emphasizes in the adopting release that the forward-looking threshold of "reasonably likely" applies throughout Item 303, and whether a matter is "reasonably likely" to have a material impact on future operations is based on "management's assessment," consistent with the MD&A objectives in the new Item 303(a).

This "reasonably likely" threshold requires a thoughtful analysis that applies an objective assessment of the likelihood that an event will occur balanced with materiality analysis regarding the need for disclosure regarding such event. When applying this standard to known trends, demands, commitments, events, or uncertainties that management considers likely to come to fruition, companies should provide disclosure if that likely occurrence would reasonably be likely to have a material effect on the company's future results or financial condition. In cases of known trends, demands, commitments, events, or uncertainties where management cannot make an assessment as to the likelihood that they will come to fruition, and their occurrence would be reasonably likely to have a material effect on the company's future results or financial condition were they to come to fruition, companies should provide disclosure if a reasonable investor would consider omission of the information as significantly altering the mix of information made available in the company's disclosures. Disclosure of immaterial or remote future events is not required.

Results of Operations — Net Sales and Revenue

Codifying previous guidance, amended Item 303(a)(3)(iii), renumbered as Item 303(b)(2)(iii), clarifies that the results of operations discussion should describe not only the underlying reasons for material "increases" but also decreases in net sales or revenues attributable to changes in prices, the volume or amount of goods or services being sold, or the introduction of new products or services.

Results of Operations — Inflation and Price Changes

Current Item 303(a)(3)(iv) requires companies to discuss the impact of inflation and price changes on their net sales, revenues, and income from continuing operations for the three most recent fiscal years. The amendments eliminate this requirement and the corresponding instructions to encourage a focus on disclosure of material information in MD&A that is tailored to a company's facts and circumstances, and to avoid duplicative disclosure. However, under amended Item 303, companies will be required to discuss the impact of inflation or changing prices if these are part of a known trend or uncertainty that had, or is reasonably likely to have a material impact on net sales, revenue, or income from continuing operations.

Off-Balance Sheet Arrangements

To avoid duplicative disclosure and promote the principles-based nature of MD&A, the amendments replace the current prescriptive off-balance sheet arrangements disclosure requirement in Item 303(a)(4) with a new Instruction to Item 303(b) that requires companies to discuss commitments or obligations arising from arrangements with unconsolidated entities or persons that have or are reasonably likely to have, a material current or future effect on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, cash requirements, or capital resources. No longer required in a separately captioned section, the off-balance sheet arrangements disclosure is expected to be presented as a part of the capital resources discussion required by Item 303(b)(1), which specifically calls for consideration of off-balance sheet financing arrangements. Companies may continue to provide a separate discussion of off-balance sheet arrangements to the extent warranted to facilitate investors' understanding of such arrangements.

Contractual Obligations

The amendments eliminate current Item 303(a)(5), which requires companies to provide a table of contractual obligations arranged by type of obligation, overall payments due, and four prescribed periods. The SEC notes that this elimination will not result in a loss of material information to investors in light of the expansion of the liquidity and capital resources disclosure requirements, which include disclosure of material cash requirements from known contractual and other obligations.

Critical Accounting Estimates

Currently, the 2003 MD&A Interpretive Release requires companies to consider whether accounting estimates and judgments could materially affect reported financial information and disclose critical accounting estimates. The amendments add a new Item 303(b)(3), which is intended to codify and clarify the disclosure required under that guidance, eliminate disclosure that duplicates the financial statement discussion of significant accounting policies, and promote enhanced analysis of measurement uncertainties.

Focusing the definition of critical accounting estimates on estimation uncertainties, companies will be required under new Item 303(b)(3) to disclose for each critical accounting estimate, to the extent material, why the estimate is subject to uncertainty; how much each estimate or assumptions has changed during a relevant period; and the sensitivity of the reported amounts to the methods, assumptions, and estimates underlying the estimate's calculation. The discussion of critical accounting estimates should provide quantitative as well as qualitative information, to the extent such information is reasonably available and will provide material information to investors.

Interim Periods

Current Item 303(b) requires companies to provide MD&A disclosure discussing any material change (1) in financial condition from the end of the preceding fiscal year to the date of the most recent interim balance sheet and (2) in their results of operations for the most recent fiscal year-to-date period presented in their income statements, along with a similar discussion of the corresponding period from the previous fiscal year. If an income statement is provided for the most recent fiscal quarter, the discussion must cover material changes with respect to that fiscal quarter and the corresponding fiscal quarter in the previous fiscal year.

As amended and renumbered to be new Item 303(c), companies will still be required to discuss any material changes in financial condition from the end of the preceding fiscal year to the date of the most recent interim balance sheet and their results of operations for the most recent fiscal year-to-date interim period and the corresponding period of the preceding fiscal year. However, the new Item 303(c) interim period disclosure requirement will allow companies to compare their most recently completed quarter to either the corresponding quarter of the previous year *or* the immediately preceding quarter. If the comparison is to the immediately preceding quarter, the companies must provide summary financial information for that quarter or identify the EDGAR filings where the information is presented. In addition, companies will be required to not only explain the reasons for a change in comparison from prior periods but also to provide both comparisons when there is such a change. The SEC believes this will allow companies to provide a more tailored and meaningful analysis relevant to their specific business cycles while providing investors with material information to assess quarterly performance.

Smaller Reporting Companies

The amendments also eliminate current Item 303(d), which modifies the application to smaller reporting companies of the current inflation and changing price and contractual obligations disclosure obligations, since the underlying Regulation S-K items addressing these requirements are eliminated by the amendments. The SEC notes that smaller reporting companies are required to provide disclosure addressing liquidity and capital resources under the amended requirements, including disclosure of material cash requirements from known contractual and other obligations.

Conforming changes

The amendments make various conforming changes to rules that apply to foreign private issuers and other SEC rules, forms, and reports, including Item 914(a) of Regulation S-K; Regulation AB; Forms 20-F, 40-F, S-1, F-1, S-4, F-4; and Schedule 14A.

Transition

A company may voluntarily comply with the amended rules any time after 30 days after their publication in the *Federal Register*, as long as it complies with an amended item in its entirety. The mandatory compliance date for the amended rules is 210 days after their publication in the *Federal Register*, and compliance is required for the first fiscal year ending on or after the mandatory compliance date. Companies will be required to apply the amended rules in a registration statement and prospectus that, on its initial filing date, is required to contain financial statements for a period on or after the mandatory compliance date.

The full text of the amendments is available here. For more information on the content of this alert, please contact your Nixon Peabody attorney or:

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