

# Legal Update

## SEC Adopts Significant Changes to MD&A and Related Disclosures

On November 19, 2020, the US Securities and Exchange Commission (SEC) continued its recent efforts to modernize and simplify certain financial disclosure requirements in Regulation S-K by amending Item 303 of Regulation S-K (Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)) and revising or eliminating several other requirements of Regulation S-K.<sup>1</sup> The SEC adopted these changes "to eliminate duplicative disclosures and modernize and enhance MD&A disclosures for the benefit of investors, while simplifying compliance efforts for registrants." The amendments aim to provide investors with company-specific, tailored disclosure that will enable investors to see a company "through the eyes of management."

Over the past several years, the SEC has modernized, or proposed to modernize, several of its rules. The amendments further extend that effort to MD&A and certain related disclosure requirements in Regulation S-K.

### Effective and Compliance Dates

The amendments will become effective 30 days after they are published in the *Federal Register*. To allow companies adequate time to adjust their disclosures to the new requirements, the SEC is requiring compliance with the amendments beginning with the first fiscal year ending on or after the date that is 210 days after publication in the *Federal Register* (mandatory compliance date). Companies must 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. Companies may comply with the amendments any time after the effective date as long as they provide disclosure responsive to an amended item in its entirety.

### Changes to MD&A

The SEC made significant changes to MD&A by adding new requirements to Item 303, deleting some requirements, simplifying some of the instructions to Item 303 and revamping other requirements. The more significant changes to Item 303 of Regulation S-K include:

### ***New paragraph (a) – objective***

The SEC added a new paragraph (a) to Item 303 to clarify the objective of MD&A by incorporating much of current Instructions 1, 2 and 3 to the Item to emphasize the objective of MD&A for both full fiscal years and interim periods. According to the adopting release, disclosure responsive to this objective requirement generally is expected to better allow an investor to view the company from management's perspective. Current Items 303(a) and (b) have been recaptioned as Items 303(b) and (c), respectively.

### ***Changes to current Item 303(a) – full fiscal years – to be reflected in new Item 303(b)***

**Capital Resources.** The SEC has revised current paragraph (a)(2) to require companies to disclose material cash requirements, including commitments for capital expenditures, the anticipated source of funds needed to satisfy these cash requirements and the general purpose of the cash requirements, as now 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. The amendments also add product lines as an example of other subdivisions that may need to be discussed where necessary to understand a company's business.

**Results of Operations.** The SEC made three changes to current paragraph (a)(3) as now reflected in Item 303(b)(2)(ii). First, companies will be required 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. The change uses a disclosure threshold of "reasonably likely," which is consistent with the SEC's guidance on forward-looking statements. Second, companies will be required to disclose the reasons underlying material changes in net sales or revenues. The change codifies existing SEC MD&A guidance. Third, the SEC has eliminated current paragraph (a)(3)(iv) with regard to specific disclosure with respect to the impact of inflation and changing prices. Companies will still be required to discuss these matters if they are part of a known trend or uncertainty that has had, or is reasonably likely to have, a material impact on net sales or revenue. This will allow companies to focus on material disclosure that is tailored to their business, facts and circumstances.

**Off-Balance Sheet Arrangements.** The SEC eliminated current paragraph (a)(4) and replaced it 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. As a result of this change, companies should consider off-balance sheet arrangements within the broader context of their MD&A.

**Tabular Disclosure of Contractual Obligations.** The SEC eliminated this disclosure requirement currently in paragraph (a)(5). However, in a change from the proposal, the SEC amended Item 303(b) to specifically require disclosure of material cash requirements from known contractual and other obligations as part of a liquidity and capital resources discussion, in recognition of commenter concerns that such information may be lost with the elimination of Item 303(a)(5). The adopting release 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.”

**Material Changes in Line Items.** The SEC moved a portion of current Instruction 4 into new Item 303(b) to clarify that where there are material changes in a line item, including those that offset each other, disclosure of the underlying reasons for these material changes in quantitative and qualitative terms is required. The change codifies existing SEC MD&A guidance.

**Critical Accounting Estimates.** The SEC added a new paragraph (b)(4) to Item 303 to explicitly require disclosure of critical accounting estimates. This change is intended to codify existing SEC MD&A guidance, eliminate disclosure that duplicates the financial statement discussion of significant policies and promote enhanced analysis of measurement uncertainties. The rule directs companies to provide qualitative and quantitative information necessary to understand the estimation uncertainty and the impact the critical accounting estimate has had or is reasonably likely to have on financial condition or results of operations to the extent the information is material and reasonably available. This information should include why each critical accounting estimate is subject to uncertainty and, to the extent the information is 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. Notably, in a change from the proposal and in response to concerns of commenters that the proposed amendments could require disclosure that is not material, or is otherwise costly to prepare, new Item 303(b)(3) more clearly states that the “material and reasonably available” 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.”

#### ***Change to current Item 303(b) – quarterly periods – reflected in new Item 303(c)***

The SEC is allowing companies to compare their most recently completed quarter to either the corresponding quarter of the prior year or to the immediately preceding quarter. This change gives companies the flexibility to choose how to best present quarterly disclosure to investors. Under the amendments, if a company changes the comparison from the prior interim period comparison, it will have to explain the reason for the change and present both comparisons in the filing where the change is announced.

#### ***Deletions to Item 303***

In light of the changes and deletions to current Item 303(a) discussed above, the SEC also deleted current paragraphs (c), dealing with a safe harbor for the forward-looking statements, and (d), dealing with the requirements relating to smaller reporting companies.

### **Changes to Supplementary Financial Information and Selected Financial Data**

In addition to the revisions to Item 303 discussed above, the SEC also amended Item 302 of Regulation S-K (Supplementary Financial Information) and eliminated Item 301 of Regulation S-K (Selected Financial Data). The changes are designed to modernize the disclosure requirements in light of technological developments, simplify disclosure requirements, reduce repetition and better focus disclosure on material information.

In a change from the proposal to eliminate Items 302(a) and 302(b), the SEC amended the current Item 302(a) requirement to provide two years of tabular selected quarterly financial data by replacing it with a principles-based requirement that requires disclosure only when there are one or more retrospective changes that pertain to the 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. When this disclosure is required, companies will need to provide an explanation of the reasons for the material changes and to disclose, for each affected quarterly period and the fourth quarter in the affected year, summarized financial information related to the statements of comprehensive income (as specified in Rule 1-02(bb)(ii) of Regulation S-X) and earnings per share reflecting such changes. Depending on the facts and circumstances, this disclosure could involve a single quarter in which the material retrospective change applies, or it may flow through to subsequent quarters during the relevant look-back period. The amendments did not change the type of companies that are not required to provide disclosure pursuant to Item 302(a), such as first-time registrants conducting an initial public offering or companies that are only required to file reports pursuant to Section 15(d) of the Securities Exchange Act of 1934 (Exchange Act). Amended Item 302(a) will apply beginning with the first filing on Form 10-K after the company's initial registration of securities under sections 12(b) or 12(g) of the Exchange Act.

Because the Financial Accounting Standards Board has not finalized amendments to US generally accepted accounting principles that would require incremental disclosure called for by Item 302(b), the SEC has not eliminated Item 302(b) but may do so in the future.

## Foreign Private Issuers

Consistent with the changes discussed above and for similar reasons, the SEC is adopting conforming changes to Form 20-F (the annual report filed by foreign private issuers) and Form 40-F (the annual report filed by Canadian issuers pursuant to the Multijurisdictional Disclosure System).

## Other Conforming Amendments

Consistent with the changes adopted by the SEC and to eliminate references to rules the SEC eliminated, the SEC made conforming revisions to Item 914 of Regulation S-K (addressing disclosure in roll-up transactions); Items 1112, 1114 and 1115 of Regulation AB (addressing disclosure in asset-backed securities transactions); Forms S-1 and F-1 (addressing disclosure requirements for summary prospectuses); Forms S-4 and F-4 and Schedule 14A (addressing disclosure requirements in business combination transactions); and Form S-20 (addressing disclosure requirements in standardized option offerings).

## Practical Considerations

Although the compliance date comes after the next Form 10-K due date for many companies, it is important to understand the recent amendments and begin considering how they will be addressed in the future.

Companies should also evaluate whether it makes sense for them to voluntarily begin to provide disclosure pursuant to an amended item earlier. If they do, their disclosure must completely comply with the amended item. For example, once the amendments become effective, a company may immediately cease providing disclosure pursuant to former Item 301 and may voluntarily provide disclosure pursuant to amended Item 303 before its mandatory compliance date. However, if the company chooses to take this approach, it must provide disclosure pursuant to each provision of amended Item 303 in its entirety, providing such disclosure in any applicable filings going forward.

Companies should regularly revisit the objectives in Item 303(a) whenever they prepare their MD&A and consider ways they can enhance the quality of the analysis provided.

MD&A is an active area of focus for the SEC and its staff. For example, on January 30, 2020, the SEC provided guidance regarding the disclosure of key performance indicators and metrics companies use in MD&A. And on January 24, 2020, the staff of the SEC's Division of Corporation Finance issued three compliance and disclosure interpretations providing additional guidance regarding implementation of MD&A rule changes that were effective in May 2019, allowing companies to omit from an MD&A discussion the earliest of three years in a filing that includes financial statements covering three years to the extent certain requirements are complied with.<sup>2</sup> Interested companies should continue to monitor this area for continuing developments and guidance.

Companies should be aware that the amendments were adopted by a split vote of the SEC commissioners. Commissioners Lee and Crenshaw issued a joint dissent explaining why they voted against adopting the amendments. Although the amendments passed by majority vote, the commissioners in the minority now will soon be in the majority. Commissioners Lee and Crenshaw noted what they see as an "opportunity going forward to address climate, human capital, and other ESG risks, in a comprehensive fashion with new rulemaking specific to these topics." Although the SEC rulemaking process is lengthy and permits notice and comment, further changes to MD&A disclosure requirements could be on the not-too-distant horizon.

Companies should also note that on June 23, 2020, the Division of Corporation Finance published "Disclosure Topic No. 9A: Coronavirus (COVID-19) — Disclosure Considerations Regarding Operations, Liquidity, and Capital Resources." While Disclosure Topic No. 9A is staff guidance only and does not override any of the amendments in the more recent rulemaking, companies should look to Disclosure Topic No. 9A for further guidance in preparing disclosures regarding operations, liquidity and capital resources that the staff will review.

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*If you have any questions regarding these proposed changes, please contact the author of this Legal Update, Laura D. Richman, at +1 312 701 7304, any of the lawyers listed below or any other member of our Corporate & Securities group.*

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## Endnotes

<sup>1</sup> See Management’s Discussion and Analysis, Selected Financial Data and Supplementary Financial Information, Securities Act Release No. 33-10890, available at <https://www.sec.gov/rules/final/2020/33-10890.pdf>.

<sup>2</sup> For more information on these actions, see our Legal Updates “SEC Issues MD&A Guidance,” dated February 4, 2020, available at <https://www.mayerbrown.com/en/perspectives-events/publications/2020/02/sec-issues-md-a-guidance> and “SEC Adopts Rules to Modernize and Simplify Disclosure,” dated March 27, 2019, available at <https://www.mayerbrown.com/en/perspectives-events/publications/2019/03/sec-adopts-rules-to-modernize-and-simplify-disclosure>.

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