

Insights

SEC SIMPLIFIES MD&A AND RELATED FINANCIAL DISCLOSURE REQUIREMENTS

Nov 23, 2020

In yet another 3-2 vote, the SEC adopted significant amendments to MD&A and related financial disclosures in order to streamline the disclosure system and move to a more “principles-based approach,” focused on material information for the benefit of investors. Among other things, the November 19, 2020 amendments:

- Eliminate Item 301 (Selected Financial Data);
- Simplify Item 302(a) (Supplementary Financial Information) by replacing the current requirement for quarterly tabular disclosure with a principles-based requirement for material retrospective changes; and
- Simplify Item 303 (MD&A) as follows:
 - Adding a new Item 303(a), *Objective*, to state the principal objectives of MD&A;
 - Amending current Item 303(a)(1) and (2) (amended Item 303(b)(1)) to update, enhance and clarify disclosure requirements for *liquidity and capital resources*;
 - Amending current Item 303(a)(3) (amended Item 303(b)(2)) to clarify and streamline disclosure requirements for *results of operations*;
 - Adding a new Item 303(b)(3), *Critical accounting estimates*, to clarify and codify SEC guidance on critical accounting estimates;
 - Replacing current Item 303(a)(4), *Off-balance sheet arrangements*, with an instruction to discuss such obligations in the broader context of MD&A;
 - Eliminating current Item 303(a)(5), *Tabular disclosure of contractual obligations*, in light of the amended disclosure requirements for liquidity and capital resources and certain overlap with information required in the financial statements; and
 - Amending current Item 303(b), *Interim periods* (amended Item 303(c)) to clarify and streamline the item and allow for flexibility in the comparison of interim periods to help

companies provide a more tailored analysis relevant to business cycles.

The two dissenting Commissioners (Lee and Crenshaw) issued a [statement](#) criticizing the elimination of required disclosures, including the contractual obligation table, as weakening investor protections. Further, they objected to the failure to address climate risk, noting investor and commenter support for such disclosures. Perhaps recognizing the upcoming change in Administrations, they concluded by stating that they “look forward to rolling up our sleeves to establish requirements for standard, comparable, and reliable climate, human capital, and other ESG disclosures.”

In a footnote in the adopting release, the SEC affirmed its decision not to address ESG or sustainability matters as “[i]n keeping with [its] principles-based approach to MD&A,” and instead continued to emphasize its 2010 guidance (SEC Guidance Regarding Disclosure Related to Climate Change).

EFFECTIVE DATE

The amendments will become effective 30 days after they are published in the Federal Register. Companies are required to comply with the amended rules beginning with the first fiscal year ending on or after the date that is 210 days after publication in the Federal Register (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. Although companies need not apply the amended rules until their mandatory compliance date, they may comply with them any time after the effective date, so long as they provide disclosure responsive to an amended item in its entirety.

The adopting release illustrates, as an example, that upon the effective date, 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. In that case, the company must provide disclosure pursuant to each provision of amended Item 303 in its entirety, and must begin providing such disclosure in any applicable filings going forward.

DESCRIPTION OF AMENDMENTS

ELIMINATION OF SELECTED FINANCIAL DATA TABLE

Companies will no longer be required to provide five years of selected financial data. The SEC believes that equivalent information is readily available on Edgar and the earlier two years creates additional cost and complexity. Further, it believes the original purpose of eliciting disclosure about trends is sufficiently addressed through MD&A.

However, the SEC encourages companies to consider whether trend information for periods earlier than those presented in the financials are advisable, as well as whether tabular presentation of relevant financial data is appropriate as part of an introductory or overview section of MD&A.

SIMPLIFICATION OF SUPPLEMENTARY FINANCIAL INFORMATION TABLE

Companies will no longer be required to provide two years of tabular selected quarterly financial data. The item will be replaced with a principles-based requirement for material retrospective changes. In those cases, companies will need to explain the reasons for such material changes and the related quantitative effect, by disclosing, for each affected quarterly period and the fourth quarter in the affected year, summarized financial information related to the statements of comprehensive income and earnings per share reflecting such changes.

The SEC cited as examples of retrospective changes that may trigger disclosure: correction of an error; disposition of a business that is accounted for as discontinued operations; a reorganization of entities under common control; or a change in an accounting principle. The adopting release also provides guidance for companies that lose emerging growth company (EGC) status with respect to affected periods.

The SEC believes requiring other quarterly financial data would result in immaterial or duplicative disclosures. For those companies that voluntarily provide fourth quarter disclosure or disclosure of selected quarterly financial information, that information will be subject to the PCAOB AS 2710 requirements for auditors to read and consider such information for material inconsistencies with the audited financial statements.

As amended, Item 302(a) will continue to not apply to first time registrants conducting an IPO and companies only required to file reports pursuant to Section 15(d). The item will apply to new registrants beginning with the first Form 10-K after registration under Section 12(b) or 12(g), with the adopting release indicating retrospective disclosure only applies to interim periods covered in the IPO registration statement.

AMENDMENTS TO MD&A

RESTRUCTURING AND STREAMLINING

Objective of MD&A. The amendments clarify the objective of MD&A, directing companies to focus on:

- Material information to assess the 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 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.
- Any material financial and statistical data believed to enhance a reader's understanding of the financial condition, cash flows and other changes in financial condition, and results of operations.

The stated objectives for MD&A:

- emphasize future prospects and highlight the importance of materiality and trend disclosures
- remind companies that MD&A should provide an analysis that encompasses short-term results as well as future prospects
- specify that the disclosure must include matters that are reasonably likely, based on "management's assessment," to have a material impact on future operations

Reasons underlying material changes. The amendments will now require disclosure of the "underlying reasons" for material changes in quantitative and qualitative terms, rather than only "causes," in order to elicit more meaningful discussion. The requirement includes circumstances where material changes within a line item offset one another.

An instruction states:

- If the reasons underlying a material change in one line item also relate to others, no repetition of such reasons is required and a line-by-line analysis is neither required nor generally appropriate.
- Companies need not recite the amounts of changes from period to period if they are readily computable from the financial statements.
- The discussion must not merely repeat numerical data contained in the financial statements.

Segment or other subdivision information. The amendments require that the discussion focus on each "relevant reportable segment" and/or other subdivision of the business, such as geographic areas or products lines, and on the company as a whole, where necessary to an understanding of the company's business.

Streamlining. The amendments also streamline the fourteen instructions.

CAPITAL RESOURCES – MATERIAL CASH REQUIREMENTS

Companies will need to provide 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. This reflects an expansion beyond the current instruction to disclose “commitments” for capital expenditures, although consistent with the SEC’s guidance in its [2003 Interpretative Release](#), and to complement the deletion of the contractual obligations table. The SEC stated that the amendments address only cash requirements that are material, including those related to normal operations, and do not reflect a new threshold.

The discussion should analyze material cash requirements from known contractual and other obligations. Such disclosures must specify the type of obligation and the relevant time period for the related cash requirements.

The amended item also requires disclosure of the company’s plans for cash in the short-term (i.e., the next 12 months from the most recent fiscal period end required to be presented) and separately in the long-term (i.e., beyond the next 12 months).

RESULTS OF OPERATIONS – KNOWN TRENDS AND UNCERTAINTIES

Similar to the SEC’s guidance in its [1989 Interpretative Release](#), companies 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. As part of MD&A’s objectives, as discussed above, whether a matter is “reasonably likely” to have a material impact on future operations is based on “management’s assessment.” The amended rules clarify that this standard applies throughout MD&A.

The SEC rejected objections that its 1989 guidance – i.e., the so-called “two-part test” – is “unclear, not well understood and difficult to apply,” with the result of leading to disclosure of immaterial matters. The two-part test provides that:

“Where a trend, demand, commitment, event or uncertainty is known, management must make two assessments:

- (1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
- (2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management

determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.”

In an effort to “alleviate these concerns,” the SEC stated:

“As the Commission has previously stated with respect to the evaluation of whether a known trend or uncertainty is reasonably likely, ‘the development of MD&A disclosure should begin with management’s identification and evaluation of what information...is important to providing investors and others an accurate understanding of the company’s current and prospective financial position and operating results.’ When considering whether disclosure of a known event or uncertainty is required, the analysis is based on materiality and what would be considered important by a reasonable investor in making a voting or investment decision. The ‘reasonably likely’ threshold does not require disclosure of any event that is known but for which fruition may be remote, nor does it set a bright-line percentage threshold by which disclosure is triggered. Rather, this threshold requires a thoughtful analysis that applies an objective assessment of the likelihood that an event will occur balanced with a materiality analysis regarding the need for disclosure regarding such event.

“Taking these concepts into account, when applying the ‘reasonably likely’ threshold, registrants should consider whether a known trend, demand, commitment, event, or uncertainty is likely to come to fruition. If such known trend, demand, commitment, event or uncertainty would reasonably be likely to have a material effect on the registrant’s future results or financial condition, disclosure is required. Known trends, demands, commitments, events, or uncertainties that are not remote or where management cannot make an assessment as to the likelihood that they will come to fruition, and that would be reasonably likely to have a material effect on the registrant’s future results or financial condition, were they to come to fruition, should be disclosed if a reasonable investor would consider omission of the information as significantly altering the mix of information made available in the registrant’s disclosures. This analysis should be made objectively and with a view to providing investors with a clearer understanding of the potential material consequences of such known forward-looking events or uncertainties. Because the analysis does not call for disclosure of immaterial or remote future events, it should not result in voluminous disclosures or unnecessarily speculative information.”
[footnotes omitted]

The SEC considered but rejected alternative tests, including:

- Reformulating the language to require an affirmative determination, because it would not account for circumstances where management cannot ascertain the likelihood of the matter coming to fruition;
- Providing guidance on a timeframe, as that will depend on the particular facts and circumstances;

- The *Basic v. Levinson* sliding scale probability/magnitude test, because it could result in disclosure of issues that are large in potential magnitude but low in probability (the SEC noted that the probability/magnitude test was developed in the context of a potential merger, where the probability of the event, the potential timing and the expected effects may be readily estimated); and
- Utilizing a “reasonably expects” threshold, because the SEC believes the analysis should “focus on an objective determination of the likelihood of an event occurring, rather than on whether management’s expectation of such event occurring would be objectively reasonable.”

RESULTS OF OPERATIONS – NET SALES AND REVENUES

The amended rules clarify that a discussion of material changes in net sales or revenue is required - rather than only material increases. This complements the change to Item 303(b) that requires, where the financial statements reveal material changes from period-to-period in one or more line items, a description of the underlying reasons for these material changes in quantitative and qualitative terms.

RESULTS OF OPERATIONS – INFLATION AND PRICE CHANGES

The requirement to discuss the impact of inflation and price changes, and corresponding instructions, will be eliminated. Companies will still be 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 favorable or unfavorable impact on net sales, revenue or income from continuing operations. Further, amended Item 303(b) will require a description of the underlying reasons for these material changes.

OFF-BALANCE SHEET ARRANGEMENTS

The item requiring disclosure of material off-balance sheet arrangements will be replaced by a new instruction to Item 303. Under that instruction, companies will be required to discuss commitments or obligations, including contingent obligations, arising from arrangements with unconsolidated entities or persons that have, or are reasonably likely to have, a material current or future effect on such company’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 company’s consolidated balance sheets.

The SEC noted that new FASB requirements have caused GAAP to overlap with the former requirement, resulting in many companies providing cross references to notes to their financial statements or providing duplicative disclosures. Further, the SEC believes the new instruction is consistent with its effort to promote a principles-based approach to MD&A.

By no longer requiring this disclosure in a separately-captioned section, the SEC expects that the discussion of off-balance sheet arrangements will be incorporated into a broader discussion of liquidity and capital resources.

The SEC also amended Items 2.03 and 2.04 of Form 8-K to include the definition of “off-balance sheet arrangements” that is currently in Item 303(a)(4) in order to retain the current definition in Form 8-K in light of the Form’s four business day filing requirement.

CONTRACTUAL OBLIGATIONS TABLE

Companies will no longer be required to provide a contractual obligations table. A discussion of material contractual obligations will remain required through an enhanced principles-based liquidity and capital resources requirement focused on material short- and long-term cash requirements from known contractual and other obligations.

The SEC believes that eliminating the requirement will not result in a loss of material information given the overlap with information in the financial statements as a result of changes in GAAP since the table was first required, and the expansion of the capital resources requirement, as discussed above.

The SEC recognized that elimination of the table would be controversial, and identified the following amendments as designed to ensure that material cash requirements from contractual and other obligations would be addressed:

- New Item 303(b)(1) that provides the overarching requirements for liquidity and capital resources disclosures in order to clarify these requirements;
- Amended Item 303(b)(1) that incorporates portions of current Instruction 5 to Item 303(a), which defines “liquidity” as the ability to generate adequate amounts of cash to meet the needs for cash, clarifying its applicability to the liquidity and capital resources requirements more generally;
- Codification of prior SEC guidance in the 1989 Interpretative Release that specifies that short-term liquidity and capital resources covers cash needs up to 12 months into the future while long-term liquidity and capital resources covers items beyond 12 months;
- Required discussion of material cash requirements from known contractual and other obligations and such disclosures to specify the type of obligation and the relevant time period for the related cash requirements;
- A new instruction that states that the discussion of material cash requirements from known contractual obligations may include, for example, lease obligations, purchase obligations or other liabilities reflected on the company’s balance sheet; and

- A new instruction that states, consistent with prior SEC guidance in the 2003 Interpretative Release, the analysis for all of Item 303(b) should be in a format that facilitates easy understanding and does not duplicate disclosure already provided in the filing.

Noting that the current table does not have a materiality threshold, the SEC believes that focusing on a principles-based approach will relieve companies of the burden of tracking immaterial data while providing investors with material information.

CRITICAL ACCOUNTING ESTIMATES

Companies will be explicitly required to disclose critical accounting estimates, as previously addressed in the 2003 Interpretative Release. They are defined as those estimates made in accordance with GAAP that involve a significant level of estimation uncertainty and have had or are reasonably likely to have a material impact on the company's financial condition or results of operations.

For each critical accounting estimate, companies must disclose why the estimate is subject to uncertainty and, to the extent material and reasonably available:

- quantitative as well as qualitative 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;
- how much each estimate has changed during the relevant period (which may also be met through a discussion of changes in the assumptions during the period); and
- the sensitivity of the reported amounts to the methods, assumptions, and estimates underlying the estimate's calculation.

To address concerns about the potential scope of the sensitivity requirement, the amended rule expressly states 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. Further, the SEC stated its view that, "in practice, if the disclosure is 'impracticable' to provide, it would not be 'reasonably available.'"

The SEC explained that the requirement to discuss changes in estimates, along with the sensitivity disclosure, is not intended to mirror period-over-period discussions like those for results of operations, but instead "to provide investors with a greater understanding of the variability that is reasonably likely to affect the financial condition or results of operations so investors can adequately evaluate the estimation uncertainty of a critical accounting estimate."

The SEC also compared the required disclosure to GAAP requirements, noting that GAAP does not require discussion of material assumptions over a relevant period, or underlying assumptions for all material accounting estimates. However, to the extent the financial statements include that information, a new instruction specifies that MD&A should supplement – but not duplicate – disclosures in the notes to the financial statements. Further, unlike GAAP, the amended item also emphasizes forward-looking information by focusing on estimation uncertainty that is reasonably likely to have a material effect.

INTERIM PERIOD DISCUSSION

Companies 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. Companies subject to Rule 3-03(b) of Regulation S-X will be afforded the same flexibility (i.e., utility companies that elect to provide a statement of comprehensive income and cash flows for the 12-month period ended as of the most recent interim balance sheet date to discuss material changes with respect to the preceding fiscal year, rather than the corresponding preceding period.)

The SEC believes this flexibility will help companies provide a more tailored and meaningful analysis that is relevant to their specific business cycles, while also providing investors with material information to assess quarterly performance.

If a company elects to discuss changes from the immediately preceding quarter, it must provide summary financial information that is the subject of the discussion for that quarter or identify the prior EDGAR filing that presents such information so that a reader may have ready access to the prior quarter information. In addition, if in a subsequent Form 10-Q, a company changes the comparison from the comparison presented in the immediately prior filing, the company must explain the reason and present both comparisons in the filing where the change is announced.

The SEC also adopted several amendments to streamline the item, including the deletion of various instructions.

The SEC considered, but did not adopt, suggestions to make the year-to-date comparative information optional, viewing that discussion as valuable and complementary to annual MD&As.

SAFE HARBOR FOR FORWARD-LOOKING INFORMATION

The amendments eliminate current Item 303(c), which expressly addressed the availability of the safe harbor for forward-looking formation to the required off-balance sheet disclosures and the contractual obligations table. The SEC stated, however, that the elimination of that item does change the availability or scope of the statutory and regulatory safe harbors for all of amended Item 303, including the new requirement to disclose critical accounting estimates.

SMALLER REPORTING COMPANIES

In light of the elimination of current Items 303(a)(3)(iv) and (5), the amendments eliminate current Item 303(d), which expressly relieves SRCs from those disclosure requirements. New Item 303(b) specifically requires disclosure of material cash requirements from known contractual and other obligations as part of a liquidity and capital resources discussion. SRCs are currently required to provide MD&A disclosure addressing liquidity and capital resources, and the SEC believes that SRCs should continue to provide this disclosure under the amended item.

The SEC noted that, although SRCs are not currently required to include a contractual obligations table, they are already required under GAAP to assess most of the currently prescribed categories that would otherwise be included in that table. Additionally, some of the revisions to the liquidity and capital resources disclosure requirements codify current MD&A guidance, which already applies to SRCs.

Foreign Private Issuers

The SEC adopted corresponding amendments to Forms 20-F and 40-F, which apply to FPIs and eligible Canadian FPIs, respectively. It also amended current Instruction 11, which applies to various governmental and other policies that affect operations or investments by U.S. nationals to incorporate a discussion of hyperinflation in a hyperinflationary economy.

CONFORMING AMENDMENTS

The SEC adopted additional conforming amendments to rules or forms relating to roll-up transactions (Item 914), asset-backed issuers (Regulation AB), summary prospectuses (Forms S-1 and F-1), business combinations (Form S-4, Form F-4 and Schedule 14A) and standardized options (Form S-20).

For further information on this topic, please contact [Randy Wang](#) or any other BCLP Securities and Corporate Governance lawyer. Additional resources are available on our website for the [BCLP Securities and Corporate Governance Practice](#). Bryan Cave Leighton Paisner LLP makes available the information and materials in its website for informational purposes only. The information is general in nature and does not constitute legal advice. Further, the use of this site, and the sending or receipt of any information, does not create any attorney-client relationship between us. Therefore, your communication with us through this website will not be considered as privileged or confidential.

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