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SEC Amends MD&A Disclosure Rules and Trims Financial Disclosure Requirements

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On November 19, 2020, the Securities and Exchange Commission (SEC) adopted amendments to Regulation S-K that update and streamline its rules governing Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) disclosure and related requirements to provide selected financial data and quarterly financial information.[1] The rule changes are part of the SEC's ongoing effort to modernize its disclosure requirements and are intended to simplify compliance efforts for companies. For a discussion of other recent changes that modernize the SEC's disclosure rules, see our previous client alert here.

The amended rules eliminate certain existing disclosure requirements, codify longstanding SEC guidance on MD&A disclosure, and revise the scope of information that must be disclosed. The amendments will take effect 30 days after publication in the Federal Register, but compliance will not be mandatory until later next year. While companies may benefit from early adoption of some of the rule changes, they may need a longer period of time to transition fully to the new rules. This alert describes some of the key changes included in the amendments.

Selected Financial Data and Quarterly Financial Information

Item 301 of Regulation S-K requires a company to provide selected financial data for each of the last five fiscal years. This rule was intended to highlight trends in the company's financial condition and results of operations by presenting selected line items that are also included in the company's financial statements. The amendments eliminate Item 301. The SEC concluded that the information required by Item 301 is no longer necessary because trend information must be included in MD&A disclosures and historical financial data are available in a company's periodic reports filed on the EDGAR system.

Item 302 of Regulation S-K requires companies to disclose certain financial data for each full quarter within the two most recent fiscal years and any subsequent interim period. The amended rules will require companies to provide quarterly information only when there are one or more retrospective changes in the income statement for any quarter within the last two fiscal years and any subsequent interim period, and such changes are material either individually or in the aggregate. Companies also will be required to provide disclosure explaining the reasons for the changes, as well as summarized financial information related to the income statement and earnings per share reflecting such changes for each affected quarterly period and the fourth quarter in the affected year. Examples of retrospective changes that could trigger disclosure under the amended rule include correction of an error, disposition of a business that is accounted for as a discontinued operation, or a change in accounting principle.

Management's Discussion and Analysis

Item 303 of Regulation S-K requires companies to disclose information relevant to assessing the company's financial condition, changes in financial condition and results of operations. Together, these disclosures are intended to provide a narrative explanation of a company's financial statements that should enable investors to see the company through the eyes of management. The amendments to Item 303 add a new statement of objectives that applies to all aspects of MD&A disclosure, eliminate certain line item requirements that the SEC considered duplicative or unnecessary, codify prior SEC guidance on disclosure of critical accounting estimates and allow greater flexibility in presenting interim comparative periods.

Objectives

New Item 303(a) states the objectives of MD&A, which apply throughout the amended item. The objectives consolidate historical SEC guidance as well as certain existing instructions to Item 303. While the new statement of objectives does not represent a significant change to current practice, it does clarify the SEC's views on the appropriate focus for MD&A disclosure and should ease compliance by providing relevant guidance within the item.

Consistent with historical SEC guidance and existing provisions in Item 303, the objectives specify that the discussion and analysis must include descriptions and amounts of matters that have had a material impact on reported operations and those that are reasonably likely, based on management's assessment, to have a material impact on future operations. The objectives also confirm that MD&A is intended to communicate an understanding of the company from management's perspective. Additionally, as currently stated in an instruction to Item 303, the discussion and analysis must be of the financial statements and other statistical data that the company believes will enhance a reader's understanding of the company's financial condition, cash flows, changes in financial condition and results of operations.

Material Changes in Financial Condition and Results of Operations

Amendments to Item 303 specify that when a company's financial statements reflect material changes in one or more line items, the company must describe the underlying reasons for material changes in quantitative and qualitative terms. This new requirement generally is consistent with current instructions to Item 303 but adds an explicit requirement for quantitative disclosure. For some companies, isolating and quantifying the reasons for specific material changes in the financial statements could be difficult, making compliance with this new requirement more challenging. In such circumstances, the SEC encouraged companies to acknowledge and explain such challenges, to the extent possible. The SEC further cited separate rules that generally provide that information must be disclosed only to the extent it is known or "reasonably available" to the company,[2] suggesting that there may be some flexibility when the reasons for material changes are interrelated and difficult to isolate.

Capital Resources – Material Cash Requirements

Prior to the amendments, Item 303(a)(2) required a discussion of the company's material commitments for capital expenditures as of the end of the last fiscal period, as well as the anticipated source of funds needed to fulfill such commitments. Under the revised rule, a company must disclose its "material cash requirements" from contractual and other obligations, including capital expenditures, and the anticipated source of funds needed to satisfy such cash requirements. The "cash requirements" language is consistent with prior SEC guidance, which explained that MD&A requires disclosure, to the extent material, of the existence and timing of "commitments for capital expenditures and other known and reasonably likely cash requirements."[3] While many companies already include a broad disclosure about material cash requirements in their liquidity and capital resources discussion, consistent with SEC guidance, this amendment may cause some companies to expand their disclosures.

Table of Contractual Obligations

The amendments to Item 303 eliminate Item 303(a)(5), which required tabular disclosure of a company's contractual obligations. The amended requirement to disclose "material cash commitments" in the liquidity and capital resources discussion captures some of the information previously called for in the table of contractual obligations, including the type of obligation and the relevant time period for the related cash requirements. A new instruction identifies the types of contractual obligations that may be disclosed as material cash requirements, including lease obligations, purchase obligations or other liabilities reflected on the company's balance sheet. These categories are similar to the categories currently included in the table of contractual obligations. However, disclosure of material cash commitments under the amended rule may be more limited than the contractual obligations table because Item 303(a)(5) does not include a materiality qualifier.

Off-Balance Sheet Arrangements

Item 303(a)(4) currently requires MD&A to include a separately captioned section that discusses a company's off-balance sheet arrangements that have had or are reasonably likely to have an effect on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors. The amendments eliminate this requirement and provide a new instruction that takes a more principles-based approach to addressing disclosure of off-balance sheet arrangements. Instead of a separately captioned section and prescribed disclosure items, the new instruction directs companies to integrate disclosure about material off-balance sheet arrangements within other aspects of MD&A. Although a separately captioned section is no longer required, the amended rules permit companies to continue presenting disclosure about off-balance sheet arrangements in a separately captioned section if it would facilitate an understanding of the disclosure.

Critical Accounting Estimates

The amendments to Item 303 codify prior SEC guidance on disclosure of critical accounting estimates[4] by adding an explicit line item to MD&A. The new provision specifies that companies must provide qualitative and quantitative information necessary to understand the estimation uncertainty and the impact of the estimate on financial condition and results of operations to the extent information is material and reasonably available. Companies must disclose why each critical accounting estimate is subject to uncertainty and how much each estimate has changed over a relevant period. Consistent with prior SEC guidance, a company also must disclose sensitivity of the reported amount to the methods, assumptions and estimates underlying its calculation. A new instruction emphasizes that disclosure of critical accounting estimates must supplement, but not duplicate, the description of accounting policies or other disclosure in the notes to financial statements. While this instruction mirrors the SEC's prior guidance, it may require some companies to develop new disclosure for MD&A that is distinct from the disclosure in their notes to financial statements.

Interim Period Discussions

Currently, Item 303(b) requires companies to discuss any material changes in their results of operations for the most recent fiscal year-to-date period presented in the income statement, along with a similar discussion of the corresponding period from the prior fiscal year. If the company provides an income statement 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 prior fiscal year. The amended item (renumbered Item 303(c)) gives companies the flexibility to compare their most recently completed quarter to either the corresponding quarter of the prior year (as is currently required) or the immediately preceding quarter. If a company opts for comparing its current quarter to the immediately preceding quarter, it must also provide summary financial information for that immediately preceding quarter or identify the company's SEC filing where the information is presented.

Foreign Private Issuers

The SEC adopted conforming changes to the disclosure requirements in Forms 20-F and 40-F, which apply to foreign private issuers.

Effective Date and Compliance Date

The amendments will take effect 30 days after publication in the Federal Register. Companies will be required to apply the amended rules for their first fiscal year ending on or after 210 days after publication in the Federal Register. The amended rules also will apply to a registration statement that, on its initial filing date, is required to include financial statements for a period ending on or after the mandatory compliance date. Companies are permitted to apply the amended rules at any time after the effective date, so long as they provide disclosure that is responsive to an amended item in its entirety. For example, a company may omit Item 301 selected financial data at any time after the effective date but continue to provide disclosure pursuant to existing Item 303 until the mandatory compliance date.

Takeaways

The amended rules continue the SEC's efforts to make its disclosure requirements more principles-based by replacing some of the prescriptive items with a more flexible approach. In addition, eliminating certain disclosure requirements, such as selected financial data and the table of contractual obligations, should ease the costs and burdens of preparing MD&A under the amended rules and encourage companies to focus on material information. Codification of previous SEC guidance will be more user-friendly and may provide more clarity to companies in preparing these disclosures. Other changes, such as the explicit focus on quantitative information about the material reasons for changes in the financial statements, are likely to result in new disclosures for many companies and possibly modifications to their disclosure practices and procedures.

We anticipate that many companies will cease providing selected financial data currently required under Item 301 as soon as the rules take effect. Similarly, we expect early adoption of the changes to Item 302, even for companies that are required to provide the more limited quarterly financial information under the amended rule. The impact of changes to MD&A disclosure may take more time for companies to evaluate, and some companies may use these amendments as an opportunity to revisit the scope and format of their MD&A disclosures going forward. Any updated disclosures should be drafted carefully in consultation with outside counsel.

If you have questions about how these new rules apply to your business, please contact your Proskauer attorney or one of the capital markets attorneys listed on this alert.

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[1] *Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information,* SEC Release No. 33-10890 (Nov. 19, 2020) ("Adopting Release").

[2] *Id.* at note 115, citing Securities Act Rule 409 and Securities Exchange Act Rule 12b-2.

[3] Adopting Release at 41, citing *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operation*, Release No. 33-8350 (Dec. 19, 2003) ("2003 MD&A Interpretive Release").

[4] 2003 MD&A Interpretive Release.

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