

SEC Adopts Major Changes to MD&A and Related Requirements

December 7, 2020

On November 19, 2020, the Securities and Exchange Commission adopted amendments to Regulation S-K, including changes to its MD&A requirements that will make significant and long-overdue improvements to a central disclosure requirement of the U.S. securities laws.

The twin themes of the amendments are dropping outmoded requirements and taking a more principles-based approach. This memorandum provides a brief summary of the changes.

The amendments will become effective 30 days after they are published in the Federal Register, so probably in January 2021. At that time advance voluntary compliance is permitted, so long as registrants provide disclosure responsive to an amended item in its entirety.

Compliance is not mandatory until a registrant reports on its first fiscal year ending on or after 210 days following publication – so for a calendar-year end filer, the Form 10-K for 2021 – but we would expect that many issuers will find the new rules congenial and begin complying sooner.

The full text of the SEC release adopting the amendments is available [here](#).

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Background and context

The amendments were proposed on January 30, 2020 (the full text of the proposals is available [here](#)) and have been adopted generally as proposed. The changes are based in large part on the SEC staff's November 2016 Report on Modernization and Simplification of Regulation S-K, as well as a July 2016 concept release on the business and financial disclosure requirements in Regulation S-K. They are part of a broader "disclosure effectiveness initiative" (DEI) undertaken by the SEC and its staff, partly at the direction of Congress under the 2012 Jumpstart Our Business Startups (JOBS) Act and the 2015 Fixing America's Surface Transportation (FAST) Act. The stated objective of the DEI is to improve the SEC disclosure regime for both investors and registrants. See Cleary Gottlieb's Disclosure Simplification Explainer [here](#).

These amendments are among the more consequential components of the DEI, while some of the prior rulemaking has been fairly technical. They address MD&A, which is a core disclosure requirement under the SEC's forms, and they include some major changes. The general orientation of the changes – dropping requirements that have become obsolete, replacing prescriptive rules with principles-based requirements, and clarifying requirements that have not previously been properly codified – is sensible and provides registrants with increased flexibility.

The two Democratic Commissioners jointly dissented from the adoption of these amendments, as they have for most of the Commission's major rulemaking over the past year. Their dissent focused mainly on the Commission's failure to address climate risk with specific disclosure requirements, and it underlined a contrast in regulatory philosophy between principles-based requirements and standardized disclosures that facilitate comparison. The principles-based approach has dominated recent SEC rulemaking on disclosure, and it was ardently defended in recent public statements by Jay Clayton and William Hinman.¹ Of

¹ See Putting Principles into Practice, the SEC from 2017-2020 (Nov. 19, 2020), available [here](#), and The Regulation of

course, they are leaving the SEC, and beginning in 2021 the dissenters' view may be ascendant.

Major elements of the amendments

The most significant elements of the amendments are summarized below. Parallel amendments also apply to disclosures provided by foreign private issuers in annual reports on Form 20-F.²

- ***New Language Describing the Principal Objectives of MD&A.*** The amendments add a new Item 303(a) stating the purposes of MD&A disclosure. The language codifies longstanding SEC guidance that states that a registrant should provide a narrative explanation of its financial statements that enables investors to see the registrant "through the eyes of management." It also emphasizes the importance of statistical data in enhancing a reader's understanding of the registrant's financial condition and results of operations.
- ***Elimination of the Requirement for 5 Years of "Selected Financial Data."*** The amendments eliminate Item 301 of Regulation S-K, which requires most registrants to furnish selected financial data in comparative tabular form for each of the registrant's last five fiscal years. Item 301 disclosure is currently required in an annual report on Form 10-K or a registration statement on Form S-1.

The SEC noted that for reporting companies, financial data from earlier years is readily available, unlike when the precursor to Item 301 was adopted in 1970. In particular, the tagging of financial information using eXtensible Business Reporting Language (XBRL) has facilitated access

Corporation Finance – A Principles-Based Approach (Nov. 18, 2020), available [here](#).

² Item 5 of Form 20-F provides the requirements for "Operating and Financial Review and Prospects," which is analogous to the MD&A requirements applicable to domestic issuers under Item 303 of Regulation S-K. Although the general concepts are similar, the wording differs substantially, and the amendments are different as well. For the most part, the effect is to converge the requirements of Form 20-F and Regulation S-K Item 303.

to information in the financial statements that selected financial data was meant to highlight. For IPO issuers, there are no prior filings to reference, but the SEC noted that emerging growth companies (EGCs), which represent a high proportion of IPOs, are already permitted to exclude disclosure of the earlier two of the five years required by Item 301. The adopting release notes that registrants may continue to include a tabular presentation of financial information to the extent that such presentation would be useful for understanding MD&A disclosure.

- ***Elimination of the 8-Quarter Table.*** Item 302(a) of Regulation S-K, which applies to an annual report on Form 10-K or a registration statement on Form S-1, requires tabular disclosure of selected financial data for each quarter within the two most recent fiscal years. The amendments replace that requirement with a requirement to disclose material retrospective changes (e.g., error corrections, certain dispositions and reorganizations or changes in accounting principles). Disclosure is only required when there are retrospective changes that pertain to quarterly financial data within the two most recent fiscal years and that, individually or in the aggregate, are material. If so, the registrant must provide an explanation of the reasons for the changes, and summary financial information for each affected quarter and the fourth quarter in the affected year.

For a registrant that is a year or more out from its IPO, the data for the first three quarters that Item 302(a) currently requires can be found in prior quarterly reports and the fourth quarter data generally can be calculated from the annual report. If retrospective changes apply to that information, the amended Item 302(a) will require tabular disclosures by quarter.

Item 302(a) will no longer require a description of the effect of any discontinued operations and unusual or infrequently occurring items. The purpose of this requirement is addressed by other requirements, including MD&A (requiring a

discussion of unusual events that materially affect reported income and trends and uncertainties that have an impact on net sales, revenues, or operating income), and by U.S. GAAP disclosure rules (requiring disclosure of disposals of components of an entity and unusual or infrequently occurring items for the fourth quarter).

- ***Elimination of the Contractual Obligations Table.*** The amendments eliminate the requirement for a table of contractual obligations under Item 303(a)(5). The SEC believes that eliminating the requirement will not result in a loss of material information to investors given the overlap with information required under accounting standards. Instead of the contractual obligations table, the amendments add a requirement in Item 303(b)(1) to discuss material cash requirements from known contractual and other obligations, including but not limited to commitments for capital expenditures. Disclosures under this requirement must specify the type of obligation (e.g., lease obligation, purchase obligation, or other balance sheet liability) and the relevant time period for the related cash requirements.

Like many of the other amendments, the elimination of the contractual obligations table is intended to reduce redundancy and streamline disclosure. The enhanced disclosure requirement as to material cash requirements largely tracks existing SEC guidance and may not require extensive new information.

- ***Requirement for Critical Accounting Estimates Disclosure.*** The amendments add a requirement, in Item 303(b) of Regulation S-K, to disclose critical accounting estimates, codifying longstanding SEC guidance on the subject. A critical accounting estimate is defined as an estimate made in accordance with generally accepted accounting principles that involves a significant level of estimation uncertainty and has had or is reasonably likely to have a material impact on the registrant's financial condition or results of operations. The new requirement calls for both qualitative and quantitative information to

convey estimation uncertainty and financial impact of the estimate, but in each case only to the extent such information is material and reasonably available.³

SEC guidance has called for disclosure of critical accounting estimates since 2003⁴, and registrants sometimes provide disclosure that duplicates information in the required note to the financial statements on significant accounting policies. The new rule includes an instruction specifying that the disclosure of critical accounting estimates must supplement, but not duplicate, the description of accounting policies or other disclosures in the notes to the financial statements.

- ***Elimination of Separate Section on Off-balance Sheet Arrangements.*** Current Item 303(a)(4) requires a separately captioned section of MD&A with disclosures about off-balance sheet arrangements, which – in an echo of the Enron scandal of the early 2000s – are defined specifically to capture derivatives on the registrant’s own equity. The amendments eliminate this requirement, and they add an instruction emphasizing the importance of discussing off-balance-sheet obligations in the broader context of MD&A disclosure when they have or are reasonably likely to have a material current or future effect.

The adopting release notes that changes in U.S. GAAP since the implementation of Item 303(a)(4) have resulted in substantial disclosure overlap. The change is intended to encourage a more principles-based approach to disclosure about off-balance sheet arrangements.

- ***New Flexibility in Quarter-by-Quarter Comparisons.*** In a quarterly report on Form 10-Q,

³ In amended Form 20-F, this requirement does not apply to an issuer that uses IFRS, because IFRS has a similar requirement applicable to the notes to the financial statements. See IFRS 1, paragraph 129, and see Proposing Release at notes 245 and 247.

⁴ See Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operation (Dec. 19, 2003), available [here](#).

current Item 303(b) requires that MD&A compare the most recent quarter to the comparable quarter of the prior year. Under the amendments, MD&A in a quarterly report on Form 10-Q may compare the most recent quarter to either the corresponding quarter of the prior year or the immediately preceding quarter. If a registrant changes from one approach to the other, it must explain the reason for the change and present both comparisons in the filing when it first makes the change.

In making this change, the SEC recognized that not all businesses are seasonal and that a comparison to the corresponding quarter of the preceding year (as is currently required) may not be as meaningful as a comparison to the preceding quarter.

Other amendments

Other elements of the amendments include:

- Elimination of unnecessary cross-references to industry guides in Instructions 13 and 14 of Item 303(a).
- Amendment of current Item 303(a)(3)(iii) to clarify that a registrant should discuss *material changes* (as opposed to only *material increases*) from period to period in net sales or revenue.
- Elimination of current Item 303(a)(3)(iv), which requires registrants to discuss the impact of inflation and changing prices.
- Simplification of current Item 303(b) by eliminating certain instructions and providing cross-references to similar instructions in current Item 303(a).
- Retention of current Item 302(b), *Information About Oil and Gas Producing Activities*, which was initially proposed to be eliminated and may be reconsidered in the future, subject to the Financial Accounting Standards Board’s amendment of U.S. GAAP to require the disclosure called for by Item 302(b).

Compliance date

The amendments will become effective 30 days after they are published in the Federal Register, at which time advance voluntary compliance is permitted, so long as registrants provide disclosure responsive to an amended item in its entirety. The adopting release makes clear that Item 303 must be viewed as a single item for this purpose. Registrants are required to comply with the rule beginning with the first fiscal year ending on or after the date that is 210 days after publication in the Federal Register (for a calendar-year end filer, mandatory compliance will likely not be required until its Form 10-K covering the fiscal year ended December 31, 2021). Registrants 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 (210 days after the amendments are published in the Federal Register).

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