SEC Adopts Amendments to MD&A and Financial Disclosures

A Practical Guidance® Article by Thomas J. Fraser, Keith F. Higgins, Paul M. Kinsella, Craig E. Marcus, and Patrick O'Brien, Ropes & Gray LLP

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Introduction

This First Analysis article discusses the amendments adopted by the Securities and Exchange Commission (the SEC or Commission) on November 19, 2020 to the financial disclosure requirements of Regulation S-K, including the requirements governing the presentation of Management's Discussion and Analysis (MD&A) as set out in Item 303.

Continuing on its methodical march through the corporate disclosure rulebook, the SEC adopted final amendments to the disclosure rules affecting MD&A and related financial disclosures. The amendments follow the theme of emphasizing principles-based disclosure tailored to a company's business and financial situation. Companies will be required to apply the amendments to filings for the first fiscal year ending on or after 210 days following publication of the rules in the Federal Register. Thus, calendar year companies will not be required to apply the rules until 2022. Companies may voluntarily provide disclosure consistent with the amendments any time after the effective date, so long as they provide disclosure responsive to an amended item in its entirety. This article discusses the most important changes and their impact on MD&A.

For a comprehensive list of Practical Guidance resources on the topics covered in this article, see Periodic and Current Reporting Resource Kit and Financial Statements and Reporting Resource Kit.

Initial Guidance

Selected Financial Data

As proposed, the Commission eliminated the requirement for a five-year selected financial data table contained in current Item 301 of Regulation S-K. Although a few commenters preferred having the information in a single place, the Commission recognized that all the financial information in the table appears in a company's filings, and the table thus provided duplicative disclosure.

Supplementary Financial Information

The Commission had also proposed to eliminate Item 302 – which requires quarterly financial information for the eight quarters in the prior two fiscal years and any subsequent quarterly period – as largely duplicative of information appearing elsewhere. In this instance, however, commenters expressed concerns about the loss of standalone fourth quarter financial information and the effects of retrospective changes on prior quarters. The Commission addressed those concerns by requiring disclosure only when retrospective changes to the statement of comprehensive income during the prior two fiscal years (or subsequent interim period) have been material, either individually or in the aggregate. In those instances, companies must explain the reasons for the changes and provide summarized financial information relating to the statement of comprehensive income and earnings per share reflecting the changes.

MD&A

Objective. As proposed, the Commission included as paragraph (a) of Item 303 a section setting forth the objective of MD&A. The substance is consistent with how the Commission has for years characterized its view of MD&A – disclosure intended to provide material information so investors can view the company from management's perspective. A broad statement of objectives appearing in the form of a rule, however, is unusual. Given its hortatory nature, one would expect this provision not to become an independent source for the finding of non-compliance with the MD&A rules.

Full fiscal years. The press release announcing the amendments stated that the new rules will "modernize, enhance and clarify disclosure requirements" relating to liquidity and capital resources and results of operations. The amendments affecting fiscal years are consistent with this characterization and break no new ground. MD&A remains a largely principles-based disclosure requirement. Discussion and analysis of liquidity and capital resources will continue to focus on known trends and uncertainties that would reasonably be expected to materially affect a company's liquidity as well as its material cash requirements. Discussion of operating results will similarly focus on material impacts on the income statement, along with discussion of known trends and uncertainties reasonably likely to have a material impact.

On the known trends and uncertainties aspect of the MD&A, the adopting release seems to deviate slightly from the Commission's historical "two-step" approach to this forward-looking disclosure. The prior guidance stated that when a company could not estimate whether a known trend or uncertainty would come to fruition, it had to assume that it would and disclose any material impact from that occurrence. In the adopting release for the new rules, the Commission now says that disclosure is required in those circumstances "if a reasonable investor would consider omission of the information as significantly altering the mix of information made available in the registrant's disclosures." As updated, the rule requires management to make a thoughtful and objective evaluation, based on materiality, including where the fruition of future events is unknown.

Interim period discussion. The requirement for an interim period discussion remains largely the same except that, for the second and third fiscal quarters, in addition to the six- and nine-month comparisons to the prior year, companies may elect to discuss the current quarter either in a year-over-year or a sequential quarter comparison. If the company elects the sequential discussion, it must either include summarized financial information on the immediately prior quarter or identify the EDGAR filing that includes that information so that a reader may have ready access to the prior quarter financial information being discussed.

Off-balance sheet arrangements. Companies have been required to provide information on off-balance sheet arrangements since 2003, following rules mandated by the Sarbanes-Oxley Act of 2002. The information required by this rule has largely become a requirement of U.S. Generally Accepted Accounting Principles. As proposed, the Commission has eliminated this separate requirement and replaced it with an instruction reminding companies that discussion of material commitments and obligations must include those arising from off-balance sheet arrangements.

Contractual obligations table. The amendments eliminate the requirement to include a table of contractual obligations. The current requirement does not have a materiality threshold and, although not all of the information in the table is necessarily disclosed as a result of U.S. GAAP or other Commission requirements, all material information about a company's cash obligations should be. To reinforce that point, the Commission has added an instruction to the liquidity and capital resources requirement that the discussion must address material cash commitments from obligations of all types.

Critical accounting estimates. As the result of Commission guidance, companies have since 2003 been including a discussion of critical accounting estimates in their MD&A. The new rules effectively codify this Commission guidance and may go further than current disclosure practices. The adopting release also acknowledges that many registrants repeat the discussion of significant accounting policies from the notes to their financial statements in their MD&A and provide limited additional discussion of critical accounting estimates, which was not the intended result of Commission guidance. Under the revised rule, companies will be required to provide information – both qualitative and quantitative – needed to understand the uncertainty in these estimates and the impact on the company's results of operations and financial condition. The information should include why an estimate is uncertain. In addition, to the extent the information is material and reasonably available, the company should disclose how much the estimate or assumption has changed over time and the sensitivity of the reported amounts. This latter requirement, at least on a quantitative basis, is more extensive than most companies currently disclose and is the MD&A topic to which companies will likely give the most thought as they prepare to comply with the new rules.

Miscellaneous. Various conforming changes were made to rules affecting smaller reporting companies, foreign private issuers and other Commission forms and reports.

Looking Ahead

As noted above, the rules will apply to fiscal years beginning 210 days or more after the rules are published in the Federal Register. If the timeframe for publication tracks current trends, the rules will not apply to any fiscal year commencing before September 1 of next year. Companies are permitted to use the new rules on a voluntary basis at any time after the effective date (30 days after publication), but only if they provide disclosures relating to the amended item in their entirety. Thus, for example, if a company wanted to eliminate the contractual obligations table in its upcoming Form 10-K, it would be required to comply with the requirements for disclosure under the critical accounting estimates amendment (and all other amended requirements of Item 303).

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Keith rejoined the firm in 2017, after having served as Director of Corporation Finance at the U. S. Securities & Exchange Commission since 2013. While in that role, Keith led the Division's implementation of significant rulemaking under the Dodd-Frank Wall Street Reform and Consumer Protection Act, Jumpstart Our Business Startups Act (JOBS Act), and Fixing America's Surface Transportation Act (FAST Act). He also led the Division's Disclosure Effectiveness project and oversaw the issuance of significant interpretive guidance to companies and investors under the federal securities laws.

Prior to serving at the SEC, Keith had for more than 30 years been counseling public companies in securities offerings, mergers and acquisitions, compliance and corporate governance. Keith advises companies, their boards, and investors on matters with the SEC, including disclosure and financial statements, no-action letters, as well as SEC enforcement actions and related internal investigations.

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Craig Marcus co-chairs the firm's capital markets group. A leading capital markets and private equity attorney, Craig is a trusted advisor to many prominent public companies—as well as some of the nation's foremost private equity sponsors and alternative asset managers—in their capital raising and strategic transactions. Institutional investors also turn to Craig for sophisticated SEC reporting guidance related to their investment positions.

Craig has led a number of high profile initial public offerings, including Domino's Pizza and Dunkin' Brands, and has developed a particular expertise in navigating the IPO process for private equity portfolio companies. His innovation in all aspects of capital markets financing is especially valued by clients in the health care, consumer retail, industrials and technology industries. He has also been involved in several high-profile whole business securitization transactions, including the first of its kind over a decade ago.

Longtime clients recognize Craig as a committed, savvy negotiator with extensive experience in all of the details of the IPO process. Craig also provides clients with valuable insight on a wide range of corporate governance, executive compensation and disclosure matters.

Top legal publications and directories consistently recognize Craig as a leader in his field, and he is frequently quoted in articles on capital markets trends and innovations.

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