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November 24, 2020

## SEC Updates MD&A and Other Financial Disclosure Requirements

The SEC has adopted amendments to the financial disclosure requirements of Regulation S-K, including the requirements (set out in Item 303) governing the presentation of Management's Discussion and Analysis (MD&A) (available [here](#)). These amendments are a part of the SEC's modernization initiatives, and are intended to better focus disclosure on material information while reducing compliance efforts for SEC reporting companies.

The amendments restructure and simplify the MD&A disclosure requirements (Item 303), by introducing a more principles-based approach to MD&A, reducing duplicative disclosures and codifying certain SEC guidance. Some key highlights of the MD&A amendments:

- *Objective*: This is a new introductory section to MD&A, and is intended to help registrants focus on the key purpose of MD&A and on "material" and "reasonably likely" impacts.
- *Liquidity and Capital Resources*: These disclosure items have been combined and updated to require disclosure of "material cash requirements."
- *Critical Accounting Estimates*: The amendments codify and enhance prior SEC guidance to require the disclosure and discussion of critical accounting estimates.
- *Off-Balance Sheet Arrangements and Tabular Disclosure of Contractual Obligations*: As part of the effort to reduce duplicative disclosure, current Items 303(a)(4) (off-balance sheet arrangements) and 303(a)(5) (tabular disclosure of contractual obligations), both introduced in 2003 as part of the Sarbanes-Oxley reforms, have been eliminated.
- *Interim Period Disclosures*: The amendments give registrants the flexibility to compare quarterly results to the prior year's quarter or the immediately preceding quarter.

In addition, the amendments eliminate the requirement to present five years of selected financial data (Item 301); and simplify and streamline the presentation of supplementary financial data (Item 302). Registrants will no longer be required to provide two years of tabular supplementary quarterly financial information.

The amendments also make conforming changes to Forms 20-F, 40-F and certain other rules and regulations that replicate or reference the impacted items. For a summary of the changes to Form 20-F and Form 40-F, please see our separate Client Alert, "[SEC Updates Form 20-F and Form 40-F MD&A and Other Financial Disclosure Requirements](#)."

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**Management's Discussion and Analysis (Item 303)***Objective – New Item 303(a)*

The SEC has added new Item 303(a), which articulates the objectives of MD&A disclosure. New Item 303(a) is intended to emphasize the purpose of MD&A, and to provide clarity and focus for registrants as they consider the information to cover in their MD&A disclosure. This new section codifies SEC guidance that registrants should provide a narrative explanation of their financial statements that would enable investors to see the registrant “through the eyes of management.”

The objectives specifically require registrants to disclose:

- material information relevant to an assessment of 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 to not be necessarily indicative of future operating results or future financial condition, which 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; and
- material financial and statistical data that the registrant believes will enhance a reader’s understanding of financial condition, cash flows and other changes in financial condition and results of operations.

The SEC reminded registrants to regularly revisit the Item 303(a) objectives. The SEC noted that “[t]hese objectives provide the overarching requirements of MD&A and apply throughout amended Item 303. As such, they emphasize a registrant’s future prospects and highlight the importance of materiality and trend disclosures to a thoughtful MD&A. These amendments are intended to remind registrants that MD&A should provide an analysis that encompasses short term results as well as future prospects.”

*“Reasonably Likely” Standard*

The SEC made clarifying remarks regarding the “reasonably likely” standard articulated in Item 303. The SEC noted that this standard:

- “requires 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.” The SEC expressly rejected a “reasonably expects” standard proposed by commenters in favor of an objective determination of likelihood.

- “does not call for disclosure of immaterial or remote future events.” The SEC explicitly stated that it was not adopting the probability/magnitude test of *Basic v. Levinson* (which could require disclosure of remote events).

The “reasonably likely” standard would require disclosure in the following circumstances:

- If a 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.
- Where 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, if a reasonable investor would consider omission of the information as significantly altering the mix of information made available in the registrant’s disclosures.

#### *Full Fiscal Year Disclosure – Item 303(b)*

The requirements for full year MD&A disclosures are now set forth in revised Item 303(b). In an effort to encourage registrants to provide a more meaningful discussion, the SEC has revised the requirement that registrants identify the “causes” of material changes in line items with a requirement that they discuss any “underlying reasons” for those changes. Additionally, revised Item 303(b) codifies prior SEC guidance (and longstanding practice) that registrants should discuss material changes within a line item even when such material changes offset each other.

Where there are material changes period-to-period, the underlying reasons for the changes should be presented in qualitative and quantitative terms. The SEC noted that, where in the registrant’s judgment, a discussion of segment information and/or of other subdivisions (*e.g.*, geographic areas, product lines) of a business would be necessary to an understanding of the business, the discussion must focus on each relevant reportable segment and/or other subdivision of the business as well as on the registrant as a whole.

#### **Liquidity and Capital Resources**

Liquidity and capital resource items are grouped together, with a common introduction urging a principles-based approach to this disclosure. The introduction instructs registrants to present this disclosure on both a short-term and long-term basis, and codifies prior SEC guidance 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.

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New Item 303(b)(1)(ii) (Capital Resources) expands the disclosure requirement beyond “commitments for capital expenditures” to require disclosure of “material cash requirements,” in recognition that certain expenditures and cash commitments that are not necessarily capital investments may be increasingly important to registrants. Disclosure is required of anticipated sources of funds needed to satisfy cash requirements and the general purpose of such requirements.

This analysis will need to specify the type of obligation and relevant time periods for the cash requirements. New Instruction 4 to Item 303 identifies some examples of contractual obligations that would prompt this disclosure requirement: lease obligations, purchase obligations or other liabilities reflected on the balance sheet.

### **Net Sales and Revenues**

The amendments codify prior SEC guidance (and longstanding practice) that disclosure should explain material changes in net sales or revenues (not just material increases) attributable to changes in price, volume, amount of goods or services sold, or new products or services sold.

### ***Inflation and Price Changes***

The amendments eliminate current Item 303(a)(3)(iv) and Instructions 8 and 9, which require disclosure of inflation and price changes. The SEC noted that because registrants are already expected to address the impact of inflation or price changes if they are part of a known trend or uncertainty that has had, or is reasonably likely to have, a material favorable or unfavorable impact, that these additional items are unnecessary and duplicative.

### **Off-Balance Sheet Arrangements**

In an effort to reduce the duplication caused by the overlap between GAAP disclosure requirements and current Item 303(a)(4), the SEC is eliminating Item 303(a)(4) and replacing it with a principles-based disclosure requirement in new Instruction 8 to Item 303(b). Under new Instruction 8, registrants must discuss any such off-balance sheet commitments or obligations that have, or are reasonably likely to have, a material current or future effect on financial condition, changes in financial condition, revenues or expenses, results of operation, liquidity, cash requirements or capital resources. The SEC expects registrants will incorporate this discussion in their broader discussion of liquidity and capital resources.

### **Contractual Obligations**

As further part of the SEC’s efforts to reduce duplicative disclosure, the amendments delete current Item 303(a)(5) which required tabular presentation of a registrant’s known contractual obligations. The SEC believes this change should not result in the loss of material information, given financial statement

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disclosure requirements and the new requirements to discuss material cash requirements as part of the liquidity and capital resources disclosures.

### **Critical Accounting Estimates**

The amendments codify the prior SEC guidance to explicitly require registrants to disclose critical accounting estimates. To avoid repetition of the significant accounting policies disclosure made in financial statement footnotes, the requirements clarify that the critical accounting estimates disclosure should focus on “estimation uncertainty.” Critical accounting estimates 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 financial condition or results of operations of the registrant.”

Registrants must disclose:

- To the extent material and reasonably available, the qualitative and quantitative information necessary to understand the estimation uncertainty and impact the estimate has had or is reasonably likely to have.
- Why each critical accounting estimate is subject to uncertainty.
- To the extent material and reasonably available, how much each estimate and/or assumption has changed over a relevant period (note, to give registrants flexibility, this is deliberately not tied to the “reporting period” though the disclosure should provide insight into those estimation uncertainties that have had or are reasonably likely to have a material impact on the reported financial statements being discussed).
- The sensitivity of the reported amount to the methods, assumptions and estimates underlying the calculation of the estimate.

### **Supplementary not Duplicative**

While the amendments do away with many duplicative disclosure requirements, new Instruction 3 to Item 303(b) emphasizes that the MD&A is to supplement, not duplicate, disclosure already provided in the filing. Registrants are reminded that the MD&A is to be presented in a format that facilitates easy understanding.

#### *Interim Periods – Item 303(c)*

Registrants will now be able to make quarterly comparisons to the prior year’s quarter or to the immediately preceding quarter. If the comparison is to the immediately preceding quarter, then

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registrants must either provide summary financial information for that quarter or identify the filings on EDGAR that contain such information. If there is a change in the form of presentation from period to period, registrants must discuss the reasons for changing the basis of comparison and provide both comparisons in the first filing in which the change is made.

*Elimination of Safe Harbor for Forward-Looking Information – Current Item 303(c)*

Current Item 303(c) states that the safe harbors provided in Section 27A of the Securities Act and Section 21E of the Exchange Act apply to all forward-looking information provided in response to the requirements in current Item 303(a)(4) to disclose off-balance sheet arrangements and current Item 303(a)(5) to disclose contractual obligations in tabular form. Current Item 303(c) was added when current Items 303(a)(4) and 303(a)(5) were added (in 2003) to remove any possible ambiguity about the application of the statutory safe harbors to these items. Because these specific disclosure items have been eliminated as part of these amendments, and the disclosure is instead integrated more fully into MD&A, the amendments eliminate Item 303(c). In response to comments, the SEC explicitly confirmed that this change “does not alter the application or availability of the statutory safe harbors or the regulatory safe harbors for all of amended Item 303, including the new requirement to disclose critical accounting estimates.”

*Smaller Reporting Companies*

The amendments delete current Item 303(d), which modified the application of Items 303(a)(3)(iv) (inflation and changing price disclosure) and Item 303(a)(5) (tabular disclosure of contractual obligations) to smaller reporting companies (SRCs) because, as discussed above, these underlying items have been eliminated. SRCs will be required to provide disclosure of material cash requirements as part of their liquidity and capital resources disclosures.

**Elimination of Selected Financial Data Requirement (Item 301)**

The amendments delete current Item 301 of Regulation S-K, which requires the presentation of five years of selected financial data in tabular form. In adopting this change, the SEC noted the ease with which this information is accessed elsewhere. The SEC did make a point, however, of encouraging registrants to consider whether a tabular presentation of financial information may be helpful to demonstrate material trends and thus be appropriate to include.

**Streamlining of Supplementary Financial Data Requirements (Item 302)**

Current Item 302(a) requires the presentation of certain financial data for each quarter of the last two completed fiscal years and any subsequent interim period. The amendments significantly modify the applicability and content of this requirement.

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### *Material Retrospective Change*

Revised Item 302(a) will only require the disclosure of supplementary financial data where there are one or more retrospective changes to the statements of comprehensive income within any quarter of the last two completed fiscal years or any subsequent interim period that are, individually or in the aggregate, material. In that case, registrants will be required to provide an explanation of the reasons for such material changes, and provide summary financial information for each affected quarterly period and the fourth quarter in the affected year.

The SEC provided some examples of retrospective changes that could trigger Section 302(a) disclosures (note that this is not an exhaustive list): 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 accounting principle.

### *Time Periods to Be Presented*

Depending on the circumstances, the presentation of supplementary financial information may only be required for a single affected quarter, or it may be required for multiple quarters if the material change flows through to subsequent quarters in the covered time period. Registrants will not be required to provide disclosures for interim periods prior to those presented in an IPO registration statement. The SEC stated that if a new registrant has a material retrospective change to the year-to-date interim period information included in its registration statement, but has not yet disclosed that information in quarterly increments, it would allow Item 302(a) disclosures to be presented for the year-to-date interim period and the fourth quarter in the affected year (as opposed to requiring a quarterly presentation).

### *Financial Information Required*

To give registrants more flexibility, the SEC has deleted from Item 302(a) the prescribed list of items and instead referred registrants to Rule 1-02(bb)(ii) of Regulation S-X for the summary financial information related to statements of comprehensive income that they should provide.

### *Oil and Gas Disclosures (Item 302(b))*

While the SEC had proposed eliminating Item 302(b) to avoid the duplication of disclosures required by GAAP, because the FASB has not yet finalized certain GAAP amendments relating to these disclosures, the final rules retain current Item 302(b). The SEC noted that it may reconsider this proposal in the future after the FASB has finalized the proposed amendments to GAAP.

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**Conforming Amendments**

The amendments make several conforming changes to Form 20-F and Form 40-F to ensure that the existing MD&A requirements for foreign private issuers mirror the substantive MD&A requirements set forth in revised Item 303 and the elimination of Item 301 of Regulation S-K.

In addition, the amendments include conforming changes (reflecting the deletion of Item 301 of Regulation S-K) to Item 914(a) of Regulation S-K, Regulation AB, the summary prospectus requirements in Forms S-1 and F-1, and Forms S-4, F-4 and Schedule 14A.

**Effectiveness and Transition**

The amendments will be effective 30 days after publication in the *Federal Register*. Registrants will be required to apply the amended rules for the first fiscal year ending on or after the date that is 210 days after publication in the *Federal Register* (the “compliance date”), and will be required to apply the amended rules in registration statements and prospectuses that at the time of the initial filing are required to contain financial statements for a period on or after the compliance date.

Registrants may comply with the amended requirements at any time after the effective date, so long as they comply with any amended item (*e.g.*, all of Item 303) in its entirety.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Mark S. Bergman  
+44-20-7367-1601  
[mbergman@paulweiss.com](mailto:mbergman@paulweiss.com)

Christopher J. Cummings  
+1-212-373-3434  
[ccummings@paulweiss.com](mailto:ccummings@paulweiss.com)

David S. Huntington  
+1-212-373-3124  
[dhuntington@paulweiss.com](mailto:dhuntington@paulweiss.com)

Brian M. Janson  
+1-212-373-3588  
[bjanson@paulweiss.com](mailto:bjanson@paulweiss.com)

John C. Kennedy  
+1-212-373-3025  
[jkennedy@paulweiss.com](mailto:jkennedy@paulweiss.com)

Raphael M. Russo  
+1-212-373-3309  
[rrusso@paulweiss.com](mailto:rrusso@paulweiss.com)

Tracey A. Zaccone  
+1-212-373-3085  
[tzaccone@paulweiss.com](mailto:tzaccone@paulweiss.com)

*Practice Management Consultant Jane Danek and Securities Practice Management Attorney Monika G. Kislowska contributed to this client alert.*