

SEC Revision of MD&A – Focus on Future Uncertainties Disclosure

WRITTEN BY

Stanley Keller

The Securities and Exchange Commission has continued its effort to update and streamline the disclosure requirements for filings with the SEC. In November, the SEC adopted amendments to the rules for Management's Discussion and Analysis and related financial disclosures. [1] MD&A, because of its principles-based nature, is among the most challenging of the disclosure requirements. Within MD&A, addressing "known trends or uncertainties," because the requirements are not only principles-based but also future oriented, can be especially challenging. In the recent amendments, the SEC, although not directly modifying its previous interpretations regarding disclosure of known trends or uncertainties that have troubled practitioners over the years, provides useful guidance that should align the specific requirements with the approaches followed in practice.

MD&A, as required by Item 303 of Regulation S-K, has long been a part of required disclosure. It is designed to provide additional meaning to the required financial information and to put that information in context "through the eyes of management." Part of providing that context is to disclose known trends, demands, commitments, events or uncertainties that have had or would reasonably have a material effect on the company's financial condition, cash flow or results of operations in a way that makes the past financial information not necessarily indicative of future condition or results.

In 1989, the SEC established a two-step test for determining whether a known trend or uncertainty required disclosure.[2] First, management must determine if the known trend or uncertainty is likely to occur – if it determines it is not likely to occur, no disclosure is required. If it cannot make that determination, it must go to the next step, which is to evaluate objectively the materiality of the known trend or uncertainty on the assumption that it will occur. Disclosure is then required unless management determines that the effect is not reasonably likely to be material. This two-step negative presumption test has caused concern for practitioners. Despite comments expressing that concern, the Commission chose to reaffirm the 1989 two-step test, asserting that the language of Item 303 as amended codified that position. At the same time, however, the Commission provided guidance in the adopting release on how to apply the two-step test in making disclosure determinations that should align Item 303's requirements with how it is generally applied in practice.

First, the Commission has included in Item 303(a) general concepts applicable to MD&A that previously appeared as guidance in instructions and interpretations. Although provisions of Regulation S-K items usually are applied as legal requirements, because of their generality the provisions of Item 303(a) are unlikely to be applied that way. The Commission also makes clear in the adopting release that MD&A should include a thoughtful discussion and analysis of factors specific to the particular company's business that from management's perspective are

necessary to an understanding of the company's financial condition, changes in financial condition and results of operations. The Commission emphasizes that materiality is the overarching principle of MD&A disclosure.

With specific reference to known trends and uncertainties, the amendments to Item 303 establish a consistent "reasonably likely" standard as opposed to a "will" or "reasonably expected" standard. The required analysis is to be based on "management's assessment," which must be "objectively reasonable." The Commission then explains that in applying the two-step test in assessing whether disclosure of a known trend or uncertainty is required, the analysis is to be based on "materiality," as commonly understood as being what would be considered important by a reasonable investor in making a voting or investment decision. In applying the two-step test under the "reasonably likely" standard, a company must first objectively consider whether it is likely to occur. If the known trend or uncertainty is not remote or if management cannot make that determination, management must then on an objective basis consider whether, if the known trend or uncertainty were to occur, it would have a material effect. If so, disclosure would be required if omission of the information would significantly alter the mix of information a reasonable investor would consider important, with the objective being to provide investors with an understanding of the material consequences of the known forward-looking trends or uncertainties. The Commission expressly rejected use in this context of the *Basic* probability/magnitude standard for assessing materiality.^[3]

Although the two-step negative presumption test is reaffirmed, the Commission's guidance puts it in a context that should give companies somewhat more leeway in assessing the materiality to investors of non-remote known trends or uncertainties and greater comfort in reaching good faith thoughtful disclosure decisions.

Other Changes

The following is a summary of some of the other changes made by the SEC:

- Item 301 requiring a five-year selected financial data table is eliminated in recognition that the financial information appears in other filings.
- Item 302 calling for tabular quarterly financial information for the prior two fiscal years and any subsequent quarterly period, which applies to an annual report on Form 10-K and certain registration statements on Form S-1, is modified to require disclosure only when prior changes to the income statement during those periods have been material, thus substituting a principles-based approach for a technical requirement that replicates information largely available in other filings.
- In addition to adding a new Item 303(a) called "Objective," the requirements for analysis and discussion of liquidity and capital resources and results of operations in Item 303(b)(1) and (2) for the full fiscal years and for material changes in financial condition and results of operations for interim periods were revised to "modernize, enhance and clarify" and, in some cases, streamline the disclosure requirements. They largely call, however, for the same primarily principles-based substantive information as has been required. In the case of interim period information, the SEC has added flexibility to allow companies to tailor their disclosure to their own situation by choosing the year-over-year traditional comparison or a sequential quarter comparison. If a company changes the approach, it must explain the reason and provide both comparisons in the first changed filing.
- Instead of a separate provision for off-balance sheet arrangements, an instruction to discuss material commitments and obligations arising from those off-balance sheet arrangements in the context of the MD&A discussion is substituted.
- The requirement to include a table of contractual obligations is eliminated in favor of expanded disclosure regarding liquidity and capital commitments of material cash commitments from obligations, including contractual obligations.

- New Item 303(b)(3) is added to codify the SEC's guidance on critical accounting estimates to make clear that the discussion should not repeat the financial statement note on significant accounting policies. Instead, the discussion should provide qualitative and quantitative information necessary for an investor to understand the uncertainty of those accounting estimates reflected in the financial statements that involve significant uncertainty and are likely to have a material impact on financial condition or results of operation.
- Conforming changes are made to the requirements for smaller reporting companies and foreign private issuers, along with other changes in rules and forms to reflect the amendments.

Effective Date and Transition.

The amendments become effective 30 days after publication in the Federal Register but the changes only apply to filings beginning the first fiscal year ending on or after 210 days following publication in the Federal Register (for calendar year companies that will be the fiscal year ending December 31, 2021). Companies may choose to use the new rules any time after they become effective so long as they comply with an item (such as Item 303) in its entirety.

* * *

If you have any questions about these amendments or related topics, your regular Locke Lord contact or any of the authors can discuss these matters with you.

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

[2] Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, [Release No. 33-6835](#) (May 18, 1989).?

[3] *Basic, Inc. v. Levinson*, 485 U. S. 224 (1988).?

RELATED INDUSTRIES + PRACTICES

- [Capital Markets](#)