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Preparing for 10-K Season – a Guide to the MD&A Rule Changes

January 3, 2022

Securities and Capital Markets

Public companies are required to comply with amendments to the rules governing Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) and related financial disclosures in reports for their first fiscal year ended on or after August 9, 2021. Accordingly, most calendar year-end companies will be implementing the amended MD&A disclosures for the first time in their annual reports on Form 10-K and Form 20-F for the year ended December 31, 2021.[1] This alert provides a high-level overview of the key changes to the MD&A disclosure requirements.

Amendments at a Glance

The amendments remove duplicative requirements, replace some prescriptive rules with materiality-based standards and provide companies with more flexibility in presenting their narrative analysis of their financial performance. The amendments eliminate the requirement in Item 301 of Regulation S-K to provide five years of selected financial data and streamline and revise the supplemental financial information requirement under Item 302 of Regulation S-K.

1 MD&A's Objective

Amended Item 303(a) of Regulation S-K adds a new disclosure requirement, which is intended to clarify the objective of MD&A disclosure. This new disclosure requirement draws from, and enhances, guidance previously located in the instructions to Item 303 and incorporates longstanding SEC guidance from prior interpretive releases. This statement of the MD&A's objective includes the following key points:

- MD&A should provide material information relevant to an assessment of the company's financial condition and results of operations, including an evaluation of the amounts and certainty of cash flows from operations and from outside sources;

[1] In addition, companies filing registration statements and prospectuses under the Securities Act of 1933 that contain or incorporate financial statements for a fiscal year ended on or after August 9, 2021 will be required to comply with the amended MD&A rules.

- MD&A should focus specifically on material events and uncertainties known to management that are reasonably likely to cause reported financial information not to be necessarily indicative of future operating results or of future financial condition;
- MD&A should encompass both short-term results and future prospects;[2] and
- MD&A should enable investors to see the company "through the eyes of management."[3]

2 Key Changes to MD&A Requirements

Amended Item 303(b) reorganizes and updates the information required with respect to full fiscal years. Key changes include the following:

- Disclosure of Reasons Underlying Material Changes in Line Items. The SEC has amended the requirement to provide a narrative discussion of the causes of material changes in line items of a company's financial statements to include a discussion of the underlying reasons for such changes. The SEC indicated that this change was to emphasize the need for a meaningful analysis of the quantitative and qualitative reasons underlying material changes in line items from year to year, instead of a mere recitation of year-over-year changes to reported results. In addition, the amended rule now specifically calls for discussion of the reasons for material changes in line items where material changes *within* a line item offset one another.
- Liquidity and Capital Resources. The SEC has amended the requirement to discuss material commitments for "capital expenditures" to require disclosure of "cash requirements," including commitments for capital expenditures. The amended rule also requires an analysis of the company's ability to generate and obtain adequate amounts of cash to meet its requirements and its plans for cash in both the short-term (the next 12 months from the most recent fiscal period-end required to be presented) and long-term (beyond the next 12 months). Companies are required to analyze and disclose their ability to generate and obtain adequate amounts of cash and their plans for its utilization over each of these periods. This discussion must analyze material cash requirements from known contractual and other obligations, including specifying the type of obligation and relevant time periods of related cash requirements.

Practice Tip

Companies will want to consider enhancing their discussion of liquidity and capital resources in MD&A to address their short-term and long-term cash requirements. Companies with substantial sums held offshore should disclose any potential difficulties repatriating these funds.

[2] See 1989 MD&A Interpretive Release.
[3] See 2003 MD&A Interpretive Release.

- Contractual Obligations Table. The SEC eliminated the requirement that companies disclose their known contractual obligations in a tabular format since it was often duplicative of information contained in the financial statements. The SEC further noted that it did not believe that the change would result in a loss of material information, as companies are still required to integrate known contractual and other obligations into the broader discussion of their liquidity and cash requirements.

Practice Tip

Although no longer required, we believe some companies may retain this table because their reporting structures for preparing this information remain in place, and they believe it will aid investors' understanding above and beyond the required narrative disclosure of material cash requirements from known contractual and other obligations.

- Segment Information. The amended rule clarifies that, in addition to disclosure regarding reportable segments, a company should provide information regarding other subdivisions, such as geographic areas and product lines, when necessary to understand its business.
- Known Trends and Uncertainties. In the Results of Operations, the SEC has amended the requirement to disclose known events that "will" cause a material change in the relationship between costs and revenues to require disclosure of known events that are "reasonably likely" to cause such a material change. The SEC noted that this amendment is intended to conform the rule's language to other MD&A disclosure requirements for known trends, in accordance with current practice and prior guidance in the SEC's 1989 MD&A Interpretive Release.
- Net Sales or Revenues. In the Results of Operations, the SEC codified guidance in the 1989 MD&A Interpretive Release to require companies to discuss the extent to which material changes in net sales or revenue are attributable to changes in prices, changes to volumes of goods or services sold or to the introduction of new products or services.
- Inflation and Price Changes. The amended rule no longer mandates a narrative discussion of the impact of inflation and price changes on net sales, revenues and income from continuing operations. Rather, companies are expected to discuss such impacts if they constitute part of a known trend or uncertainty that has had, or is reasonably likely to have, a material impact on net sales, revenues or income from continuing operations.[4]

Practice Tip

These amendments will be important to review in the context of recent inflationary trends.

[4] In its adopting Release, the SEC noted that where the financial statements reveal material period-to-period changes, companies must describe the underlying reasons for these material changes in quantitative and qualitative terms, citing to amended Item 303(b).

- Off-Balance Sheet Arrangements. Amended Item 303 eliminates the previous line item requirement to discuss off-balance sheet arrangements. However, a new instruction has been added to Item 303(b) that effectively requires the same disclosure where commitments or obligations, including contingent obligations, arising from arrangements with unconsolidated entities or persons have, or are reasonably likely to have, a material current or future effect on a company's financial condition, revenues or expenses, results of operations, liquidity, cash requirements or capital resources. This disclosure is required by the instruction even where the arrangement results in no obligations being reported on the consolidated balance sheet.

Practice Tip

Item 2.03 of Form 8-K was amended to retain the definition of off-balance sheet arrangement from prior Item 303(a)(4). As a result, Form 8-K reporting requirements under Items 2.03 and 2.04 for entry into and acceleration of an off-balance sheet arrangement, respectively, are unchanged.

- Critical Accounting Estimates. Amended Item 303 codifies longstanding guidance from the 2003 MD&A Interpretive Release that companies should consider whether accounting estimates and judgments could materially affect reported financial information. Companies are now required to provide qualitative and quantitative information, to the extent material and reasonably available, necessary to understand the uncertainty regarding their critical accounting estimates and the impact these estimates have had or are reasonably likely to have on the company's financial condition and results of operations. Companies are now further required to discuss why each critical accounting estimate is subject to uncertainty and, to the extent material and reasonably available, how much each estimate or assumption has changed over the relevant period, and the sensitivity of the reported amount to the methods, assumptions and estimates underlying its calculation. The instructions to this amended rule clarify that such disclosure should supplement, but not duplicate, the description of accounting polices otherwise disclosed in the financial statements.

3 Enhanced Flexibility for Interim Period Presentation

The amendments provide greater flexibility for MD&A disclosure regarding interim periods. Under amended Item 303(c) of Regulation S-K, companies may compare their most recently completed quarter to either the corresponding quarter of the prior year (as previously required) or the immediately preceding quarter. If a company elects to adopt a sequential comparison, it must state the reasons for changing the basis of comparison and include both the sequential and year-over-year comparisons in the first filing where the change is made. A sequential quarterly comparison must also either provide summary financial information for the previous quarter or identify the company's prior SEC filing that presents such information. As under the prior rule, companies must continue to discuss material changes in results of operations with respect to the most recent year-to-date period for which a statement of comprehensive income is provided and the corresponding year-to-date period of the prior fiscal year.

4 Selected Financial Data and Supplementary Financial Information

- The SEC eliminated Item 301 of Regulation S-K, which required companies to furnish financial data from the prior five fiscal years in comparative tables.
  - Instead, companies should consider whether trend information for periods earlier than those presented in the financial statements may be necessary in the MD&A discussion when assessing material information relevant to financial condition and results of operations.
- Item 302(a) of Regulation S-K, which required tabular disclosure of financial data for each full quarter within the two most recent fiscal years, has been replaced with a principles-based approach.
  - Item 302(a) now requires companies to disclose retrospective changes that are material, individually or in the aggregate, to statements of comprehensive income for any of the quarters in the two most recent fiscal years.
  - Companies are required to explain the reasons for material changes and to disclose summarized financial information for each affected quarterly period and the fourth quarter in the affected year.

5 Other Changes and Developments

- Parallel and conforming amendments were also made to the MD&A disclosure requirements for foreign private issuers, Canadian companies and smaller reporting companies.
- To preserve disclosure of financial information in summary prospectuses given the elimination of Item 301, the requirement to disclose selected financial data in Forms S-1 and F-1 was replaced with a requirement to disclose summarized financial information under Item 1-02(bb) of Regulation S-X, which includes disclosure regarding a company's assets, liabilities and results of operations for each of the last three years (or the life of the relevant entity or group of entities, if less).
- To avoid duplication of pro forma information otherwise required in Forms S-4 and F-4 and to give effect to the purpose of the elimination of Item 301, Items 3(e) and (f) of such forms, which required Item 301 or Item 3.A of Form 20-F (tabular disclosure of selected financial data for foreign private issuers) information, respectively, were removed from these forms.
- In addition to the MD&A requirements described herein, in September 2020, the SEC issued a final rule making additional changes to MD&A disclosure for banking registrants by replacing Guide 3 with Subpart 1400.
  - Banking registrants are required to comply with Subpart 1400 for their first fiscal year ending on or after December 15, 2021. For additional information regarding these requirements, please refer to our earlier client alert.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Securities and Capital Markets practice:

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