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Implementing the SEC's New MD&A Rule Part One: An Overview of the Changes

George Wilson, SEC Institute Director

Now that fall is approaching, it is time to give some thoughtful consideration to implementing the SEC's November 19, 2020 MD&A changes. This document reviews the details of the new rules and discusses implementation steps and challenges.

As a reminder, this is the rule that modernized and updated several areas in S-K Item 303, including:

- Modernizing and moving the principal objectives of MD&A to new Item 303(a);
- Adding Item 303(b)(1) to modernize, enhance and clarify disclosure requirements for liquidity and capital resources;
- Adding Item 303(b)(2) to clarify, modernize and streamline disclosure requirements for results of operations;
- Moving critical accounting estimate disclosures to new Item 303(b)(3) and modernizing these disclosure requirements;
- Replacing current Item 303(a)(4), Off-balance sheet arrangements, with a more principles-based instruction to discuss such obligations in the broader context of MD&A;
- Eliminating current Item 303(a)(5), Tabular disclosure of contractual obligations, as this information is required in a more principles-based, narrative form in the revised liquidity and capital resources disclosure requirements;
- Adding an option to the interim period MD&A requirements to include sequential-quarter analysis rather than year-over-year analysis; and
- Removing the paragraph addressing the impact of inflation, as such discussion would be required by the overall objective of MD&A.

The transition for the new rules provides that companies could **voluntarily adopt the changes on an S-K item-by-item basis after the effective date of February 10, 2021**. If a company did not early implement the new rule, the **mandatory transition date is the company's fiscal year that ends on or after August 9, 2021**. For calendar year-end companies, the new rules must be implemented for the year ended December 31, 2021.

A Reminder – Selected Financial Data and Quarterly Information

This is the Final Rule that also changed the requirement for the five-year summary and quarterly information disclosures. We explored these changes in this blog post from January 14, 2021. Removing the five-year summary and only including quarterly information if it has been materially, retrospectively adjusted are changes that are fairly straightforward and easy to implement. An issue to note: if a company decides it wants to keep the five-year summary, there is no longer a Form 10-K Item 6, as it is now "reserved." This means that a company that wants to keep the five-year summary would have to include it somewhere else, likely MD&A.

Transition Planning – MD&A

Implementing the new MD&A rules will require more planning and thought. There are many considerations, ranging from the new liquidity and capital resources requirements to clearer critical accounting estimate disclosures. Additionally, in most organizations, there are several stakeholders in MD&A disclosure who will need to be involved in the implementation. To help in this process, this document, which is based on a series of blog posts, will explore each MD&A change and discuss the practical issues and challenges in implementation. Each section is designed to help companies who have not implemented these new requirements plan the process and build the team to make these changes.

The subsequent sections of this document review and discuss:

- The addition of an objective to S-K Item 303;
- New critical accounting estimate disclosures;
- Changes to results of operations and known trend discussions;
- The elimination of a separate paragraph with disclosure requirements for off-balance sheet arrangements;

- [Replacing the Contractual Obligations Table with a Principles-Based Requirement];
- [Sequential Quarterly Analysis in Interim MD&As]; and
- [Expansion and clarification of the requirements for the discussion of liquidity and capital resources].

Perhaps more importantly, the new principles-based MD&A requirements are designed to help companies build a clearer and more informative MD&A. This transition provides an opportunity to make MD&A more informative and helpful for investors. Companies can combine the objective of improving their MD&A with the process of implementing the new S-K Item 303 guidance.

To provide an example of a company that went all in and implemented the new rules for their year-ended December 31, 2020, check out Lumen Technologies 2020 Form 10-K.

To help readers understand why their 2020 Form 10-K looks different, Lumen provided this helpful disclosure at the very beginning of Item 1 about the changes in their 10-K related to new rules:

> **Changes from Prior Periodic Reports**
>
> In this report we have complied with the disclosures required by the Securities and Exchange Commission ("SEC") release No. 33-10825 "Modernization of Regulation S-K Items 101, 103, and 105", and we have early adopted the changes in disclosure standards included in SEC release No. 33-10890 "Management's Discussion and Analysis, Selected Financial Data, Supplementary Financial Information."
>
> **Modernization of Regulation S-K Items 101, 103 and 105**
>
> Effective as of November 9, 2020, the SEC issued Release No. 33-10825, "Modernization of Regulation S-K Items 101, 103, and 105." This release was adopted to modernize the description of business, legal proceedings, and risk factor disclosures that registrants are required to make pursuant to Regulation S-K. Specifically, this release requires registrants to provide disclosures relating to their human capital resources and to restructure their risk factor disclosures. Additionally, the release increases the threshold for disclosure of environmental proceedings to which the government is a party.
>
> These changes are required for any annual period subsequent to the effective date of November 9, 2020. As such, we have adopted these changes in this report.
>
> **Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information**

> In November 2020, the SEC issued Release No. 33-10890, "Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information" which will become fully effective on August 9, 2021, with voluntary compliance permitted on or after February 10, 2021. This release was adopted to modernize, simplify, and enhance certain financial disclosure requirements in Regulation S-K. Specifically, the SEC eliminated the requirement for selected financial data, only requiring quarterly disclosure when there are retrospective changes affecting comprehensive income, and amending the matters required to be presented under Management's Discussion and Analysis ("MD&A") to, among other things, eliminate the requirement of the contractual obligations table.
>
> With our early adoption of this release, we have eliminated from this document the items discussed above that are no longer required. Information on our contractual obligations is still disclosed in a narrative within the "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 of Part II of this report.

Lumen's MD&A can be found on page 34 of their Form 10-K.

The New MD&A Rule: Part Two – Objective

George Wilson, SEC Institute Director

This section explores the first of the changes to the MD&A requirements, the addition of an objective to S-K Item 303.

A clear writing objective is crucial to effective business writing such as MD&A. Before this new rule, the most recent statement of the MD&A objective was in FR 72, the 2003 MD&A release which states:

> The purpose of MD&A is not complicated. It is to provide readers information "necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations." The MD&A requirements are intended to satisfy three principal objectives:
>
> - to provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management;
> - to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
> - to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

This articulation of MD&A's objective is over 17 years old, but it has never been part of the core guidance for MD&A in S-K Item 303. In the new rule, the SEC included a writing objective as part of S-K Item 303 and modernized the language:

> **229.303 (Item 303) Management's discussion and analysis of financial condition and results of operations.**
>
> (a) Objective. The objective of the discussion and analysis is to provide material information relevant to an assessment of the financial condition and results of operations of the registrant including an evaluation of the amounts and certainty of cash flows from operations and from outside sources. The discussion and analysis must 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. This 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. The discussion and analysis must be of the financial statements and other statistical data that the registrant believes will enhance a reader's understanding of the registrant's financial condition, cash flows and other changes in financial condition and results of operations. A discussion and analysis that meets these requirements is expected to better allow investors to view the registrant from management's perspective.

In the Final Rule, the SEC included these statements about the new objective:

> By emphasizing the purpose of MD&A at the outset of Item 303, the proposal was intended to provide **clarity and focus to registrants as they consider what information to discuss and analyze**. The proposal was also intended to facilitate a thoughtful discussion and analysis, and encourage management to disclose factors specific to the registrant's business, which management is in the best position to know, and underscore materiality as the overarching principle of MD&A.
>
> Registrants should regularly revisit these objectives in Item 303(a) as they prepare their MD&A and consider ways to enhance the quality of the analysis provided. These 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.

The Final Rule also focused on the principles-based requirements for MD&A:

> [W]e continue to believe that MD&A's materiality-focused and principles-based approach facilitates disclosure of complex and often rapidly evolving areas, without the need to continuously amend the text of the rule to update or impose additional prescriptive requirements. These amendments are intended to further emphasize these goals.

This objective will help companies improve MD&A. Based on this new objective, here are three key issues to remember in drafting and reviewing MD&A:

1. Don't write from a theoretical or academic perspective. Write about what management regards as important and regularly reviews in the financial statements.

2. Focus on the future as much as the past. Any known issues that indicate historical financial performance is not predictive of future financial performance must be considered for disclosure. (As a reminder of this disclosure requirement check out this enforcement action, which involved a $5,000,000 fine when a company failed to disclose an issue that meant that revenues were likely to decline in future periods.)

3. MD&A must focus on the financial statements but cannot stop there. It should include "other statistical data that the registrant believes will enhance a reader's understanding of the

registrant's financial condition, cash flows and other changes in financial condition and results of operations." (This is very consistent with the SEC's metrics release which you can read about in this post and hear more about in PLI's March 6, 2020 One-Hour Briefing.)

The updated objective of MD&A and these three framing concepts help us understand what we must communicate to investors and are the foundation for effective MD&A disclosure.

Please note that the content of this document is intended as practical and useful information. It is provided with the understanding that the SEC Institute and PLI are not engaged in rendering accounting, auditing, legal or other consulting or professional services. If accounting advice or other expert assistance is required, the services of a competent professional should be sought.

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The New MD&A Rule: Part Three – Critical Accounting Estimate Disclosure

George Wilson, SEC Institute Director

This section addresses disclosure of critical accounting estimates. The history of this disclosure has created more than a bit of confusion about its goal. As a result, disclosure about critical accounting estimates is too often vague and uninformative.

The first mention of anything "critical" about accounting principles or estimates was a very short "Cautionary Advice" issued on December 2, 2001, in the wake of Enron's downward spiral. It builds on the belief that "[i]nvestors may lose confidence in a company's management and financial statements if sudden changes in its financial condition and results occur, but were not preceded by disclosures about the susceptibility of reported amounts to change, including rapid changes."

Without defining "critical accounting policy," the Release suggested several disclosure steps, including:

1) "Each company's management and auditor should bring particular focus to the evaluation of the critical accounting policies used in the financial statements."; and
2) "Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies."

This was the first step in addressing accounting policies involving subjective and challenging estimates which could potentially create material financial statement volatility. The SEC issued a proposed rule in 2002 that would have required "critical accounting estimate" disclosure. (Note the change in terminology from "policy" to "estimate.")

This rule was never finalized.

One of the reasons the SEC never finalized this rule was their conclusion that existing MD&A guidance provides for "critical accounting estimate" disclosure. The 2003 MD&A release, FR 72, formally changed the terminology to "critical accounting estimates" and provided disclosure guidance:

> **V. Critical Accounting Estimates**
>
> Many estimates and assumptions involved in the application of GAAP have a material impact on reported financial condition and operating performance and on the comparability of such reported information over different reporting periods. Our December 2001 Release reminded companies that, under the existing MD&A disclosure requirements, a company should address **material implications of uncertainties** associated with the methods, assumptions and estimates underlying the company's critical accounting measurements. In May 2002 we proposed rules, which remain under consideration, that would broaden the scope of disclosures beyond those currently required.
>
> **When preparing disclosure under the current requirements**, companies should consider whether they have made accounting estimates or assumptions where:
>
> - the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and
>
> - the impact of the estimates and assumptions on financial condition or operating performance is material.

FR 72, the 2003 MD&A release, goes on to say:

> **Such disclosure should supplement, not duplicate, the description of accounting policies** that are already disclosed in the notes to the financial statements. The disclosure should provide greater insight into the quality and variability of information regarding financial condition and operating performance. While accounting policy notes in the financial statements generally describe the method used to apply an accounting principle, the discussion in MD&A should present a company's analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time.

This disclosure guidance is consistent with the MD&A's overall objective to help investors understand how well historical financial performance is predictive of future financial performance. If a company makes an estimate which could materially change in future periods, investors should be aware of this risk.

With all of this as preamble, it is still clear that many companies do not disclose information consistent with this guidance. All too frequently this disclosure is simply a repetition of information in the financial statement's summary of significant accounting policies.

This leads us to the Final Rule, which **adds a critical accounting estimate disclosure requirement to S-K Item 303**. This clarifies and codifies existing Commission guidance. S-K Item 303 now includes this paragraph:

> (3) Critical accounting estimates. Critical accounting estimates are those estimates made in accordance with generally accepted accounting principles 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. Provide qualitative and quantitative information necessary to understand the estimation uncertainty and the impact the critical accounting estimate has had or is reasonably likely to have on financial condition or results of operations to the extent the information is material and reasonably available. This information should include why each critical accounting estimate is subject to uncertainty and, to the extent the information is material and reasonably available, how much each estimate and/or assumption has changed over a relevant period, and the sensitivity of the reported amount to the methods, assumptions and estimates underlying its calculation.

The rule also adds this language in new Instruction 3, using the same wording as the 2003 MD&A release: "For critical accounting estimates, this disclosure must supplement, but not duplicate, the description of accounting policies or other disclosures in the notes to the financial statements."

The SEC explained their rationale for adding this requirement to S-K Item 303 in this comment from the Final Rule:

> The Commission proposed amending Item 303 to add new Item 303(b)(4), which would explicitly require disclosure of critical accounting estimates in order to clarify the required disclosures of critical accounting estimates, facilitate compliance, and improve the resulting disclosure. Because registrants often repeat the information in the financial statement footnotes about significant accounting policies, the proposals were also intended to eliminate disclosure that duplicates the financial statement discussion of significant accounting policies and, instead, promote enhanced analysis of measurement uncertainties.

The Final Rule also articulates the overall goal of critical accounting estimate disclosure and its forward-looking focus:

> Further, unlike existing requirements in U.S. GAAP, our amendments emphasize forward-looking information as they are intended to provide investors with greater insight into estimation uncertainty that is reasonably likely to have a material impact on financial condition and operating performance. We remind registrants that the principle that MD&A should not be a recitation of financial statements in narrative form extends to disclosure of critical accounting estimates.

This new requirement will create an opportunity for many companies to review their current disclosure and eliminate information that does not help assess potential variability or that simply duplicates information in the financial statements. There is also an opportunity to consider whether critical accounting estimate disclosure should be similar to the auditor's discussion of critical audit matters.

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The New MD&A Rule: Part Four – Results of Operations Changes

George Wilson, SEC Institute Director

This section addresses changes for the **results of operations** and **known trend discussions**. While they are not momentous, these changes are important reminders that this part of MD&A is not just about what happened but why things happened. As we explored in our discussion on MD&A's objective, one of the MD&A's goals is to help readers assess whether past performance is predictive of future performance. Understanding the causal factors behind changes helps a reader to evaluate whether these causal factors and the related changes will continue in the future.

Results of Operations Discussion

One area that has always required a bit of extra thought in this section of MD&A is this S-K Item 303 guidance about changes in revenues:

Before the change:

> (iii) To the extent that the financial statements disclose **material increases** in net sales or revenues, provide a narrative discussion of the extent to which such increases are attributable to increases in prices or to increases in the volume or amount of goods or services being sold or to the introduction of new products or services.

The fact that this paragraph refers only to *increases* in revenues leaves open the question about what should be discussed about decreases in revenues. We refer readers to Instruction 4, which requires discussion of all material changes in line items to close this gap. The Final Rule changes the wording to include all material changes in revenues:

From the Final Rule:

> (iii) If the statement of comprehensive income presents **material changes** from period to period in net sales or revenue, if applicable, describe the extent to which such changes are attributable to changes in prices or to changes in the volume or amount of goods or services being sold or to the introduction of new products or services.

The second change in the results of operations discussion is also related to Instruction 4. In the existing S-K Item 303, Instruction 4 reads:

Before the change:

> 4. Where the consolidated financial statements reveal material changes from year to year in one or more line items, the causes for the changes shall be described to the extent necessary (sic) to an understanding of the registrant's businesses as a whole; provided, however, that if the causes for a change in one line item also relate to other line items, no repetition is required and a line-by-line analysis of the financial statements as a whole is not required or generally appropriate. Registrants need not recite the amounts of changes from year to year which are readily computable from the financial statements. The discussion shall not merely repeat numerical data contained in the consolidated financial statements.

The Final Rule adds language like the first part of this Instruction to the actual text of S-K Item 303 in new paragraph (b):

From the Final Rule:

> Where the financial statements reflect **material changes** from period-to-period in one or more line items, including where **material changes within a line item offset one another**, describe the **underlying reasons** for these material changes in **quantitative and qualitative** terms. Where in the registrant's judgment a discussion of segment information and/or of other subdivisions (e.g., geographic areas, product lines) of the registrant's business would be necessary to an understanding of such business, the discussion must focus on **each relevant reportable segment and/or other subdivision** of the business and on the registrant as a whole.

This language includes two new requirements:

1) Discuss issues even if they offset, and

2) Discuss changes in both qualitative and quantitative terms.

The SEC issues many comments requiring a quantitative discussion of causal factors in MD&A.

The second part of Instruction 4 dealing with not repeating information and making the important point that a line-by-line analysis is not generally appropriate in new Instruction 2:

From the Final Rule:

> 2. If the reasons underlying a material change in one line item in the financial statements also relate to other line items, no repetition of such reasons in the discussion is required and a line-by-line analysis of the financial statements as a whole is neither required nor generally appropriate. Registrants need not recite the amounts of changes from period to period if they are

> readily computable from the financial statements. The discussion must not merely repeat numerical data contained in the financial statements.

The Final Rule also deletes the following language in S-K Item 303 concerning the impact of inflation.

Before the change:

> (iv) For the three most recent fiscal years of the registrant or for those fiscal years in which the registrant has been engaged in business, whichever period is shortest, discuss the impact of inflation and changing prices on the registrant's net sales and revenues and on income from continuing operations.

The SEC cites several reasons for removing this requirement, including that the current language may cause companies to focus "undue attention" on inflation. In the related proposed rule, the SEC states that they believe the current known trend disclosure requirements necessitate a discussion about inflation if management reasonably expects it to have a material impact on the company's finances:

> The precursors to Item 303(a)(3)(iv) and Instructions 8 and 9 were adopted in 1980, during a period of rapid domestic inflation. At that time, the Commission was concerned with the adequacy of disclosures about the effect of inflation and changing prices on registrants.
>
> Although Instruction 8 to Item 303(a) specifies that a discussion of inflation and other changes in prices is required only when such matters are considered material, we believe that the reference to inflation and changing prices **may give undue attention to the topic**, even when such information is not necessary to an understanding of a registrant's financial condition or results of operations. In order to encourage registrants to focus their MD&A on material information that is tailored to their respective facts and circumstances, we propose to eliminate Item 303(a)(3)(iv) and current Instruction 8 and Instruction 9 to Item 303(a).
>
> We do not believe that these proposed changes would result in a loss of material information. **Despite these proposed deletions, registrants would still be expected to discuss the impact of inflation or changing prices if they are part of a known trend or uncertainty that has had, or the registrant reasonably expects to have, a material favorable or unfavorable impact on net sales, or revenue, or income from continuing operations.**

Known Trend Discussion

The known trend disclosure requirements are not changed dramatically. They are clarified and emphasized in the Final Rule. This process starts with the following portion of the objective, articulated in new paragraph S-K Item 303(a):

> The discussion and analysis must 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**. This 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**.

This direct language has been in various interpretive Releases but never directly in S-K Item 303. Including this language in S-K Item 303 provides greater clarity about the requirement to disclose forward-looking information.

The second change here is another clarification. The current language in S-K Item 303 about known trend disclosures includes this requirement:

Before the change:

> (ii) …. If the registrant knows of events that **will cause** a material change in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments), the change in the relationship shall be disclosed.

From the Final Rule:

> (ii) …. If the registrant knows of events that are **reasonably likely to cause** a material change in the relationship between costs and revenues (such as known or reasonably likely future increases in costs of labor or materials or price increases or inventory adjustments), the reasonably likely change in the relationship must be disclosed.

This change clarifies that the requirement to discuss changes in the relationships between line items that might occur in the future is subject to the same probability assessment as other known trends.

For a refresher on this known trend probability level and a review of how misinterpreting it can result in big problems, check out the SEC Institute's Blog, where you can read about the disclosure requirements and a known trend related enforcement case.

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The New MD&A Rule: Part Five – Off-Balance Sheet Arrangements

George Wilson, SEC Institute Director

This section addresses the SEC's changes to disclosures about off-balance sheet arrangements or OBAs.

The history of OBA disclosures is deeply entwined with the history of one company: Enron. When MD&A was created in 1980, well before Enron made news, it required discussion of OBAs via this requirement in S-K Item 303(a) for capital resources:

> (2) Capital resources. (i) Describe the registrant's material commitments for capital expenditures as of the end of the latest fiscal period, and indicate the general purpose of such commitments and the anticipated source of funds needed to fulfill such commitments.
>
> (ii) Describe any known material trends, favorable or unfavorable, in the registrant's capital resources. Indicate any expected material changes in the mix and relative cost of such resources. The discussion shall consider changes between equity, debt and **any off-balance sheet financing arrangements.**

Even with this requirement, Enron demonstrated that companies did not always robustly disclose these risks. In the wake of Enron's use of OBAs, Congress wrote new requirements into the Sarbanes-Oxley Act to expand OBA disclosures. The SEC implemented this requirement via a new paragraph 4 in S-K Item 303, which starts with this language:

> (4) Off-balance sheet arrangements. (i) In a separately-captioned section, discuss the registrant's off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

While the term off-balance sheet arrangements can be interpreted in several ways, S-K Item 303(a) limits this disclosure to four very technical areas:

> (ii) As used in this paragraph (a)(4), the term off-balance sheet arrangement means any transaction, agreement or other contractual arrangement to which an entity unconsolidated with the registrant is a party, under which the registrant has:

> (A) Any **obligation under a guarantee contract** that has any of the characteristics identified in FASB ASC paragraph 460-10-15-4 (Guarantees Topic), as may be modified or supplemented, and that is not excluded from the initial recognition and measurement provisions of FASB ASC paragraphs 460-10-15-7, 460-10-25-1, and 460-10-30-1.
>
> (B) A **retained or contingent interest in assets transferred to an unconsolidated entity** or similar arrangement that serves as credit, liquidity or market risk support to such entity for such assets;
>
> (C) Any **obligation, including a contingent obligation, under a contract that would be accounted for as a derivative instrument, except that it is both indexed to the registrant's own stock and classified in stockholders' equity** in the registrant's statement of financial position, and therefore excluded from the scope of FASB ASC Topic 815, Derivatives and Hedging, pursuant to FASB ASC subparagraph 815-10-15-74(a), as may be modified or supplemented; or
>
> (D) **Any obligation, including a contingent obligation, arising out of a variable interest** (as defined in the FASB ASC Master Glossary), as may be modified or supplemented) in an unconsolidated entity that is held by, and material to, the registrant, where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the registrant.

Over time the FASB began to require financial statement disclosures about many of these areas. In the Final Rule, the SEC notes:

> Since the adoption of Item 303(a)(4), as described further in the Proposing Release, the FASB has issued additional requirements that have caused U.S. GAAP to further overlap with the item. In the Commission staff's experience, this overlap often leads to registrants providing cross-references to the relevant notes to their financial statements or providing disclosure that is duplicative of information in the notes in response to Item 303(a)(4).

The SEC also includes the following rationale for the change:

> For the reasons discussed in the Proposing Release, we continue to believe that the updates to U.S. GAAP since the adoption of Item 303(a)(4), as well as the current amendments designed to emphasize the principles-based nature of MD&A, justify the replacement of the current, more prescriptive requirement with a principles-based instruction.

The new MD&A guidance removes the old disclosure in paragraph (a)(4) and adds this instruction to S-K Item 303:

> 8. Discussion of commitments or obligations, including contingent obligations, arising from arrangements with unconsolidated entities or persons that have or are reasonably likely to have a material current or future effect on a registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, cash requirements or capital resources must be provided even when the arrangement results in no obligations being reported

in the registrant's consolidated balance sheets. Such off-balance sheet arrangements may include: guarantees; retained or contingent interests in assets transferred; contractual arrangements that support the credit, liquidity or market risk for transferred assets; obligations that arise or could arise from variable interests held in an unconsolidated entity; or obligations related to derivative instruments that are both indexed to and classified in a registrant's own equity under U.S. GAAP.

In theory, this change would eliminate disclosure that essentially duplicates information in the financial statement footnotes and would focus on the potential "future effect" such arrangements might have. The opportunity to improve MD&A here focuses on eliminating information that is already in the financial statements and making MD&A disclosure more focused on risk and how OBAs might affect future financial position and performance.

The New MD&A Rule: Part Six – Replacing the Contractual Obligations Table with a Principles-Based Requirement

George Wilson, SEC Institute Director

This sixth section addresses a change many preparers welcome: **eliminating the Contractual Obligations Table**. As is frequently the case though, when a disclosure requirement is removed, a new requirement is put in place. The Final Rule expands disclosures about liquidity requirements and capital resources in a new, principles-based requirement. (More about this in the last section in this document.) Thus, the rules-based table is replaced with a broad, principles-based requirement for disclosure about capital resources and related information.

Over the years since the Sarbanes-Oxley Act, when the table was introduced, a multitude of questions has arisen about how to handle situations that did not easily fit the table's brief instructions. Perhaps the best suggestion about the table was in the SEC's 2010 Liquidity Release – FR 83:

> The purpose of the contractual obligations table is to provide aggregated information about contractual obligations and contingent liabilities and commitments in a single location so as to improve transparency of a registrant's short-term and long-term liquidity and capital resources needs and to provide context for investors to assess the relative role of off-balance sheet arrangements; registrants should prepare the disclosure consistent with that objective. … Registrants should determine how best to present the information that is relevant to their own business in a manner that is clear, consistent with the purpose of the disclosure and not misleading, and should provide additional disclosure where necessary to explain what the tabular data includes and does not include.

This is a very rules-based disclosure, and even this statement of an overall objective for the table did not eliminate questions. In the MD&A Final Rule Release, the SEC commented on eliminating the table:

> Our amendments are also intended to address commenters' concerns about the challenges imposed by the current contractual obligations table. We recognize that, because the current contractual obligations table does not have a materiality threshold, the burdens imposed by the

> table on registrants can include identifying, evaluating, and aggregating contracts that are not material.
>
> By eliminating the prescriptive requirement to prepare a contractual obligations table and refocusing instead on a principles-based approach that requires a robust discussion of liquidity and capital resources, including a discussion of contractual obligations, our intent is to relieve registrants of these burdens while continuing to provide investors with material information.

In addition, the Final Rule Release makes these important points about the principles-based approach to the discussion of contractual obligations:

> We are eliminating Item 303(a)(5) as proposed and, in consideration of comments received, we are also amending Item 303(b) to specifically require disclosure of material cash requirements from known contractual and other obligations as part of a liquidity and capital resources discussion. As discussed in the Proposing Release, the Commission believed that eliminating current Item 303(a)(5) should not result in the loss of material information.

This approach is now built into S-K Item 303 with the following new instruction:

> 4. For the liquidity and capital resources disclosure, discussion of material cash requirements from known contractual obligations may include, for example, lease obligations, purchase obligations, or other liabilities reflected on the registrant's balance sheet. Except where it is otherwise clear from the discussion, the registrant must discuss those balance sheet conditions or income or cash flow items which the registrant believes may be indicators of its liquidity condition.

So, along with elimination of the table, we need to delve into the Final Rule's principles-based expansion of the liquidity and capital resources discussion. With these changes, there is a real opportunity to improve MD&A. The liquidity and capital resources discussion is, unfortunately, frequently poorly written. Part of this is attributed to the lack of clarity and the brevity of the old requirements, but is also due in part to challenges in discussing what is presented in the statement of cash flows. All in all, most companies have a chance to improve this section of their MD&A. The last section in this document explores the changes for liquidity and capital resources.

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The New MD&A Rule: Part Seven – Sequential Quarterly Analysis in Interim MD&As

George Wilson, SEC Institute Director

This seventh section addresses another change many preparers welcome: the addition of a provision to the interim MD&A requirements that allows companies to use sequential quarterly analysis. With this option, companies can compare the most recent quarter to the immediately preceding quarter rather than to the same quarter in the previous fiscal year. This new option for sequential quarterly analysis may be a more meaningful presentation for companies that do not have significant seasonality in their operations. Under the old rules, a company that thought sequential quarter analysis was a better fit for the business still had to present the quarter this year compared to the quarter last year along with sequential quarter analysis.

In the final rule, the SEC commented:

> We continue to believe that the flexibility provided by these amendments will help registrants provide a more tailored and meaningful analysis that is relevant to their specific business cycles while also providing investors with material information to assess quarterly performance. Because not all businesses are seasonal, a comparison to the corresponding quarter of the preceding year may not be as meaningful as a comparison to the preceding quarter. Additionally, by requiring registrants not only to explain the reasons for a change in comparison from prior periods but also to provide both comparisons when there is such a change, we believe investors will benefit from greater insight into a registrant's decision making and have sufficient disclosure to understand any period-over-period change.

The change was made by adding language to the old MD&A requirement, which was also moved to new paragraph S-K Item 303(c):

> (ii) Discuss any material changes in the registrant's results of operations with respect to either the most recent quarter for which a statement of comprehensive income is provided and the corresponding quarter for the preceding fiscal year or, **in the alternative, the most recent quarter for which a statement of comprehensive income is provided and the immediately preceding sequential quarter**. If the latter immediately preceding sequential quarter is discussed, then provide in summary form the financial information for that immediately preceding sequential quarter that is subject of the discussion or identify the registrant's prior

> filings on EDGAR that present such information. If there is a change in the form of presentation from period to period that forms the basis of comparison from previous periods provided pursuant to this paragraph, the registrant must discuss the reasons for changing the basis of comparison and provide both comparisons in the first filing in which the change is made.

If a company uses sequential quarterly analysis, it must include summary financial information for the preceding quarter or identify the prior filing that contains the earlier quarter. And, if a change in approach is made, the company must discuss the reasons for the change and present both comparisons in the filing where the change is made.

At the most recent meeting of the Center For Audit Quality SEC Regulations Committee, the staff addressed a question for companies that want to change to the sequential quarter approach when they adopt this new guidance. The meeting minutes include the following guidance from the SEC Staff:

> …the staff confirmed, that a registrant which elects to revise the quarterly periods being compared upon initial compliance with the New Rules would be **required to present the MD&A comparison in both its historic presentation and the new revised presentation**. For example and assuming the change in MD&A comparison occurs in the first quarter Form 10-Q, the registrant would disclose both the comparison of the first quarter of the current year with that of the prior year and the comparison of the first quarter of the current year with the fourth quarter of the prior year. **It would also disclose the reason for the change.**

For an example of a company using this presentation, check out Champion X Corporation's Form 10-Q.

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The New MD&A Rule: Part Eight – Liquidity and Capital Resources

George Wilson, SEC Institute Director

This eighth and last section addresses perhaps the most significant change in the final rule: expansion and clarification of the requirements for the discussion of liquidity and capital resources. The ***old*** S-K 303(A) guidance for this part of MD&A was very brief and "high level":

> (1) Liquidity. Identify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way. If a material deficiency is identified, indicate the course of action that the registrant has taken or proposes to take to remedy the deficiency. Also identify and separately describe internal and external sources of liquidity, and briefly discuss any material unused sources of liquid assets.
>
> (2) Capital resources.
>
> > (i) Describe the registrant's material commitments for capital expenditures as of the end of the latest fiscal period, and indicate the general purpose of such commitments and the anticipated source of funds needed to fulfill such commitments.
> >
> > (ii) Describe any known material trends, favorable or unfavorable, in the registrant's capital resources. Indicate any expected material changes in the mix and relative cost of such resources. The discussion shall consider changes between equity, debt and any off-balance sheet financing arrangements.

This old MD&A guidance did not provide a clearly articulated goal for the discussion of liquidity and capital resources. As a result, in many MD&As, it is challenging to understand how a business has funded itself in its most recent year and how it plans to fund itself in future years.

The new liquidity and capital resources disclosure requirements clarify the purpose and objective of this disclosure and add helpful detail. Included are requirements to:

- Provide an overall analysis of cash requirements by type of obligation and discuss how the company will generate or obtain liquidity to meet these requirements;
- Analyze liquidity and capital resources in both the short and long term; and

- Include cash requirements related to contractual obligations in the discussion.

These requirements are spelled out in this new language in S-K Item 303:

> (1) Liquidity and capital resources. Analyze the **registrant's ability to generate and obtain adequate amounts of cash to meet its requirements and its plans for cash in the short-term (i.e., the next 12 months from the most recent fiscal period end required to be presented) and separately in the long-term (i.e., beyond the next 12 months).** The discussion should analyze **material cash requirements from known contractual and other obligations.** Such disclosures must specify the type of obligation and the relevant time period for the related cash requirements. As part of this analysis, provide the information in paragraphs (b)(1)(i) and (ii) of this section.
>
> (i) Liquidity. Identify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way. If a material deficiency is identified, indicate the course of action that the registrant has taken or proposes to take to remedy the deficiency. Also identify and separately describe internal and external sources of liquidity, and briefly discuss any material unused sources of liquid assets.
>
> (ii) Capital resources.
>
> (A) **Describe the registrant's material cash requirements, including commitments for capital expenditures, as of the end of the latest fiscal period, the anticipated source of funds needed to satisfy such cash requirements and the general purpose of such requirements.**
>
> (B) Describe any known material trends, favorable or unfavorable, in the registrant's capital resources. Indicate any reasonably likely material changes in the mix and relative cost of such resources.

The primary focus of these new requirements is a clear discussion of cash requirements, including requirements from contractual obligations, and an analysis of how those cash requirements will be met. This discussion must include both short- and long-term analyses. While we could discuss how old FR 72 included similar guidance, it is now included in the core S-K Item 303 requirements.

As we discussed in this section, the requirement for the contractual obligations table was removed in the Final Rule and replaced with this more principles-based instruction:

> 4. For the liquidity and capital resources disclosure, discussion of material cash requirements from known contractual obligations may include, for example, lease obligations, purchase obligations, or other liabilities reflected on the registrant's balance sheet. Except where it is otherwise clear from the discussion, the registrant must discuss those balance sheet conditions

> or income or cash flow items which the registrant believes may be indicators of its liquidity condition.

The SEC made this overall comment about improving this disclosure in the Final Rule:

> The amendments to Item 303(b) are intended to clarify the requirements while continuing to emphasize a principles-based approach focused on material short- and long-term liquidity and capital resources needs, while also specifying that material cash requirements from known contractual and other obligations should be considered as part of these disclosures. Specifically, these amendments:
>
> - Create a new Item 303(b)(1) to provide the **overarching requirements** for liquidity and capital resources disclosures in order to clarify these requirements;
> - Incorporate in Item 303(b)(1) portions of current Instruction 5 to Item 303(a), which defines "liquidity" as the ability to generate adequate amounts of cash to meet the needs for cash, clarifying its applicability to the liquidity and capital resources requirements more generally;
> - Codify prior Commission guidance that specifies 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;
> - Require the discussion on both a short-term and long-term basis; and
> - Require the discussion to analyze material cash requirements from known contractual and other obligations and such disclosures to specify the type of obligation and the relevant time period for the related cash requirements.

The Final Rule's principles-based expansion and clarification of the liquidity and capital resources discussion provides an important opportunity to improve MD&A. This discussion is, unfortunately, frequently hard to understand. While there are many causes for this lack of clarity, the brevity of the old requirements is likely one of them. With the new requirements in S-K Item 303, many companies have a chance to improve the liquidity and capital resources section of their MD&A.

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- **Annual SEC Reporting & FASB Forum**

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- **SEC 101 Reporting Essentials for Financial Professionals Workshop**
- **Form 10-K SEC Reporting Essentials Workshop**
- **MD&A SEC Reporting Essentials Workshop**
- **Form 8-K SEC Reporting Essentials Workshop**
- **Form 10-Q, Form 8-K and Proxy Disclosures SEC Reporting Essentials Workshop**
- **SEC 10-K Disclosure Best Practices Essentials Workshop** ***(two half days)***

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