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Practice Pointers
Anticipating and Addressing SEC Comments on Non-GAAP Financial Measures

The use of non-GAAP financial measures by public companies continues to draw regulatory scrutiny and media attention. The Securities and Exchange Commission ("SEC"), whose threefold mandate is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation, has focused the spotlight on the prevalence and increased prominence of non-GAAP financial measures in company disclosures, amid concerns of their potential to distort actual company performance numbers and mislead the investing public. In May 2016, the staff of the SEC's Division of Corporation Finance (the "Staff") released its updated Compliance and Disclosure Interpretations on the use of non-GAAP financial measures (the "Updated C&DIs"), in an effort to clarify and amplify the SEC's existing rules and regulations in this area and to rein in problematic practices by companies involving the use of these measures. Since the release of the Updated C&DIs to date, the Staff has issued more than 700 comment letters involving over 600 public companies related to non-GAAP financial measures. In the same time frame, the topic of non-GAAP financial measures has become one of the most frequently cited issues in Staff comment letters. The heightened SEC attention has also piqued the media's interest. Throughout the past year, the media has reported on the SEC's "crackdown" on "fuzzy math," "novel earnings measures," and "made-up accounting metrics," as well as the Staff's specific interactions with a number of high-profile companies in relation to the review of their non-GAAP financial reporting disclosures.[1] In September 2016, the SEC's Division of Enforcement brought civil charges against the former chief accounting officer and former chief financial officer of a publicly traded real estate investment trust ("REIT") for purposely inflating a key non-GAAP financial measure used by analysts and investors to assess the issuer's performance. A parallel criminal action brought by the U.S. Attorney's Office for the Southern District of New York culminated in a securities fraud conviction meted out by a jury on June 30, 2017.

In this guide, we tackle the nature of non-GAAP financial measures and the disclosure rules governing them, including the Updated C&DIs. We look at recent SEC comment letters addressing non-GAAP financial measures and examine common themes or areas of concern identified by the Staff. We also highlight pronouncements by senior members of the Staff on the important "critical gatekeeper" role audit committee members play in ensuring credible and reliable financial reporting. Finally, we look at industry initiatives aimed at improving the dialogue among management, audit committee members, external auditors and other stakeholders with respect to the use and disclosure of non-GAAP financial measures and also offer some practical guidance for public companies to comply with the updated SEC guidance.[2]

SEC Comment Letters

In general, the Staff routinely asked registrants to explain and demonstrate whether and how their non-GAAP disclosures comply with the Updated C&DIs, Regulation G ("Regulation G") under the Securities Act of 1933, as amended (the "Securities Act"), and Item 10(e) ("Item 10(e)") of Regulation S-K under the Securities Act ("Regulation S-K"). The comment letters we reviewed focused on the non-GAAP disclosures made by registrants not only in their SEC filings, such as their 10-Ks, 10-Qs, proxy statements, and 8-Ks, but also non-GAAP disclosures presented in or on earnings releases, websites, investor presentations, and earnings calls. The Staff's comments revolve around the following specific areas of concern:

<u>Reconciliation to the Most Directly Comparable GAAP Financial Measure</u>

This topic received a large number of comments from the Staff. The Staff called out registrants' practice of using non-GAAP financials in their disclosures without presenting the most directly comparable GAAP financial measure and without providing the required quantitative reconciliation from the non-GAAP financial measure to the most directly comparable GAAP financial measure.

- **No reconciliation or incorrect reconciliation.** In many instances, registrants either failed to identify a particular measure they used as a non-GAAP financial measure (and hence omitted the required presentation or reconciliation altogether), or improperly reconciled the non-GAAP financial measure to a GAAP financial measure that was not the most directly comparable GAAP financial measure. Examples of non-GAAP financial measures used by registrants without the required presentation and reconciliation include the following: adjusted earnings, EBITDA margin, debt/adjusted EBITDA, adjusted dividend payout ratio, non-GAAP net loss, working capital intensity, return on net assets, cash burn, non-GAAP operating expenses, non-GAAP net operating loss, and free cash flow. Examples of incorrect reconciliations include reconciling EBITDA and adjusted EBITDA (when used as operating performance measures) to gross profit (where each such measure should have been reconciled to GAAP net income or net loss instead); reconciling free cash flow (used as a liquidity measure) to adjusted operating income (where such measure should have been reconciled not to a non-GAAP financial measure, but to GAAP cash flow from operating activities); and reconciling Core EBITDA to operating income (where such measure should have been reconciled to net income). In a few instances, the Staff noticed that the slides provided by registrants in relation to their earnings calls used non-GAAP measures such as free cash flow and adjusted EBITDA, but no reconciliations were provided therein. In another example, a registrant did not include the reconciliations of its non-GAAP financial measures such as EBITDA and Operating Cash Cost in its earnings release but instead provided a URL address at which those reconciliations can be found. The Staff called out such practice and asked the company to include the required reconciliations within the filing itself. The Staff also reminded registrants that the reconciliation must begin with the GAAP measure (rather than the non-GAAP measure to which it is reconciled) and, thereafter, the GAAP measure should be reconciled to the non-GAAP measure.

- **Separate presentation of each non-GAAP adjustment in reconciliation.** In some comment letters, the Staff asked registrants to provide more detail and expand their disclosures with respect to the non-GAAP adjustments presented in their reconciliation. For example, in one instance, the Staff pointed out that the registrant's non-GAAP reconciliation had combined all non-GAAP adjustments to the GAAP financial measure into just one line item, and this made it difficult to understand fully the nature and amounts of each of the adjustments. Specifically, in reconciling its non-GAAP financial measure "industrial segment organic revenue" to arrive at GAAP "segment revenue," the registrant presented in only one line item "acquisitions, business dispositions (other than dispositions of businesses acquired for investment) and currency exchange rates." The Staff asked the registrant to revise its reconciliations in future filings and earnings releases to present each of such non-GAAP adjustments separately in the reconciliation, and the registrant agreed it would do so going forward. In a number of cases, the Staff also asked registrants to include separate line items for each significant reconciling item or provide explanations in a note. For instance, registrants were asked to provide a further breakout and explanation of each significant item within "acquisition and integration activities," or to disaggregate "acquisition-related charges" into multiple types of expenses, in order to provide a method of reconciliation that is easier to understand.

<u>Equal or Greater Prominence Presentation of GAAP Financial Measures</u>

This was an area that generated a substantial number of comments from the Staff. The Staff encountered some of the situations and examples outlined in Question 102.10 of the Updated C&DIs, where non-GAAP financial measures may be considered to be more prominent than the GAAP financial measures. The Staff examined the content, formatting, sequence or ordering and labeling of the registrant's public disclosures and issued comments to registrants aimed at ensuring that their GAAP financial measures were given equal or greater prominence than their non-GAAP financial measures in their public disclosures.

- **Labeling, captions, reordering, and formatting to give GAAP financial measures equal or greater prominence.** The Staff observed that a number of registrants were presenting numerous non-GAAP financial measures throughout their earnings releases, Form 10-Ks, Form 10-Qs, and Form 8-Ks without clearly labeling them as such, preventing investors from distinguishing easily the non-GAAP financial measures from the GAAP financial measures. In a number of comment letters, the Staff asked registrants to add headers, captions, bullets, and statements to clearly indicate that a particular metric is a non-GAAP financial measure and to specify whether it is being used as either a performance measure or a liquidity measure. The Staff also noted that the location or presentation of non-GAAP financial measures and the required reconciliations in the public filings made them appear more prominent than the GAAP financial measures. For example, in one comment letter, the Staff asked the registrant why its supplemental non-GAAP disclosures and reconciliations were provided only as an Exhibit 99 to its Form 10-Q filing whereas a significant number of its non-GAAP financial measures were located within the body of the Form 10-Q itself. In another comment letter, the Staff asked the registrant to add an additional bullet providing for the GAAP financial measure "net cash flow from operating activities" right before the bullet for the non-GAAP financial measure "adjusted free cash flow" in its quarterly earnings release. In another case, the Staff asked the registrant to make a representation that it will discuss its GAAP earnings prior to its non-GAAP earnings in its future earnings releases. In a number of cases, registrants were also directed to ensure in future earnings releases and filings that their GAAP measures should precede their non-GAAP measures such as adjusted EBITDA and net adjusted EBITDA margin. Registrants whose headlines in earnings releases appeared to give more prominence to non-GAAP measures were also called out by the Staff.

- **Omitting comparable GAAP financial measures, or discussing a non-GAAP financial measure without a similar discussion of the comparable GAAP financial measure in a location with equal or greater prominence.** In a number of comment letters tackling earning releases, the Staff asked registrants why comparable GAAP financial measures were omitted altogether in disclosures, especially where the GAAP financial measures differed directionally from the non-GAAP financial measure being presented. For example, in one comment letter, the Staff pointed out that while the registrant disclosed a percentage increase in its non-GAAP earnings per share metric, it did not disclose that its GAAP earnings per share actually declined more than 80% from the prior year. In another comment letter, a registrant that presented non-GAAP earnings per share from continuing operations was asked to explain why it did not also present GAAP net earnings (loss) per share amounts. In a number of cases, the Staff also asked registrants to present the three major categories of GAAP statements of cash flows with equal or greater prominence each time the registrants presented their non-GAAP free cash flow. A number of comment letters asked registrants to balance their presentation by including the comparable GAAP measures (e.g., GAAP gross profit percentage) and presenting them with equal or greater prominence to the non-GAAP performance measure in their filings.

- **Excluding quantitative reconciliations with respect to forward-looking non-GAAP financial measures in reliance on the "unreasonable efforts" exception.** The Staff reminded registrants that included forward-looking non-GAAP financial measures in their earning releases and investor presentations that they need to either provide the required quantitative reconciliation to the most directly comparable GAAP financial measure or explain why they cannot provide such information without unreasonable efforts. To rely on the "unreasonable efforts" exception, however, the registrant must both disclose the fact that such GAAP financial measure is not accessible on a forward-looking basis and identify the information that is unavailable and its probable significance in a location of equal or greater prominence. In one case, the Staff asked a registrant that had previously indicated to the Staff in writing (in response to a prior comment letter) that it could not produce the required GAAP financial guidance projection numbers without unreasonable efforts to explain subsequent remarks made by its CEO in an earnings conference call that the registrant did in fact maintain such GAAP projections. In response, the registrant explained that the CEO did not intend to indicate that the registrant currently has or utilizes projections of GAAP net income. The registrant also indicated that, while it provided guidance with respect to GAAP revenues and non-GAAP adjusted EBITDA, it was unable to reconcile adjusted EBITDA to GAAP net income because of the inherent difficulty in forecasting and qualifying the amounts necessary under GAAP guidance. In a number of cases, the Staff observed that registrants were providing guidance only for their non-GAAP financial measures (e.g., AFFO, NOI growth, FFO, and adjusted EBITDA) but not for GAAP numbers and were thus asked to include GAAP guidance and provide a quantitative reconciliation between the GAAP and non-GAAP measures.

Potentially Misleading Non-GAAP Financial Measure Practices

Registrants also were asked by the Staff to show that certain non-GAAP financial measures they used or particular adjustments they adopted were not misleading in light of the examples cited in Questions 100.01, 100.03, 100.04, and 102.03 of the Updated C&DIs that characterized such practices as potentially misleading.

- **Non-recurring, infrequent, or unusual items.** Item 10(e) prohibits registrants from adjusting a non-GAAP financial measure to eliminate or smooth items identified as non-recurring, infrequent, or unusual when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years. In addition, using non-GAAP financial measures that exclude normal, recurring, cash operating expenses that are necessary to operate a registrant's business is potentially misleading under Questions 100.01, 100.03, and 102.03 of the Updated C&DIs. While the number, nature, and scope of permissible adjustments would vary by industry, and ultimately depend on facts and circumstances specific to a particular registrant, examples of excluded adjustments that the Staff scrutinized include the following: (1) engineering, product maintenance, and product development costs that appeared to be an integral part of the registrant's technology platform business; (2) third-party business expenses, such as maintenance, ground handling, and catering services for third parties and fuel expenses, claimed to be not directly related to airline's core business; (3) management fees, transaction fees, and IPO "readiness" costs excluded from Adjusted EBITA, notwithstanding the historical occurrence of these costs that suggested these were integral in ongoing operations of the company; (4) restructuring, integration and deal costs, new store openings, relocation and employee recruiting costs, termination of certain supply and distribution agreements costs, and legal settlement and legal proceedings, investigations, and inquiries costs that all appeared to be recurring and usual in the ordinary course of business; (5) certain pension costs; (6) other charges and gains that appeared normal and recurring in the registrant's operations and are to be settled in cash. In a number of cases, the Staff asked registrants not to refer to adjustments (e.g., legal charges and credits, gain on sale of assets, operational improvement initiatives, and acquisition-related costs) as being "non-recurring" unless these items meet the two-year "non-recurring, infrequent or unusual" criteria in Item 10(e) of Regulation S-K.

If registrants determine that some charges are "non-operational" but "recurring," then they should revise their disclosures accordingly.

- **Acquisition-related expenses; "core vs. non-core" distinctions.** The Staff also asked registrants whose operations included large, frequent, and seemingly routine acquisitions of other businesses or entities why they were excluding the impact of acquisition-related expenses and the amortization of intangible assets they acquired, given that the registrants appeared to grow through acquisitions and the acquisition of businesses appeared to be a critical strategy. In certain cases, the Staff also asked registrants to accurately describe how they define their "core" vis-à-vis their "non-core" activities. Registrants often employ a non-GAAP financial measure such as "core earnings" or "core revenues" to characterize their "core businesses" and exclude adjustments that they consider as "non-core" expenses or activities in their business. In a few cases, the Staff asked registrants why certain expenses were designated "non-core" even though they appeared to be normal, recurring, cash operating expenses that were directly attributable to the registrant's operations and lines of business.
- **Non-GAAP measures that only exclude charges but not gains.** Question 100.03 of the Updated C&DIs provides that a non-GAAP measure that is adjusted only for non-recurring charges but not for non-recurring gains, even if there were non-recurring gains that occurred during the same period, could violate Rule 100(b) of Regulation G for being misleading. In a number of comments, the Staff observed that the non-GAAP financial measures employed by registrants such as adjusted EBITDA, adjusted net income, and adjusted diluted EPS appeared to only exclude charges and not gains. For instance, the Staff pointed out to a registrant that its non-GAAP financial measures excluded a court-mandated settlement and acquisition integration costs but did not exclude income related to a settlement, the reduction of an earn-out liability for an acquired business, and gains on sales of equipment.
- **Individually tailored measures.** Question 100.04 of the Updated C&DIs provides that non-GAAP financial measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could violate Rule 100(b) of Regulation G. In addition, individually tailored recognition and measurement methods for financial statement line items other than revenue may also violate Rule 100(b) of Regulation G for being misleading. The Staff asked registrants to explain why their non-GAAP financial measures and adjustments did not represent individually tailored measurement methods substituted for that of GAAP, including in the following examples: adjusting non-GAAP pro rata balance sheets and income statements for the registrant's proportionate economic ownership of each asset in its portfolio that are not wholly owned by the registrant; presenting adjusted earnings and adjusted EBITDA by excluding step-up depreciation and amortization; removing only portions of depreciation expense (associated with the fair value step-up in acquisition accounting) and share-based compensation from the registrant's non-GAAP income measure; presenting adjusted EBITDA excluding inventory revaluation; presenting non-GAAP adjusted operating corporate costs and non-GAAP segment earnings that exclude normal, recurring, operating items such as certain pension costs, restructuring, and other charges and gains; and presenting a measure of non-GAAP gross profit, calculated as non-GAAP gross profit plus change in deferred revenues, less deferred domain expenses.

- **Use of titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, GAAP financial measures.** There were a number of comments requiring registrants to clearly identify that a particular metric is a non-GAAP financial measure and to consistently use titles for the financial measures that are clearly distinguishable from comparable GAAP titles. The Staff asked registrants to stop naming or labeling their non-GAAP financial measures with titles or descriptions that were the same as, or confusingly similar to, the GAAP financial measures. As examples, the Staff asked registrants the following: (1) to retitle their non-GAAP financial measure "operating earnings" since it is confusingly similar to the terms "earnings from operations," "operating income," "operating earnings," and "profit from operations," which are terms used under GAAP to refer to income that is generated by the ordinary and usual activity of a reporting entity; (2) to remove the reference to the word "cash" in its non-GAAP financial measure "cash earnings per share" since such title could be erroneously read to imply that it is related to cash flows; (3) to stop using "earnings per share" as a non-GAAP financial measure and ascribing to it a meaning different from the clear meaning ascribed to the term "earnings per share" under U.S. GAAP; and (4) to retitle their non-GAAP financial measure "operating margin" since it is confusingly similar to the terms "gross margin" and "operating income," which are terms used under GAAP. In certain instances, the Staff accepted the renaming of the non-GAAP financial measure by the simple addition of "(Non-GAAP)" in the caption or label of the financial measure in question.

- **Non-GAAP measures labeled as EBITDA, EBIT, FFO, or free cash flow but differ from the typical definitions of these terms.** In addition, registrants were reminded by the Staff that certain non-GAAP measures have gained wide acceptance among the general investing public, analysts and others, and within specific industries, sectors, or asset classes. If a registrant presents a non-GAAP measure that differs from the typical definitions attributed to such term, then it should be properly labeled as such, so as not to create confusion. For instance, the SEC Releases describe EBIT as "earnings before interest and taxes" and EBITDA as "earnings before interest, taxes depreciation and amortization." Thus, registrants should not label their non-GAAP measure as "EBITDA" where such measure includes additional adjustments other than interest, taxes depreciation, and amortization. Rather, they should modify the title of this measure to "Adjusted EBITDA" or another similar title. The same applies for the term FFO which, as Question 103.01 of the Updated C&DIs indicates, refers to "Funds From Operations" as used and defined by The National Association of Real Estate Investment Trusts ("NAREIT"). Hence, if the non-GAAP financial measure is calculated differently from NAREIT'S FFO definition, then the same should be called "Adjusted FFO" or a similar title. In addition, registrants' use of the non-GAAP financial measure "free cash flow" received a large number of Staff comments. Consistent with Question 102.07 of the Updated C&DIs, the Staff reminded registrants that free cash flow is typically calculated as cash from operating activities as presented in the statement of cash flows under GAAP, less capital expenditures. In a number of instances, the Staff asked registrants whose measure deviated from this typical formula to rename and revise their measure to "Adjusted Free Cash Flow" in order to "alert your investors that it has been adjusted from the measure typically referred to as 'Free Cash Flow.'" The Staff also emphasized that the term free cash flow does not have a uniform definition and its title does not describe how it is calculated. Hence, a clear description of how the measure is calculated, as well as the necessary reconciliation, should accompany the measure where it is used.

Usefulness of Non-GAAP Financial Measures to Investors and the Reasons Management Uses Them

There was a considerable increase in Staff comments asking registrants to include and expand in their disclosures the reasons why management believes the presentation of non-GAAP financial measures provides useful information to investors regarding the registrants' financial condition and results of operations. Registrants were asked to provide a more substantive and concise discussion specific to their circumstances of how their non-GAAP financial measures were useful to investors and any additional purposes for which management uses the non-GAAP financial measures, rather than just including boilerplate statements and generic disclosures that the financial measures are useful to analysts.

Non-GAAP Financial Measures of Liquidity Presented on a Per-Share Basis; Liquidity Versus Performance

Questions 102.05, 102.07, and 103.02 of the Updated C&DIs provide that a non-GAAP financial measure that is used as a liquidity measure cannot be presented on a per-share basis and that, in analyzing whether a financial measure is a performance measure or a liquidity measure, the Staff would focus on the substance of the non-GAAP financial measure and not on management's characterization. In a number of comment letters, the Staff determined that non-GAAP financial measures characterized by registrants as performance measures were actually used by them as liquidity measures and, hence, should have been characterized as such and not presented on a per-share basis. The Staff reiterated that EBITDA and adjusted EBITDA, when used as operating performance measures, should be reconciled to GAAP net income and that "adjusted free cash flow," when used as a liquidity measure, should be reconciled to GAAP cash flows from operating activities. In some cases, the Staff pointed out the inconsistencies in the disclosures made by registrants with respect to their characterization of the use of the non-GAAP financial measure as being a performance measure or a liquidity measure. In one instance, the Staff noted that, on the one hand, registrant disclosed that it considered EBITDA and adjusted EBITDA to be indicators of its ability to generate cash to service debt, fund capital expenditures, and expand business and has reconciled these measures to net income and cash provided by operating activities. On the other hand, however, the registrant also disclosed that it did not consider these non-GAAP financial measures to be measures of liquidity. The Staff asked the registrant to clarify or revise these inconsistencies in its filing. In another instance, the Staff determined that the registrant's presentation of Adjusted FFO on a per-share basis was improper since it appears that, due to the adjustments, including several non-cash adjustments and an adjustment for recurring capital expenditures, the measure could be used as a liquidity measure.

Income Tax Effects of Adjustments

Question 102.11 of the Updated C&DIs provides that adjustments to arrive at a non-GAAP financial measure should not be presented "net of tax." The Staff made this comment in a few cases and asked registrants to revise their disclosures and tabular presentations to separately present the income tax impact of their non-GAAP adjustments.

Further Guidance on the Updated C&DIs and SEC Comment Letter Review Process over the Past Year

On September 13, 2017, Mr. Kronforst spoke on a webcast sponsored by TheCorporateCounsel.net, entitled "Non-GAAP Disclosures: Corp Fin Speaks!" Speaking in his personal capacity and neither for the SEC nor for the Staff, Mr. Kronforst answered specific questions from the webcast moderator regarding the Updated C&DIs and shared some of the Staff's experience with registrants with respect to the comment letter/review process since the Updated C&DIs' release in May 2016. A few key points covered by Mr. Kronforst during the webcast are provided below.

- The pendulum on non-GAAP compliance tends to swing back and forth over the years, and, along with that, the Staff's guidance has changed a few different times. What the Staff has tried to do is to adhere to a philosophy that says "companies must be able to communicate effectively with their investors, but we (the Staff) need to protect against potentially misleading disclosures."

- Mr. Kronforst believes that, today, the pendulum has swung back from where it was in 2016. At the moment, the Staff's approach is to monitor compliance with the SEC guidance on non-GAAP financial measures, and the Staff has observed that comment levels on the topic have dropped. Non-GAAP comments are, however, always a focus of the Staff's review teams because of the potential risks to investors.

- On Question 102.05 of the Updated C&DIs (regarding "performance versus liquidity" measures and the related prohibition on presenting per share liquidity measures), Mr. Kronforst acknowledged that this indeed involves a difficult issue and requires a lot of judgment (i.e., what might look like a measure of liquidity to one person might look like a measure of performance to another). The Staff has taken the approach of not setting or defining specific parameters or drawing a clear-cut line to divide performance from liquidity measures. To draw that line would have been, in Mr. Kronforst's view, arbitrary, and putting winners and losers on either side of that arbitrary line was not a fair approach. What the Staff has done instead is to raise awareness regarding this issue and engage in dialogue with a handful of companies to see how their non-GAAP financial measures departed from performance in any significant way. If non-GAAP financial measures have elements of both a performance measure and a liquidity measure, then, as long as companies are clear with their disclosures in a way that investors will understand, those measures would be acceptable to the Staff. But if the non-GAAP financial measure looks very much like a liquidity measure, such as free cash flow, then the prohibition on presenting liquidity measures on a per-share basis will apply.

- On Question 102.10 (regarding equal or greater prominence), Mr. Kronforst stated that, in his personal view, a large number of companies are now getting the rule right in their disclosures. Before the Staff released the Updated C&DIs, Mr. Kronforst observed that there was a significant deterioration in compliance with the prominence requirement in the rules, and he believed that then SEC Chair White's remarks in December 2015 that non-GAAP measures appeared to have replaced GAAP in company disclosures was a justifiable statement. Now, more and more registrants have paid attention to the prominence rule and have made improvements. Staff comments regarding prominence, however, will continue be made, and Mr. Kronforst observed that those have been in the "menu" of comments of the Staff since 2003.

- With respect to registrants relying on the "unreasonable efforts" exception regarding forward-looking guidance, Mr. Kronforst stated that it was never the Staff's intention to audit registrants (i.e., to question them on their assertion of the "unreasonable efforts" exception) or insist that a quantitative reconciliation should instead be produced. Rather, what the Staff has done is to remind registrants regarding what the rule says (i.e., to rely on the "unreasonable efforts" exception), the registrant must both disclose the fact that such GAAP financial measure is not accessible on a forward-looking basis and identify the information that is unavailable and its probable significance in a location of equal or greater prominence.

- Lastly, with respect to the requirement that registrants disclose the usefulness of non-GAAP financial measures to investors and the reasons management uses them, Mr. Kronforst says that registrants should make the required explanations but do them succinctly. While registrants should avoid boilerplate statements and generic disclosures, the Staff is not looking for pages of disclosures explaining such usefulness and reasons.

SEC Enforcement Actions

Outside the Staff's comment letter process, the topic of non-GAAP financial measures has also attracted interest from the SEC's Enforcement Division. Beginning around late fall of 2016 (and after the release of the Updated C&DIs), the SEC's Enforcement Division reached out to a number of registrants regarding their historical non-GAAP financial disclosures. Registrants were asked to provide the SEC's Enforcement Division with documents and other information to determine if they may have violated Regulation G or Item 10(e), particularly by giving undue prominence to non-GAAP financial measures in earnings releases and other disclosures, in a way that misled investors.

In addition, in September 2016, the SEC charged the former chief financial officer and chief accounting officer of a publicly traded real estate investment trust for purposely inflating AFFO, a key non-GAAP financial measure used by analysts and investors to assess the registrant. In its complaint, the SEC alleged that the officers employed an improper hybrid method of calculating AFFO and AFFO per share and ignored repeated concerns raised by their accounting staff about the impropriety of the method used. Those numbers were included in the registrant's 10-Q and 8-K filings. The SEC alleged violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5, among other causes of action. Around the same time, a parallel criminal action was brought by the U.S. Attorney's Office for the Southern District of New York against the two officers. In June 2017, the chief accounting officer pled guilty to securities fraud and related charges. After a three-week trial, a federal jury convicted the chief financial officer of one count of conspiracy to commit securities fraud and other offenses, one count of securities fraud, two counts of making false filings with the SEC, and two counts of submitting false certifications along with required filings with the SEC. The securities fraud, false filings charges, and false certification charges each carry a maximum prison term of 20 years. The charge of conspiracy carries a maximum prison term of five years. The case is on appeal.

In January 2017, the SEC instituted an enforcement action against a registrant for its failure to comply with Item 10(e) of Regulation S-K. The registrant presented a metric called "organic revenue growth" that represented the company's growth in revenue excluding the effects of two reconciling items: acquisitions and foreign exchange impacts. But from the second quarter of 2012 to year end 2013, the registrant incorporated a third reconciling item into its calculation without informing investors of the change, which resulted in higher "organic revenue growth" results. The registrant also failed to give GAAP metrics equal or greater prominence to its non-GAAP financial measures (e.g., EBITDA, EBITDA margin, and free cash flow) in its earnings releases, despite repeated promises to the Staff that it would do so. The registrant was ordered and agreed to cease and desist from such practices and to pay a civil monetary penalty.

Effective Disclosure Controls, Audit Committee Involvement, and Other Industry Initiatives

Over the last year, senior members of the Staff emphasized that appropriate and effective disclosure controls and procedures relating to the use of non-GAAP financial measures should be considered and established by registrants. Senior members of the Staff have continued to echo that same theme, particularly with respect to increasing audit committee involvement and dialogue with stakeholders regarding the use of non-GAAP financial measures.

On December 5, 2016, SEC Chief Accountant Wesley R. Bricker, speaking at the American Institute of Certified Public Accountants ("AICPA") conference in Washington, D.C., highlighted the important "critical gatekeeper" role audit committee members play in ensuring credible, reliable financial reporting, including compliance with the Updated C&DIs.[3] Mr. Bricker stated that audit committee members should seek to understand management's judgments in the design, preparation, and presentation of non-GAAP financial measures and how those measures might differ from approaches followed by other registrants. Mr. Bricker also highlighted that the oversight of management's activities is crucial for investor protection, that it is important for both auditors and audit committees to keep and maintain a direct and open line of communication, and that audit committees have an important role overseeing external auditors, as auditors are accountable to the board of directors through the audit committee and not to management. In addition, Mr. Bricker also highlighted that:

- Good reporting practices place a premium on audit committee member understanding of the company's non-GAAP policies, procedures, and controls.
- It is important to keep in mind that businesses operate in uncertain environments. If non-GAAP adjustments replace that business reality with smooth earnings over time, accelerate unearned revenues, or defer incurred expenses, those adjustments and disclosures should be evaluated closely under the Updated C&DIs.

- It is important for both auditors and audit committees to keep and maintain the direct relationship they share. The following questions from audit committee members to their external auditor may be helpful in generating a dialogue:
  - If you as the auditor were in management's shoes and solely responsible for preparation of the company's financial statements, would they have in any way been prepared differently?
  - If you as the auditor were in an investor's shoes, would you believe that you have received the information essential to understanding the company's financial position and performance?
  - Is the company following the same internal control over financial reporting and internal audit procedures that would be followed if you were in the CEO's shoes?
  - Are there any recommendations that you as the auditor have made and management has not followed?
- Audit committees should not underestimate the importance of their role overseeing the external auditor as auditors are accountable to the board of directors through the audit committee and not to management.

In the same vein, the Center for Audit Quality ("CAQ"), a non-profit public policy organization affiliated with the AICPA, has issued suggested discussion questions for key stakeholder groups regarding the preparation and use of non-GAAP financial measures.[4] The CAQ identified these stakeholders as management, investors, investment analysts, securities counselors, audit committee members, internal auditors, independent auditors, regulators, accounting standard setters and academics. According to the CAQ, the audit committee can act as a bridge between management and investors in assessing management's reasons for presenting non-GAAP financial measures, evaluating whether these measures present a fair and balanced view of the company, and assessing how the non-GAAP financial measures are used by analysts and reported by the financial press to the broader public.[5] The sample discussion questions also aim to promote the transparency, consistency, and comparability of non-GAAP financial measures and to assist audit committees to determine whether management is complying with SEC rules and related interpretations with respect to non-GAAP financial measures.[6]

Returning to this theme, in March 2017, Mr. Bricker again emphasized the importance of reinforcing and advancing credible financial reporting through effective audit committees.[7] Mr. Bricker highlighted several ways to advance the role and effectiveness of audit committees, including the following:

- Audit committees should understand the businesses they serve and the impact of the operating environment – the economic, technological, and societal changes – on corporate strategies.
- Balancing audit committee workload is critical, given the need for audit committees to stay current on emerging issues, whether financial, internal control over financial reporting, or disclosure-related through continuing education and other means.
- Audit committees should consider training and education programs to ensure that their membership has the proper background and stays current as to relevant developments in accounting and financial reporting, including the recently issued accounting standards relating to revenue recognition, leasing, financial instruments, and credit losses.

On June 8, 2017, Mr. Bricker emphasized the importance of reliable accounting in protecting investors and the capital markets.[8] Mr. Bricker also discussed the key roles played by audit committees and independent external auditors in providing assurance to investors that financial statements are disclosed without material misstatements or omissions. Highlights of the speech include the following:

- <u>Auditor Independence</u>: Mr. Bricker noted that while audit firms are generally more active in raising independence issues to the SEC Staff, audit committees and management may also address with the SEC Staff independence matters that impact their filings or other interpretive questions. Audit committees and management should also keep in mind that the SEC Staff does occasionally reach out to the audit committee to understand its position about an independence matter that has been submitted to the SEC Staff for its consideration. When selecting a successor auditor, an audit committee should request information to be satisfied that the successor is independent at the start of the audit and professional engagement period, and audit committees should consider circumstances that might require the company to make adjustments to prior period financial statements (e.g., the reporting of discontinued operations, a retrospective application of an adoption or change in accounting principle, or the correction of an error).

- Reminders to the Audit Profession: Mr. Bricker noted that just as management needs to allocate sufficient time and resources to the preparation of their books and records (with good internal controls), so too should public accounting firms work with the audit committee and management to agree on appropriate deadlines and audit fees to ensure that audit quality is consistently maintained.
- Continuing to Advance Through Innovation: Mr. Bricker noted that there have been significant advances in technology in recent years with an accompanying increase in the use of technology by auditors, which has the potential to enhance audit quality and the auditor's detection capabilities. Mr. Bricker also mentioned that some ratings agencies and data aggregators now utilize data scraping technology and machine learning to review SEC filings and analyze trends over time, which has the potential to help auditors and users of the financial statements identify inappropriate bias in financial statements.

Conclusion

The use of non-GAAP financial measures can be an important tool for registrants to tell their own stories (i.e., to convey information to investors that registrants believe to be relevant, meaningful, and useful in understanding their financial performance, financial position, or liquidity). The prevalence and wide acceptance of non-GAAP financial measures; the importance and attention accorded by research analysts, rating agencies, financial professionals; and the business community in general to these measures; and the adoption and development of these measures by various industry groups, all point to and demonstrate that there are legitimate, meaningful, and relevant purposes in using non-GAAP financial measures. However, as the SEC has highlighted, the presentation of non-GAAP financial measures is also prone to misuse and abuse. As shown in a number of cases, non-GAAP financial measures can become tools to distort the truth; conceal, fabricate, or inflate the actual performance and financial condition of a given company; confuse investors; and even perpetuate outright fraud. The marked increase in the prevalence and wide use of these measures over the past few years has prompted the Staff to revisit the existing rules and regulations governing the use and disclosure of these measures and to issue updated guidance in the form the Updated C&DIs. The Staff has reminded registrants that non-GAAP financial measures should merely supplement, and not substitute, GAAP financial measures, and that management should understand and articulate the reasons for using non-GAAP financial measures in SEC disclosures and take steps to ensure that such measures are neither misleading nor prohibited by SEC rules. Consistent, transparent, credible, and truthful disclosures by registrants are paramount to the effective functioning of the capital markets. Therefore, it is important for registrants to carefully revisit and examine their use and presentation of non-GAAP financial measures in their disclosures and to take concrete steps to comply with the updated SEC guidance and ensure that the presentation of their non-GAAP financial measures is consistent, transparent, credible, and truthful.

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Endnotes:

[1] *See SEC Cracking Down on Fuzzy Math in Company Earnings*, USA Today (Jan. 12, 2017), *available at*: https://www.usatoday.com/story/money/2017/01/12/sec-cracking-down-fuzzy-math-company-earnings/96451422/; *SEC Cracks Down on Novel Earnings Measures that Boost Profits*, The Wall Street Journal (Apr. 28, 2016), *available at*: https://www.wsj.com/articles/sec-cracks-down-on-novel-earnings-measures-that-boost-profits-1461870107; *See SEC Targets Companies Who Use Made-up Accounting Metrics*, MarketWatch (May 31, 2016), *available at*: http://www.marketwatch.com/story/sec-stepping-up-its-tackling-of-misleading-disclosure-2016-05-31; and *SEC Probes Whether Companies are Misusing Adjusted Earnings Metrics*, The Wall Street Journal (Oct. 27, 2016), *available at*: http://www.wsj.com/articles/sec-probes-whether-companies-are-misusing-adjusted-earnings-metrics-1477577108.
[2] For more information regarding the nature of non-GAAP financial measures, the disclosure rules governing them, and the Updated C&DIs, *see* our "Practice Pointers on Non-GAAP Financial Measures," *available at*: https://media2.mofo.com/documents/160816-practice-pointers-on-non-gaap-financial-measures.pdf. We provide similar and additional practice pointers in our report, *Non-GAAP Explained*, International Financial Law Review (October 2017), *available at*: http://media.mofo.com/docs/pdf/171023-iflr-non-gaap-booklet/#?page=0.
[3] *See* Wesley R. Bricker, Deputy Chief Accountant, Securities and Exchange Commission, *Working Together to Advance High Quality Information in the Capital Markets* (Dec. 5, 2016), *available at*: https://www.sec.gov/news/speech/keynote-address-2016-aicpa-conference-working-together.html.
[4] *See* Center for Audit Quality, *Non-GAAP Financial Measures: Continuing the Conversation* (Dec. 5, 2016), *available at*: *http://thecaq.org/non-gaap-financial-measures-continuing-conversation* (hereinafter, "CAQ December 2016 Paper"). *See also* Center for Audit Quality, *Non-GAAP Measures: A Tool for Audit Committees* (June 28, 2016), *available at*: http://www.thecaq.org/questions-non-gaap-measures-tool-audit-committees (hereinafter, "CAQ June 2016 Paper").

[5] *See* CAQ December 2016 Paper, *supra* note 4, at 1.

[6] *See* CAQ June 2016 Paper, *supra* note 4, at 1.

[7] *See* Wesley R. Bricker, Deputy Chief Accountant, Securities and Exchange Commission, *Advancing Effective Internal Control and Credible Financial Reporting* (Mar. 21, 2017), *available at*: https://www.sec.gov/news/speech/bricker-remarks-annual-life-sciences-accounting-and-reporting-congress-032117. *See also* Wesley R. Bricker, Deputy Chief Accountant, Securities and Exchange Commission, *Advancing the Role and Effectiveness of Audit Committees* (Mar. 24, 2017), *available at*: https://www.sec.gov/news/speech/bricker-university-tennessee-032417.
[8] *See* Wesley R. Bricker, Deputy Chief Accountant, Securities and Exchange Commission, *Advancing the Role of Credible Financial Reporting in the Capital Markets* (June 8, 2017), *available at*: https://www.sec.gov/news/speech/bricker-remarks-financial-reporting-institute-conference-060817.

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