CORPORATE GOVERNANCE

SEC Scrutiny of Non-GAAP Financial Measures

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Since 2003, when the SEC first adopted rules regarding the use of non-GAAP financial measures, there has been a constant tension between the utility of these measures and their potential to mislead investors. In recent years, the use of non-GAAP measures in public company filings has significantly increased, as has the discrepancy between these measures and their GAAP equivalents. The SEC has taken note of these trends and, since 2016, has correspondingly escalated its scrutiny of non-GAAP disclosures. In 2018, the SEC indicated that it may further intensify its enforcement in this area for the protection of investors.

Increased Use and Variance of Non-GAAP Measures

Nearly all large public companies now report non-GAAP metrics in their financial statements. In 1996, around 60 percent of S&P 500 companies reported at least one non-GAAP earnings-per-share figure. Today, according to Audit Analytics, over 97 percent of S&P 500 companies use at least one non-GAAP metric in their financial statements. Item 10(e)(1)(i)(A) of Regulation S-K states that an issuer including non-GAAP financial measures in SEC filings must present, with equal or greater prominence, the most directly comparable financial measures calculated and presented in accordance with GAAP.

Along with the use of non-GAAP metrics, the discrepancy between GAAP and non-GAAP measures has been growing, and non-GAAP measures are invariably more favorable. In 2015, pro forma earnings-per-share were 30 percent higher on average than GAAP EPS for companies in the S&P 500. Notably, in an August 2018 comment letter, the SEC instructed an issuer not to title non-GAAP measures “pro forma” but instead, “as adjusted” if the measures do not comply with Article 11 of Regulation S-X—another indication that the SEC is keen to ensure that investors are not misled by the presentation of non-GAAP financial statements.

Increased SEC Scrutiny and Enforcement

In 2016, then-SEC Chair Mary Jo White indicated that the prevalence of non-GAAP financial measures could be confusing to investors. The SEC highlighted the issue in a number of its 2016 and 2017 comment letters, with over 35 percent of comment letters addressing the use of a non-GAAP metric in those years. Though this percentage decreased to 25 percent in the first half of 2018, the overall trend is one of heightening scrutiny: From January 2010 to June 2018, the number of comment letters issued by the SEC has dramatically decreased, but the percentage of letters addressing non-GAAP measures has grown.

It is clear that the SEC Staff under Chairman Jay Clayton is continuing to focus on this issue, and this scrutiny has led to an enforcement action in at least one case. In the first half of 2018, 22 percent of non-GAAP related comments addressed the presentation of non-GAAP measures with undue prominence, by far the most common issue addressed. At the end of 2018, the SEC instituted an enforcement action against an issuer for failing to afford "equal or greater prominence to comparable GAAP financial measures" in filings containing non-GAAP financial measures. The company settled the action in December by paying a $100,000 civil money penalty and agreeing to cease and desist from such practices. It is notable that the enforcement action stemmed only from the issue of prominence in presentation, as the settlement suggested neither that the issuer formulated the non-GAAP measure in a misleading way, nor that the issuer used it inconsistently. Though the SEC has addressed this issue in hundreds of comment letters and has updated Compliance & Disclosure Interpretations on the topic, this is the first enforcement action regarding the failure to present comparable GAAP measures with equal or greater prominence.

In comments at the AICPA Conference on SEC and PCAOB Developments in December 2018, Chairman Clayton emphasized the importance of consistency in the reporting of non-GAAP numbers and key performance indicators. As Chairman Clayton observed, non-GAAP reporting should reflect how management actually operates and views the business. As non-GAAP measures are reported precisely in order to show higher EPS and a more favorable price-to-earnings ratio than their GAAP equivalents, it is important for issuers to be rigorous in their application of the disclosure requirements so as not to paint a misleadingly rosy picture.

Board Oversight of Non-GAAP Disclosures

In his prepared statement at the AICPA conference, SEC Chief Accountant Wesley Bricker discussed the role of independent audit committees, which are tasked by the board of directors with oversight of financial reporting. He emphasized the need for each audit committee to stay current with respect to financial reporting requirements, as only an audit committee that is both financially literate and up-to-date will be able to effectively oversee and, where necessary, challenge management decisions on complex financial issues. Directors on Audit Committees may wish to review their issuer's practices with respect to using non-GAAP financial measures in order to confirm that appropriate processes are in place to ensure compliance with the SEC requirements regarding the presentation of non-GAAP financial information. Appropriate disclosure controls depend upon the rigor with which processes are followed and the consistent use of good judgment. Both Mr. Bricker and Chairman Clayton spoke at the AICPA conference about the essential human element in financial reporting and the importance of good professional judgment and analysis.

Non-GAAP financial measures can be useful disclosure metrics intended to provide insight into company performance and prospects. In certain cases they more accurately describe the financial picture than the comparable GAAP measures. However, non-GAAP measures can be misleading or confusing, and may be presented in ways that violate SEC regulations or guidance. The equal-or-greater prominence requirement is not a difficult regulation with which to comply. Particularly in light of continued SEC scrutiny and possibly increasing enforcement activity, companies should ensure that they follow the relevant reporting requirements. In order for non-GAAP financial statements to provide high-quality information that is useful to investors, they should be accurate, complete, consistent, and in compliance with applicable regulations.

David A. Katz *is a partner at Wachtell, Lipton, Rosen & Katz.* **Laura A. McIntosh** *is a consulting attorney for the firm. The views expressed are the authors' and do not necessarily represent the views of the partners of Wachtell, Lipton, Rosen & Katz or the firm as a whole.*