SEC staff updates guidance on non-GAAP financial measures

The Securities and Exchange Commission (SEC or Commission) staff updated its Compliance and Disclosure Interpretations (C&DIs) on the use of non-GAAP financial measures to provide more explicit guidance on when such measures may violate SEC rules and to try to rein in the use of these measures in ways that are potentially misleading or give them undue prominence.

The updated guidance reflects concerns that SEC officials have been discussing publicly in recent speeches about how non-GAAP measures are being used in SEC filings and earnings releases. SEC Chair Mary Jo White recently said, “We are watching this [non-GAAP] space very closely and are poised to act through the filing review process, enforcement and further rulemaking if necessary to achieve the optimal disclosures for investors and the markets.”

Accordingly, the staff in the Division of Corporation Finance (the Division) has stepped up its scrutiny of the use of non-GAAP measures in its comment letter process, and staff members have said they will “crack down” on inappropriate uses of such measures.

The C&DIs address when companies may be violating the SEC rules by using non-GAAP measures that, among other things:

- Are potentially misleading (e.g., exclude normal, recurring cash operating expenses necessary to operate the registrant's business, are presented inconsistently between periods without adequate disclosure of the change)
- Are given undue prominence (e.g., present non-GAAP measures before GAAP measures, present non-GAAP measures in bold or larger fonts)
Use “individually tailored” recognition and measurement methods in calculating a performance measure (e.g., accelerate the recognition of revenue to the time of sale that under GAAP would be recognized ratably over the performance period).

Present liquidity measures on a per-share basis (e.g., present earnings before income taxes or earnings before income taxes, depreciation and amortization (EBITDA) on a per-share basis, an adjusted EBITDA per-share measure that could in substance be a liquidity measure).

Don’t appropriately reflect the income tax effects of non-GAAP adjustments (i.e., companies should determine the effect of earnings adjustments on their tax rate and apply the appropriate rate in calculating performance measures).

Given the heightened scrutiny by the SEC staff, companies should reconsider the nature and number of non-GAAP measures they use and consider whether these measures continue to be appropriate and useful to investors. The SEC staff is likely to continue issuing comments and may request that a company revise its SEC filing or earnings release if the staff considers the measures potentially misleading. Chair White has also recommended that “appropriate controls be considered and that audit committees carefully oversee their company’s use of non-GAAP measures and disclosures.”

SEC rulemaking and implementation

SEC seeks comment on changes to Regulation S-K disclosures

The SEC issued a concept release seeking public comment on whether and, if so, how it might enhance the effectiveness of business and financial disclosures required by Regulation S-K, including the description of a registrant’s business, risk factors and management’s discussion and analysis.

The concept release is the latest step in the Commission’s broader disclosure effectiveness initiative. SEC Chair Mary Jo White has called the initiative a priority. In developing the concept release, the SEC staff considered the history and rationale behind current Regulation S-K disclosure requirements and constituent input.

The concept release explores several aspects of Regulation S-K’s disclosure requirements and includes 340 questions on broad issues (e.g., whether the requirements should be based on principles or rules, what role materiality should play), line-item disclosure requirements and the presentation and delivery of information.

The Fixing America’s Surface Transportation Act (FAST Act) requires the SEC to study the requirements in Regulation S-K, report its findings and recommendations to Congress and propose rules to modernize and simplify these requirements.

In another phase of the initiative, the SEC is considering how it might improve the effectiveness of Regulation S-X disclosure requirements for entities other than a registrant, including acquired businesses, equity method investees and subsidiary issuers and guarantors. The SEC issued a request for comment on these requirements in September 2015, and the SEC staff is currently reviewing comment letters from constituents.

SEC Chair White also has said that in a later stage of the initiative, the SEC will consider possible changes to the compensation and governance disclosures required in proxy statements.
SEC adopts interim final rules required by the FAST Act
The SEC approved interim final rules implementing one of the provisions of the FAST Act and that allow an issuer to include a brief summary in its Form 10-K. Each item in the summary must include a hyperlink to the related disclosures in the Form 10-K.

The rules are effective now, but the SEC is seeking feedback on certain aspects of the summary. Comments are due by 11 July 2016.

SEC proposes changes to the definition of a smaller reporting company
The SEC proposed a rule that would allow more companies to qualify as smaller reporting companies (SRCs) if they have a public float of less than $250 million (up from $75 million) or, if they have no public float, revenue of less than $100 million in the previous year (up from $50 million). The proposal would increase the number of companies eligible to use disclosure accommodations for SRCs, such as providing two years of financial statements, reducing executive compensation disclosures and excluding selected financial data.

Under the proposal, once companies exceed the applicable threshold, they would no longer qualify as a smaller reporting company unless they have public float of less than $200 million (up from $50 million) at the end of their second fiscal quarter or, if they have no public float, annual revenues of less than $80 million in their most recent fiscal year (up from $40 million).

The proposal would not change the $75 million public float threshold in the definition of an accelerated filer, meaning that companies could qualify as SRCs under the proposed rule but still be subject to the reporting deadlines for accelerated filers, as well as auditor attestation to internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act. Comments are due 60 days after publication in the Federal Register.

SEC amends Exchange Act registration requirements
The SEC adopted amendments to change the thresholds for registration, termination of registration and the suspension of reporting obligations under Sections 12(g) and 15(d) of the Securities Exchange Act of 1934 (Exchange Act). Most of the amendments revise Exchange Act rules to reflect provisions in the Jumpstart Our Business Startups Act and the FAST Act. The final rules also will:

- Allow savings and loan holding companies to use the same thresholds that apply to banks and bank holding companies to register, terminate registration or suspend their Exchange Act reporting obligations
- Make conforming changes to the definition of “held of record” to exclude securities received under employee compensation plans in transactions exempt from registration
- Apply the definition of “accredited investor” in Rule 501(a) of the Securities Act of 1933 to determine which record holders are accredited investors as of the last day of the fiscal year for purposes of determining whether registration is required under Section 12(g) of the Exchange Act

SEC adopts final rule on resource extraction disclosures
The SEC adopted a final rule that requires resource extraction issuers (REIs) to disclose payments they made to foreign governments or the US Federal Government by type and total amount for each project related to the commercial development of oil, natural gas or minerals. REIs must report the payments in an annual Form SD filed with the SEC within 150 days of their fiscal year end. Additionally, the type and total amount of payments made to each government are required to be disclosed. The rule, which was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), is effective for fiscal years ending on or after 30 September 2018.
The final rule requires REIs to disclose payments made by their subsidiaries and other entities under their control, including their proportionate share of payments for oil and gas interests that they proportionately consolidate. In a change from the proposal, the final rule requires REIs to also disclose “community and social responsibility payments.” The final rule also provides limited relief for payments made for exploratory activities, as well as for payments made by recently acquired companies that did not have to comply with the reporting requirements prior to acquisition. The SEC also can provide exemptive relief on a case-by-case basis under the Exchange Act.

The rule allows entities to comply by filing reports required by other regimes that the SEC determines have reporting requirements that are substantially similar to its own requirements. The SEC said these reports currently include those required by the European Union Accounting and Transparency Directives (as implemented in a European Union or a European Economic Area member country), Canada’s Extractive Sector Transparency Measures Act and the US Extractive Industries Transparency Initiative.

**SEC proposes updates to mining company disclosures**

The SEC proposed a rule that would require registrants with material mining operations to make more comprehensive disclosures about mining properties than they must today. The rule also would align disclosures with current industry and global practices and standards. Examples of disclosures that mining registrants would have to make include:

- Property disclosures by any domestic or foreign registrant (other than certain Canadian issuers) with mining operations that are material to its business or financial condition
- Information about mineral resources and material exploration results, in addition to mineral reserves
- Summary disclosure for a group of properties that are individually immaterial but material in the aggregate, as well as more detailed disclosure about properties that are individually material
- A technical report summary from a qualified person that supports the disclosures of exploration results, mineral resources and/or mineral reserves for each material property and that is filed as an exhibit in SEC filings (with the expert’s consent when included or incorporated by reference in a registration statement)
- Disclosure about the registrant’s controls over the reliability of its property disclosures and estimates

The proposed rule would rescind Industry Guide 7 and incorporate the mining property disclosure requirements in a new subpart of Regulation S-K. Comments are due by 26 August 2016.

**SEC permits filings using inline XBRL**

The SEC announced that it will allow companies to voluntarily submit filings with XBRL tag data embedded in the HTML financial statements in a manner referred to as inline XBRL. Companies otherwise are required to submit separate XBRL exhibits with their SEC filings, including annual and quarterly reports. The SEC believes that allowing the use of inline XBRL could reduce filing preparation costs, improve the quality of structured data and increase the use of XBRL data by investors and other market participants. The SEC will permit filings using inline XBRL through March 2020 and consider feedback to determine whether to require inline XBRL submissions.
SEC staff issues interpretations and compliance guide on crowdfunding
The Division of Corporation Finance issued interpretations of the SEC’s crowdfunding rules and a small business compliance guide. The rules, which went into effect on 16 May 2016, allow certain US private companies to raise up to $1 million in a 12-month period. In its interpretations, the staff clarified certain rules, including the limits on advertising and the disclosure requirements for newly formed entities.

Proposed rule would prohibit excessive incentive-based compensation by financial institutions
The SEC and five other federal agencies proposed a rule that would prohibit excessive incentive-based compensation arrangements that encourage inappropriate risks by certain financial institutions (as defined by the rule). Section 956 of the Dodd-Frank Act mandated this rule, citing evidence that “flawed incentive-based compensation packages in the financial industry were one of the contributing factors of the 2007 financial crisis.”

Among other things, the proposed rule would consider compensation excessive when amounts paid are unreasonable or disproportionate to the value of the services performed by a covered person, taking into account all relevant factors (e.g., if the covered person is connected to a fraudulent act or the compensation is dissimilar to compensation provided by comparable institutions), or the arrangement encourages inappropriate risk that could lead to material financial loss (e.g., the arrangement doesn't balance risks and rewards, the arrangement is contrary to effective risk management controls).

The rule would apply to covered financial institutions with total assets of $1 billion or more. There would be less prescriptive requirements for smaller covered institutions as determined by asset size. Comments are due by 22 July 2016.

SEC approves PCAOB rules on audit transparency
The SEC approved Public Company Accounting Oversight Board (PCAOB) rules that require auditors to disclose the name of the engagement partner and information about other accounting firms that participated in an audit in a new form (Form AP) to be filed with the PCAOB. Key provisions include:

- Form AP is due within 35 days after the audit report is first included in an SEC filing and 10 days after the report is first included in an initial public offering filing with the SEC.
- The rules do not apply to audits of brokers and dealers that aren't issuers.
- The requirements will be phased in. The requirement to disclose the name of the engagement partner applies to auditors' reports issued on or after 31 January 2017 (e.g., most reports covering 2016 financial statements for calendar-year issuers), and the requirement to disclose information about other accounting firms that participated in the audit applies to auditors' reports issued on or after 30 June 2017.

Other SEC activities
Senate Banking Committee approves SEC nominees
The Senate Banking Committee approved SEC nominees Lisa Fairfax and Hester Peirce. The Senate’s formal confirmation vote has yet to be scheduled. The SEC continues to operate with only three Commissioners, including Chair Mary Jo White.
IAC approves subcommittee recommendation on bond information

The Investor Advisory Committee (IAC) approved recommendations by the Market Structure Subcommittee to enhance information for bondholders. The IAC recommendations include encouraging the SEC to engage with the Municipal Securities Rulemaking Board and the Financial Industry Regulatory Authority to require dealers to provide more information on the costs associated with purchasing or selling a bond and to increase pricing transparency in the bond market.

Current practice matters

Center for Audit Quality SEC Regulations Committee meeting

The Center for Audit Quality (CAQ) SEC Regulations Committee issued highlights from its 21 March 2016, meeting with the SEC staff that included:

- Clarification of recent updates to the SEC staff’s Financial Reporting Manual about emerging growth companies that plan to adopt the new revenue recognition standard when it is effective for private companies (i.e., annual periods beginning on 1 January 2019, and interim periods beginning on 1 January 2020) and the standard’s effects on their quarterly financial data in the 2019 and 2020 Forms 10-K to comply with Item 302 of Regulation S-K

- Confirmation that registrants do not need to revise selected financial data for years preceding the earliest comparative period presented in the financial statements when the new leasing standard is adopted but should disclose the lack of comparability of the selected data

- Confirmation of the SEC staff’s 2014 public statement, pending further developments, that registrants are not required to describe their products as “not found to be ‘DRC conflict free’” and that only companies that voluntarily describe any product as “DRC conflict free” are required to obtain independent private sector audits of their conflict minerals reports

The CAQ SEC Regulations Committee also met on 14 June 2016, and discussed the SEC staff’s focus on non-GAAP financial measures and the application of the new revenue standard when an acquired business or equity method investee has a different adoption date. The highlights from this meeting will be released in the third quarter of 2016.

2014 XBRL US GAAP taxonomy no longer available

The SEC staff removed the 2014 XBRL US GAAP taxonomy from the EDGAR system, which no longer supports filings using that version of the taxonomy. Earlier this year, the SEC staff updated the EDGAR system to allow companies to use the 2016 taxonomy. The system now supports only the 2015 and 2016 taxonomies. The SEC staff is encouraging companies to use the 2016 taxonomy for reporting periods ending after 7 March 2016.

Personnel changes

Hetner named cybersecurity senior adviser to the SEC chair

Christopher R. Hetner has been named senior adviser on cybersecurity policy to the SEC chair. Mr. Hetner will be responsible for coordinating efforts across the agency to address cybersecurity policy, engaging with external stakeholders and further enhancing the SEC’s mechanisms for assessing broad-based market risk. He joined the SEC from EY in January 2015 to coordinate cybersecurity efforts in the Office of Compliance Inspections and Examinations.
Enforcement activities

An SEC order found that a company improperly overstated its earnings by among other things improperly accounting for work-in-process (WIP) inventory costs. The investigation noted that the vice president of operations and controller failed to implement and maintain adequate internal controls over WIP inventory and that costs were inappropriately capitalized and the WIP overhead calculation failed to consider the amount of WIP completed in each period. The company and former vice president of operations and controller settled the case without admitting wrongdoing. The company settled for $200,000. The former vice president was barred from serving as an officer or director of a public company for five years and was ordered to pay about $35,000 in disgorgement and penalty. The controller was permanently suspended from appearing and practicing before the SEC as an accountant and was ordered to pay a $40,000 penalty.

The Division has continued to award whistleblowers who voluntarily provide useful information that leads to successful enforcement actions. The SEC recently awarded $17 million to a whistleblower, the second largest award it has made since its whistleblower program began in 2011. The program has paid more than $85 million to 32 whistleblowers since its inception.2

What’s next at the SEC?

• Certain key SEC initiatives may continue to be delayed until the vacancies at the Commission are filled.

• We expect the SEC to finalize rules on executive compensation, including pay versus performance and incentive-based pay clawbacks, in 2016.

• We expect the staff to continue focusing on the disclosure of non-GAAP financial measures and issue comments if companies do not appropriately consider the new C&DIs.

• We expect the SEC staff will recommend that the Commission propose a rule to enhance board diversity disclosure requirements.

Endnotes:
