

Bringing order to non-GAAP financial measures: SEC sues to enforce “equal-or-greater-prominence” requirement

Richard J. Parrino

Abstract

Purpose – This article examines the first action by the US Securities and Exchange Commission to enforce the “equal-or-greater-prominence” requirement of its rules governing the presentation by SEC-reporting companies, in their SEC filings and earnings releases, of financial measures not prepared in accordance with generally accepted accounting principles (GAAP).

Design/methodology/approach – This article provides an in-depth analysis of the equal-or-greater-prominence rule and the SEC’s enforcement posture in the context of the SEC’s concern that some companies present non-GAAP financial measures in a manner that inappropriately gives the non-GAAP measures greater authority than the comparable GAAP financial measures.

Findings – Although the appropriate use of non-GAAP financial measures can enhance investor understanding of a company’s business and operating results, investors could be misled about the company’s GAAP results by disclosures that unduly highlight non-GAAP measures. The SEC’s enforcement action signals a focus on the manner in which companies present non-GAAP financial measures as well as on how they calculate the measures.

Originality/value – This article provides expert guidance on a major SEC disclosure requirement from an experienced securities lawyer.

Keywords US Securities Exchange Act of 1934, US Securities Act of 1933, Non-GAAP financial measures, Regulation G, Item 10(e) of Regulation S-K

Paper type Technical paper

Richard J. Parrino (richard.parrino@hoganlovells.com) is a partner at Hogan Lovells US LLP, Washington, District of Columbia, USA.

When a public company presents a non-GAAP financial measure in a filing with the US Securities and Exchange Commission (SEC) or in an earnings release, SEC rules direct it to present “with equal or greater prominence” the most directly comparable financial measure calculated in accordance with generally accepted accounting principles (GAAP). Before the SEC’s Division of Corporation Finance in May 2016 issued updated interpretive guidance on the use of non-GAAP financial measures, market practice on prominence issues had evolved to encompass a variety of presentation formats. The SEC staff’s guidance dispelled some of the uncertainty over the contours of the equal-or-greater-prominence requirement by identifying specific presentations the staff considers noncompliant.

In December 2018 the SEC sounded a warning to the public-company community about the potential consequences of failing to observe the staff’s 2016 prominence guidance. The SEC instituted cease-and-desist proceedings against a company for violating Section 13(a) of the US Securities Exchange Act of 1934 (Exchange Act) and Rule 13a-11 under the

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Exchange Act by including non-GAAP financial measures in two of its earnings releases without presenting the most directly comparable GAAP financial measures with equal or greater prominence[1]. The non-GAAP measures appeared in the headlines and a highlights section of the earnings releases. The company agreed to pay a \$100,000 civil money penalty in settlement of the enforcement action.

The proceeding represented the SEC's first action to enforce compliance with the equal-or-greater-prominence requirement since publication of the staff's guidance. It is useful to view the SEC's current enforcement posture on the prominence issue against the background of evolving agency concern over the manner in which companies present non-GAAP financial measures to investors.

Presentation of GAAP measures with equal or greater prominence

The equal-or-greater-prominence requirement has been part of the SEC's rules on non-GAAP financial measures since their adoption. Effective on March 28, 2003, as required by the Sarbanes-Oxley Act of 2002, the SEC adopted Regulation G and Item 10(e) of Regulation S-K[2] to implement the statutory mandate that publicly disclosed non-GAAP financial measures be presented in a manner that is:

- not materially misleading; and
- reconciled with the most directly comparable GAAP financial measures[3].

Item 10(e)(1)(i)(A) of Regulation S-K[4] states that, whenever a registrant includes one or more non-GAAP financial measures in an SEC filing, the registrant must include in the filing:

A presentation, *with equal or greater prominence*, of the most directly comparable financial measure or measures calculated and presented in accordance with Generally Accepted Accounting Principles (GAAP). (emphasis supplied)

With limited exceptions the non-GAAP rules, including the equal-or-greater-prominence requirement, apply to non-GAAP disclosures contained in reports, registration statements and other information filed with the SEC under the Exchange Act or the US Securities Act of 1933. Registrants also must comply with the prominence requirement in earnings releases that announce results for a completed fiscal period when they "furnish" (rather than "file") the announcements under Item 2.02 of SEC Form 8-K[5].

The SEC's releases discussing the proposed and final non-GAAP rules did not offer much insight into the agency's views on the scope of the equal-or-greater-prominence requirement. The SEC noted in its rule proposal that for filed disclosures the new rules would prohibit "presenting a non-GAAP financial measure in a manner that would give it greater authority or prominence than the comparable GAAP financial measure or measures[6]". The SEC did not solicit specific comment on the substance of the equal-or-greater-prominence proposal, and adopted it unchanged in the final rules. Although many aspects of the proposed rules attracted extensive comment, the prominence proposal does not appear to have elicited debate. In its adopting release the SEC did not identify any considerations following the comment period that had influenced it in approving the prominence requirement[7].

The SEC staff published little interpretive guidance on the equal-or-greater-prominence requirement in "frequently asked questions" (FAQs) on the new rules it issued in June 2003 or in more extensive Compliance and Disclosure Interpretations (C&DIs) it issued in January 2010. Instead, until it issued a C&DI on the prominence requirement in May 2016, the staff primarily conveyed its interpretive position on the requirement through the comment letter process it administers in its review of filings and furnished earnings releases. Although they provided helpful clues to the staff's views on prominence issues, the comments issued to

individual registrants fell short of the more authoritative guidance that would have been afforded by publication of general guidelines.

May 2016 guidance on prominence requirement

The Division of Corporation Finance, which administers the SEC's disclosure rules for registrants that are not investment companies, issued 12 C&DIs on May 17, 2016 to provide updated interpretive guidance on compliance issues under the non-GAAP rules^[8]. One C&DI specifically addresses areas of uncertainty concerning compliance with the equal-or-greater-prominence requirement.

The Division issued the new guidance against the backdrop of increasing concern among members of the Commission and its staff over the increasing use of non-GAAP financial measures and some common non-GAAP disclosure practices they viewed as inconsistent with the agency's rules. The SEC warned that the use of non-GAAP measures could mislead investors when companies do not clearly disclose the adjustments made to GAAP financial measures or when non-GAAP measures present a materially different picture of a company's results than GAAP measures. Senior members of the staff expressed the view that a permissive regulatory stance in recent years towards non-GAAP presentations had emboldened some companies to use non-GAAP financial measures to mask, rather than clarify, their operating performance as measured by GAAP. The regulatory concern extended to how companies presented their non-GAAP measures as well as to how they calculated them. In particular, some companies attracted criticism from the agency for emblazoning non-GAAP measures in their earnings release highlights in a manner designed to attract favorable investor attention (Parrino, 2016).

In its 2016 C&DI on the equal-or-greater-prominence requirement the SEC staff includes a list of presentations that it says do not meet the requirement. The staff indicates that whether a non-GAAP measure is more prominent than the comparable GAAP measure "generally depends on the facts and circumstances in which the disclosure is made." The staff then cautions that, notwithstanding this general principle, it "would consider the following examples of disclosure of non-GAAP measures as more prominent" than the comparable GAAP measures and therefore as failing to comply with the equal-or-greater-prominence requirement:

- *Non-GAAP income statement*: presenting a full income statement of non-GAAP measures or presenting a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures;
- *Omission of GAAP measures*: omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures;
- *Style of presentation*: presenting a non-GAAP measure using a style of presentation (e.g., bold text or a larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure;
- *Order of presentation*: presenting a non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption);
- *Characterization of performance*: describing a non-GAAP measure as, for example, "record performance" or "exceptional" without at least an equally prominent descriptive characterization of the comparable GAAP measure;
- *Non-GAAP tabular disclosure*: providing tabular disclosure of non-GAAP financial measures without preceding that disclosure with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table;

- *Exclusion of quantitative reconciliation*: excluding a quantitative reconciliation with respect to a forward-looking non-GAAP measure in reliance on the “unreasonable efforts” exception in Item 10(e)(1)(i)(B) without disclosing that fact and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence^[9]; and
- *Discussion and analysis of measures*: providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location of equal or greater prominence^[10].

The SEC staff outlines a two-part approach to the equal-or-greater-prominence requirement. First, the staff identifies a number of presentations that, without regard to their context, it believes do not comply with the requirements. Then, for disclosures it does not expressly characterize as impermissible, the staff invokes the type of “facts-and-circumstances” analysis that is pervasive in US securities regulation to guide registrants to consider prominence in the context of the particular non-GAAP presentation.

The presentations disfavored by the staff represent a compilation of non-GAAP disclosure practices the staff previously had challenged in the filing comment process. The staff’s guidance rules out some presentations that had gained a measure of favor in the marketplace. For example, in indicating that a non-GAAP measure may not precede the most directly comparable GAAP measure, the staff has resolved the ordering issue against the view, held by many registrants, that a GAAP measure is presented in an equally prominent manner if it immediately follows the related non-GAAP measure.

The staff does not identify the specific considerations that would underpin a facts-and-circumstances analysis of prominence issues. At a minimum, however, the analysis should be governed by the basic principle underlying non-GAAP disclosure regulation, which is that a registrant should not present non-GAAP financial measures in a way that could mislead investors by obscuring the registrant’s GAAP results. It is unclear under the staff’s guidance whether this principle would be satisfied if the non-GAAP presentation, taken as a whole, is not misleading. The staff’s focus in the C&DI on individual GAAP and non-GAAP references seems inconsistent with a compliance approach that would evaluate the prominence of particular references in the context of the overall presentation.

Market practice after publication of May 2016 guidance

The C&DIs on the non-GAAP rules reflect only views of the staff of the Division of Corporation Finance, and do not constitute official agency statements or rules. Despite the non-binding nature of the staff’s guidance, most registrants accept the Division’s views as authoritative and generally seek to conform their disclosure practices to positions endorsed by the staff.

Following publication of the C&DI on prominence, it appears that many companies heeded the SEC staff’s admonition to review and, if necessary, revise their non-GAAP presentations in light of the guidance. One review of earnings releases issued by companies in the S&P 500 index for the fiscal quarter that ended after publication of the C&DI reported that 81 per cent of those companies presented GAAP financial measures more prominently than non-GAAP measures, compared to 52 per cent of the companies in the preceding fiscal quarter.

The declining volume of SEC staff comments on the prominence issue over a longer period also reflects a shift in presentation practice. During the period from May 17, 2016 through June 30, 2019 the staff issued over 300 comments questioning compliance with the prominence requirement in filings and earnings releases. The staff issued over half of the comments in the year following publication of its interpretive guidance, about 30 per cent in the following year, and the remainder in the third year.

In the comment process the staff continues to dispute a disclosure practice on prominence grounds that it did not include in the C&DI’s list of disallowed presentations. The staff

advises registrants that the quantitative reconciliations required under Item 10(e)(1)(i)(B) should begin with the comparable GAAP measures, rather than with the non-GAAP measures, so that the non-GAAP measures are not given undue prominence.

Despite enhanced observance of the prominence rule generally, instances of noncompliance have persisted. In almost all such instances identified in the review process, the SEC staff simply obtains an undertaking from the registrant to issue compliant presentations in its future disclosures. The SEC enforcement action instituted against one such registrant in December 2018, however, signaled that public companies should not assume similar indulgence by the agency for all such disclosure violations.

SEC enforcement action for violation of prominence requirement

In cease-and-desist proceedings settled on December 26, 2018 the SEC found that ADT Inc. (ADT), an NYSE-listed company, had violated the equal-or-greater-prominence requirement in two routine earnings releases, each of which the company had furnished under Item 2.02 of Form 8-K[11]. The noncompliant presentations identified in the SEC's enforcement order involved references to adjusted EBITDA, adjusted net income and adjusted net income per share, each of which is a non-GAAP financial measure under SEC rules. ADT included the non-GAAP presentations in an earnings release announcing results for a full fiscal year and the fourth quarter of the year, and subsequently in its next quarterly earnings release.

It is unsurprising that the SEC focused on noncompliant disclosures in earnings releases. Securities analysts and other marketplace participants subject earnings releases to particularly intensive review as the first public announcement of results for the fiscal period. Companies carefully structure their non-GAAP presentations in a manner they intend to clarify underlying business trends and the company's "core" performance. The compressed presentation in an earnings release typically requires judgments on word placement and order that implicate the prominence requirement.

The SEC did not refer in its enforcement findings to the staff's C&DI on the prominence requirement. In each case, however, the non-GAAP disclosure the SEC found to be noncompliant represented a presentation that the staff in its guidance says would fail the prominence test without reference to its context.

Omission of comparable GAAP measure from earnings release headline or caption. The SEC pointed to a number of instances in the earnings releases in which ADT referred to non-GAAP measures in headlines or a highlights section without referring to the comparable GAAP measures. The offending presentations in the headlines included the following references to non-GAAP measures:

- "Adjusted EBITDA up 8 per cent" (in the full-year earnings release)
- "Adjusted EBITDA up 7 per cent" (in the next quarterly earnings release)

In each headline the company omitted reference to its net income or loss, which is the most directly comparable GAAP financial measure for adjusted EBITDA when used as a performance measure.

The highlights section of ADT's quarterly earnings release displayed the same shortcoming. The company announced that it had achieved each of the following non-GAAP results, without referring to the comparable GAAP financial measure:

- "Adjusted EBITDA of \$620 million, up 7 per cent"
- "Adjusted Net Income of \$249 million, up 26 per cent"
- "Adjusted Net Income per share of \$0.34, up 10 per cent"

The SEC noted that ADT did disclose in the second and sixth paragraphs of the release – after the highlights section – that its GAAP net loss (the most directly comparable GAAP financial measure for the first two non-GAAP measures) had increased over the measurement period. Even this disclosure would not have satisfied the staff’s guidance since, unlike each non-GAAP disclosure, which described the percentage increase in the non-GAAP measure over the corresponding prior period, the GAAP disclosure did not refer to any percentage change in the GAAP measure.

Similar presentation deficiencies occurred in the highlights section of the full-year earnings release, although the SEC did not mention those deficiencies in the order.

Other presentation issues. The SEC did not need to address related presentation issues under the staff’s bright-line test for identifying noncompliant disclosures, since ADT failed altogether to refer to the most comparable GAAP measures in its releases. Even if it had referred to the GAAP measures, however, ADT would not necessarily have satisfied the staff’s guidance. A fully compliant approach would have required ADT, in addition, to:

- refer to the comparable GAAP measure *before* the non-GAAP measure, which is specifically required “in an earnings release headline or caption”, as the staff notes in its guidance; and
- describe for the comparable GAAP measure the company’s period-over-period performance, by dollar amount, percentage or verbal characterization, in the same manner as for the non-GAAP measure.

Accordingly, augmenting the disclosure contained later in its quarterly earnings release, ADT would have had to present the adjusted EBITDA highlight as follows:

- “Net Loss of \$157 million, up 11 per cent; Adjusted EBITDA of \$620 million, up 7 per cent”

Enforcement considerations. The SEC did not announce why it selected ADT’s deficient non-GAAP disclosures for enforcement action. Among the factors it might have considered were the period of almost two years that had elapsed between publication of the staff’s guidance and the first appearance of the noncompliant disclosures; the repetition of the same types of disclosure deficiencies in a second earnings release; the occurrence of the deficiencies in earnings headlines and a highlights section, which typically command more attention among investors and the financial media than qualifying disclosures later in an earnings announcement; and the company’s failure to refer at all to the most comparable GAAP financial measures together with the non-GAAP measures.

Conclusion

The SEC’s first enforcement action for noncompliance with the equal-or-greater-prominence requirement might signal the agency’s concern that some companies have become less attentive to this aspect of its staff’s 2016 guidance with the passage of time. The action clearly indicates that the SEC will not be content in all cases to address shortcomings in non-GAAP financial presentations simply by directing the company to comply with the non-GAAP rules in future filings and earnings announcements. The action also suggests that disclosures containing presentations expressly disallowed in the staff’s guidance on prominence could attract enforcement interest even if the presentation of the company’s financial results, taken as a whole, does not appear to the company to provide a materially misleading picture of its performance as measured by GAAP.

In light of the enforcement action, SEC-reporting companies that may not yet have fully aligned their non-GAAP disclosure practice with the staff’s 2016 guidance should consider whether they need to modify their non-GAAP presentations to ensure compliance with the equal-or-greater-prominence requirement and other conditions of Item 10(e).

Notes

1. *In the Matter of ADT Inc.*, Release No. 34-84956 (Dec. 26, 2018), available at www.sec.gov/litigation/admin/2018/34-84956.pdf (last accessed 19 Aug. 2019).
2. *Conditions for Use of Non-GAAP Financial Measures*, Release No. 33-8176, **Release No. 34-47226**, 68 Fed. Reg. 4820 (Jan. 30, 2003).
3. Regulation G applies to any “registrant”, which is any entity that has a class of securities registered under Section 12 of the Exchange Act or is required to file reports under Section 15(d) of the Exchange Act, other than an investment company registered under Section 8 of the US Investment Company Act of 1940. Item 10(e) applies to such registrants as well as to the issuer of securities for which a registration statement is filed under the US Securities Act of 1933. Although registrants that are non-U.S. companies, or “foreign private issuers”, generally must comply with the SEC’s non-GAAP rules, they may qualify for exceptions that are not available to US registrants.
4. 17 C.F.R. § 229.10(e)(1)(i)(A)(2019).
5. Instruction 1 of Item 2.02 of Form 8-K states that the “requirements of this Item 2.02 are triggered by the disclosure of material non-public information regarding a completed fiscal year or quarter. Release of additional or updated material non-public information regarding a completed fiscal year or quarter would trigger an additional Item 2.02 requirement”. Instruction 2 of Item 2.02 of Form 8-K states that the “requirements of paragraph (e)(1)(i) of Item 10 of Regulation SK (17 CFR 229.10(e)(1)(i)) shall apply to disclosures under this Item 2.02”.
6. *Conditions for Use of Non-GAAP Financial Measures*, Release No. 33-8145, **Release No. 34-46768**, 67 Fed. Reg. 68790, 68795 (Nov. 13, 2002).
7. See note 2, *supra*.
8. US Securities and Exchange Commission (2016), Division of Corporation Finance, Compliance and Disclosure Interpretations, Non-GAAP Financial Measures, May 17, 2016, available at www.sec.gov/divisions/corpfin/guidance/nongapinterp.htm. The 12 new and revised C&DIs are identified by their issue date of May 17, 2016.
9. This aspect of the C&DI refers to the provision in Item 10(e), which is also found in Rule 100(a) of Regulation G, that permits a company to present a forward-looking non-GAAP measure without providing a reconciliation to the most directly comparable forward-looking GAAP measure if reconciling information is not available without “unreasonable efforts”. The guidance refers to the SEC’s statement in its 2003 release adopting Regulation G and Item 10(e), at note 2, *supra*, that a company relying on the exception must identify the reconciling information that is unavailable and disclose the probable significance of that information. Many companies that use forward-looking non-GAAP measures historically have not provided reconciliations to the comparable forward-looking GAAP measures and have included only limited references to the unavailability of reconciling information. Although this C&DI provides a reminder of the nature of the disclosure required to rely on the “unreasonable efforts” exception, particularly with respect to the probable significance of the unavailable information, it also focuses companies on where to disclose such information to meet the prominence requirement.
10. The C&DIs are presented in a Question and Answer format. The guidance in the C&DI on prominence responds to Question 102.10.
11. See note 1, *supra*.

Reference

Parrino, R.J. (2016), “New compliance guidance by SEC staff signals increased scrutiny of non-GAAP financial measures”, *Journal of Investment Compliance*, Vol. 17 No. 4, pp. 23-33.

Corresponding author

Richard J. Parrino can be contacted at: richard.parrino@hoganlovells.com

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