"Non-GAAP Measures & Metrics: Where Are We Now?"

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Non-GAAP disclosures are back in the spotlight as companies grapple with how to quantify the effect of COVID-19 on their results of operations and the Corp Fin Staff continues its focus on individually tailored accounting principles and disclosure of key performance metrics.

Join these experts:

- **Mark Kronforst**, Partner, Ernst & Young
- **Dave Lynn**, Partner, Morrison & Foerster, and Senior Editor, TheCorporateCounsel.net
- **Lona Nallengara**, Partner, Shearman & Sterling

Liz Dunshee, *Managing Editor, TheCorporateCounsel.net*: Hi. This is Liz Dunshee, Managing Editor of TheCorporateCounsel.net. Welcome to today's webcast, "Non-GAAP Measures & Metrics: Where Are We Now?"

This is a topic that seems to be a perennial interest to the Staff, and it's taking on a unique application this year as companies grapple with quantifying the effects of COVID-19 and complying with recent Staff guidance. I'm excited to hear from our panelists today, who are all very prominent former SEC staffers, so we really are hearing direct from the experts.

I want to welcome today's panelists and thank them for participating. We have Mark Kronforst, a Partner at EY and former Chief Accountant at the SEC's Division of Corporation Finance. We have Dave Lynn, a Partner at Morrison & Forrester, Senior Editor at TheCorporateCounsel.net, and former Chief Counsel at Corp Fin. And, we have Lona Nallengara, a Partner at Shearman & Sterling and former SEC Chief of Staff to former SEC Chair Mary Jo White and the former Deputy Director and acting Director of the Division of Corporation Command.

Dave is going to kick things off with a discussion of operating metrics versus non-GAAP financial measures and SEC concerns with both. Dave?

Background to SEC's 2020 MD&A Guidance

Dave Lynn, *Partner, Morrison & Foerster and Senior Editor, TheCorporateCounsel.net:* Thank you very much, Liz. Our goal for the webcast today is to really step back and take a look at where things stand in terms of the regulation of non-GAAP financial measures, key performance indicators and

operating metrics. In terms of the non-GAAP financial measure issues, I think we can all agree that a good analogy to what we see unfolding over time is a pendulum analogy.

Sometimes you have the pendulum that swings to the side where the SEC Staff and the Commission are more understanding of non-GAAP financial measures; it's less of a priority for the Commission and the Staff. A good example of that is about a decade ago, when the Staff went through the process of updating the Non-GAAP Financial Measures Compliance and Disclosure Interpretations. I think it's fair to say this softened their approach to encourage issuers to use non-GAAP financial measures in their SEC filings, and to really address a concern that there was too big of a gap between what people were saying in their earnings releases and what people were saying in their SEC filings.

We then move to a situation where the pendulum swings to the complete opposite end of the spectrum. In 2016, the Staff paid a great deal of attention to non-GAAP financial measures and concerns with the way in which issuers were presenting those measures. Again, the Staff updated the Compliance and Disclosure Interpretations to, among other things, address concerns with equal or greater prominence and the use of individually tailored accounting principles, and to address a variety of issues that had been perceived through time. We really saw an active effort on the Staff's part to review earnings releases and other investor communications and to issue comments. We even saw the Division of get involved back then in 2016, where they opened a number of inquiries that seemed to be focused on non-GAAP financial measure presentations.

All of that brings us to where we are today, which I would characterize as the pendulum hanging in the middle. This is the best analogy I can come up with because I don't think non-GAAP financial measures have gone into the background in terms of the Staff's thinking. When you look at the amount of comments the Staff issues in this area, it's still a very frequently addressed area of Staff comment. But at the same time, I don't think there's an active effort to change the approach to non-GAAP financial measures from a policy or regulatory standpoint. At least at the moment.

That is not to say we should let our guard down. Companies need to continue to be vigilant in preventing backsliding from the attention-grabbing things that happened back in 2016. There's still potential to get comments from the Staff if you don't conform to the non-GAAP financial measure rules, and there is still potential out there for an enforcement action in the right circumstances.

I do think that having the pendulum sitting in the middle has allowed the Commission to focus on another persistent concern that's been around for as long as I've been practicing securities laws, and that's the presentation of operating metrics and performance indicators that aren't themselves non-GAAP financial measures. Back to when I first began reviewing registration statements in the SEC, when I was in the Staff in the 1990s, there was a lot of focus on operating metrics. You had a lot of companies during the Internet boom that didn't necessarily have revenues or income but were still going public, and they needed some way of showing their business progress. There needed to be some approach by which to value them for the purposes of their IPOs, and so a lot of emphasis got put on operating metrics and key performance indicators that weren't, themselves, financial measures. They were calculated outside of both the GAAP process and the non-GAAP process, for that matter.

It's fair to say that back then, it made people nervous when those types of measures were presented, because there really wasn't a framework within which to deal with those measures. There weren't line item disclosure requirements that dictated specific disclosures or that prohibited certain disclosures. It was really just applying a basic 10b-5 approach that, by and large, had to be dealt with through the comment process. The issue is compounded when you think about the fact that in many cases these types of operating metrics aren't necessarily comparable across companies. One company may compute an operative metric in one way, but that doesn't necessarily mean the entire industry does or that other companies do.

In terms of the Staff's attention to the issue – back in 2003, when the non-GAAP financial measure rules were adopted, the Staff was really focused on that particular issue because Section 401(a) of the Sarbanes-Oxley Act had directed them to write those rules, and those rules didn't broach the subject of key operating metrics. The issues rattled around for a long time because so much of the focus had been on the non-GAAP financial measures.

It surfaced again back in 2013, when Mary Jo White was the Chair. In several speeches, she noted the concern that existed as a number of social media and new Internet companies came to the public market. These were similarly situated to those companies back in the 1990s, from a financial measures perspective, in that there was not a lot in the financial statements to go on. So, we looked to number of users and other operating measures that presented a different picture.

The notion that Chair White communicated, which I think was consistent with the concerns over a decade earlier, was when you show the number of users, for instance, for your website or service or social media platform, does that translate into revenue generating activity? How do I evaluate that kind of data? How do I look in that context when trying to figure out whether the company is being successful in executing its business strategy?

Even though that was seven years ago now, which is hard to believe, we still haven't really had a framework within which to work, other than what we learned from the Staff comment process. And that brings us to this year, when on January 30th, the SEC came out with an interpretive release that was focused on Management's Discussion & Analysis.

The SEC noted that a variety of preexisting guidance, including the 1989 MD&A Interpretive Release and the 2000 MD&A Interpretive Release, pointed to the fact that companies may need to disclose other statistical data, key performance indicators and information that's necessary, in the company's judgment, to enhance a reader's understanding of the MD&A, and the metrics and variables that management looks to and is useful for that purpose may also be very much material to investors.

The release reintroduced this concept that perhaps your MD&A needs to be revisited in terms of presenting these types of measures. But if you do present the measures, we need a framework by which that disclosure is being made.

With that, I'm going to turn it over to Lona to talk about what the Commission said that framework should be.

Operating Metrics vs. Non-GAAP Financial Measures

Lona Nallengara *Partner, Shearman & Sterling*: Thanks, Dave. Surprisingly, when I was rereading the guidance, I didn't expect it to be January 30th of this year. It seems like that was almost two or three years ago. But you're right, it was this year. Just a few months ago, the Commission issued guidance focused on the use of key performance indicators and metrics. Interestingly, the guidance was pretty clear that it was directed at the use of these metrics in the MD&A – not in other areas of disclosure or in your SEC filings or in filings where there isn't MD&A.

I'd be interested, Mark and Dave, maybe later we can talk about what that means and what implications that would have for using key performance indicators. The things that you described, Dave, are certainly used in places other than MD&A – for example, the business section and in press releases. What implications does this guidance have for best practices?

The second thing that's interesting is that this was Commission guidance. In the past, the interpretive information that the SEC has provided has usually been a Staff-level guidance, whether that's a disclosure guidance topic, a Staff legal bulletin or a series of CDIs. This is something that's different here. It's Commission guidance, so the focus of the guidance was on performance indicators and metrics that are used to enhance the understanding of the MD&A. They could be qualitative or

quantitative metrics used particular to the industry, they could be just unique to your company, they could be related to external or macroeconomic factors or they could be solely internally focused.

Dave gave some examples that are useful in the social media industry – user data, daily or monthly active user information, the number of active users you have – and in retail, same store sales is a common metric that's used. There are a number of these measures, and the Commission guidance provides a non-exhaustive list of what those metrics could be, but you're not limited to those nor will the Staff limit their review of your key performance indicators to the ones listed there. It's really what you're using to enhance the understanding of your operations.

What the guidance is doing is reminding companies that when you're including these kinds of metrics, you need to include information that is necessary to make the presentation of the metric not misleading. So, what does that mean? That phrase applies to everything in the MD&A and any other disclosure you have. But the guidance does give you some clarity about what you should consider, what additional information is needed to provide the right context to understand the metric, and why the company is using it.

So, what does the Commission say? The Commission says it needs three things when you're using a key performance indicator of the nature that they've described. One, you have to provide a clear definition of the metric and how you calculate it. Second, you've got to tell the reader or the investor why the metric is useful to them, why they should be looking at it, why it's important for them to understand it. And third, there has to be a statement indicating how management uses the metric to either manage the business or monitor the performance of the business.

Just to repeat those three things. The definition of the metric and how it's calculated; why it's important to investors; and how management is using the metric.

Mark Kronforst, *Partner, EY*: Just to go back really quickly about what David had mentioned about this. As an example, it was close to a decade ago when this originally came up. It was "number of users," which is a metric that we've all been talking about so far, just to get an idea of what that means. The situation was that a company was disclosing the number of users of a platform, but it was revealed that a very small number of those users were actually paying customers. And that's where the Staff really started to get into this notion of, "How does this relate to the operations?" I thought I'd offer a quick, live example. That's how it originally came up, and people need to be thinking about how it relates to the financial statement numbers you're looking at.

Nallengara: I remember that disclosure, and it's interesting. Dave spoke about the pendulum of how the Staff engages on whether it's non-GAAP measures or key performance indicators. I almost think that the level of engagement may be more reflective of the use of the metrics and the way they're being used, or maybe someone would say abused. The engagement of the Staff heightens when there is more aggressiveness in the use of non-GAAP measures, whether it be the prominence or lack of equal prominence, whether it is the type of adjustments being made or whether they are unusual or non-recurring. That example of showing a measure without context is clearly important.

The guidance is not meant to alleviate any of your responsibility with non-GAAP measures. All of the rules related to non-GAAP measures still apply. The requirements to provide reconciliations, equal prominence, all of those things with respect to non-GAAP measures still apply. The guidance goes on to indicate that if you're using these key performance measures and you've provided those three things, and if in a later period you determine that you want to change the way you calculate the measure from one period to the next, you are required to provide information to investors about the changes you've made. You should be describing the differences in the way the metric is calculated or presented as compared to prior periods. You have to tell them why you made those changes, what the effects of those changes are, the amount of information that is being disclosed now, and then what has been previously reported.

The Commission isn't saying you can't change the metrics. Obviously, you can change the metrics. More importantly, you can change the way you calculate them. But what they don't want to see is you changing metrics because a different calculation methodology will result in a better presentation of some result without providing the context, as Mark mentioned earlier. So, that may require you to restate the information and provide both prior periods with respect to the key performance indicator and not just the current period, to show that the information that we provided you with before would also change, or it may require to you show what the current period metric would've been under the prior calculated methodology. That's a summary of how the guidance works.

Dave, Mark, why do you think the Commission guidance focused only on the disclosures of these kinds of metrics in the MD&A?

Kronforst: I think the MD&A is where they saw some issues, so they restricted it to the MD&A, and they probably saw some areas where they didn't necessarily see the need for such robust disclosures. I'm not sure there are many of those, but I think it was a safer approach to restrict it to the MD&A. I also think that similar guidance is already out there being applied to the MD&A, so it was a natural extension of that. It gets a little more difficult to do that in other areas where they haven't already been interpreting things in this way. Dave, do you agree with that?

Lynn: Yes, from an interpretive release perspective, the notion is we have an actual rule here that we can interpret. We have interpretive guidance that the Commission itself has provided in the past. It says you should think about whether these key performance indicators need to be disclosed in the MD&A, and short of doing a notice and comment rulemaking to put forth this framework, that was the solid ground they could choose.

I wonder if there's a little bit of the same issue here that I had mentioned before, which was that when the pendulum had swung to the more permissive non-GAAP financial measure approach a decade ago, their big concern was companies having a lot of non-GAAP financial measure disclosure in earnings releases that never got discussed in Commission filings. The Staff was trying to figure out a way to reconcile that and had a legitimate concern that when you're showing particular information in the earnings release, you've obviously made a determination that the information isimportant, and most likely material, information for investors.

But then in the MD&A, are investors getting the same information from whatever else is disclosed, when the MD&A doesn't have the non-GAAP financial measures from the earnings release? Perhaps a little bit of that comes into play here, where if I have an already-public issuer that's out there with an earnings release that has a lot of operating data in it, but yet doesn't really discuss the same trends in the MD&A, is that something that perhaps the Staff is concerned about? That perhaps investors are missing out by reading the MD&A because they don't have the benefit of that information?

Kronforst: Dave, that raises a good question. You alluded to it earlier, and part of this that is often overlooked is all the way back in the 2003 MD&A release where they talked about key performance indicators for the first time. They said that the registrant should include any key performance indicators that they use to manage the business and that are material to investors, so that expectation is there. I'm not sure that's much of a focus today but it should be considered when evaluating that gap between earnings releases and MD&A

Nallengara: Dave and Mark, how are you advising companies on a key performance indicator that, if it was in the MD&A, they would provide those three things that the guidance has asked for? But now we're talking about a press release and earnings release, for example, where the same key performance indicators are provided but the guidance doesn't necessarily require you to do anything with it. What is your thought on the best practice there? Do they add a couple of paragraphs to the annex to the earnings release where they provide the discussion about non-GAAP financial measures and provide the similar information that they would have in the MD&A as part of the earnings release?

Lynn: My experience is that a lot of issuers already do have some explanatory information about the operating metrics, because a lot of times, understanding the operating metrics would be difficult without that. Whether it rises to the level of the explanation that is sought in the MD&A guidance is a question that has to be addressed, and my approach has been that it should be at least as fulsome as that guidance if you want to avoid a potential 10b-5 issue, because the way the Commission phrased it in the interpretive release, they strongly suggested that that disclosure is important to understanding how it works. I would definitely encourage people to try to be as descriptive as possible when talking about operating metrics in their earnings release.

Kronforst: I would agree with that. I'll just point out that you don't need pages of disclosure because for measures that are well understood, commonly used and aren't changing, I'm not sure that's a very heavy lift. Certainly for metrics that are less well understood, maybe a little more complicated, and for sure if they have changed, then I would really zero in on those disclosures, and I would advise someone to comply with the terms of that release even in other places, because I think that would be a best practice.

Nallengara: I agree, and I think you're right, Dave. A lot of companies have been doing it already. And, Mark, you're right, that it's been a complexity of the measure that has determined that. Average revenue per user, if you're giving the user number and you have the revenue, unless you're doing something funky with it, it should be a straightforward calculation. But something more bespoke for a company like backlog, for example, which has inherent understanding of the contractual process and the selling cycle and all of that for the company, that may require a little bit more information so someone can understand what goes into, or more importantly what doesn't go into, a calculation of that measure. I think we covered the guidance.

Dunshee: Mark, do you want to cover the impact of COVID-19 and what acceptable and unacceptable adjustments are?

Presenting the Impact of COVID-19: Acceptable & Unacceptable Adjustments

Kronforst: Sure. Before I do that, it's helpful to just reflect on what happened when the pandemic hit and what we actually saw in practice. I think most companies shied away from adjusting for the impacts of COVID, and there are a couple of reasons for that that I'll point out. One reason is it was a challenge to identify amounts that could be adjusted, and also amounts that the SEC Staff would agree comply with their rules and guidance, that would result in a metric that would adequately convey the impacts without having to point to other things outside of that calculation. That made the disclosure difficult from a narrative perspective to make it useful to readers.

The second reason is there was a hesitancy to use non-GAAP measures to reflect the impacts of the pandemic, because the SEC guidance generally uses this concept of what's "normal." You see that in a couple places. One example the prohibition on excluding normal cash operating expenses necessary to run the business. I think it is challenging to determine what is normal right now

Doing that presented a risk that normal could change. For example, adjusting for additional cleaning or additional pay, if those things become normal, there might be a point when those adjustments no longer comply with the SEC guidance. That would take control out of a registrant's hands if they chose to present those adjustments in terms of the duration of time that they could present them. Those are just two of the reasons.

We did see some examples of adjustments, and interestingly the SEC Staff didn't really speak about what would or would not be acceptable in terms of adjusting for the pandemic. They did offer some accommodations for reconciling non-GAAP measures when there were preliminary GAAP amounts. That was part of their original response to the pandemic, but they really didn't say anything other than non-GAAP measures can't be misleading and they can't be solely used to make a company look better.

Practice developed a general approach that an adjustment should be directly attributable to the pandemic. That one is pretty obvious. It should also be incremental to operations that prior to and after the events of the pandemic – that's the concept of "normal" that I mentioned. It also needs to be clearly separable and calculable so that it's accurate. That's a general framework that can be used to determine whether an adjustment might be acceptable. Some of those things that you could imagine might qualify are temporary premiums paid to compensate employees for performing their duties at increased risk, cost to clean and disinfect facilities more frequently or thoroughly. That's the one that I said could be at risk of being determined later on to be normal.

Contract termination fees or penalties is another one that we saw. Or going on the other side, and this goes to the concept of if you're going to back out expenses, you have to also look at the other side of the books, are insurance recoveries that a company may have received in connection with the pandemic. That would also be something that would probably be acceptable.

That's the general framework that I think practitioners have been operating under. We haven't heard a lot from the SEC. Like I said, I think a lot of companies chose more of an MD&A approach on this, and what I mean by that is to show their results on a GAAP basis or just their normal non-GAAP measures, and then talk about what's in there for effects of the pandemic without doing some math that says these are results before the effects of the pandemic. Not doing the math, of course, scopes you out of the non-GAAP rules.

That is generally what's been going on. It's been fairly quiet. I'll just add one thing. I think the fact that it was fairly quiet on the pandemic front with respect to non-GAAP measures, that could help in making sure that the pendulum David talked about doesn't start swinging the other way. If there would've been a rush to make a lot of adjustments, then the SEC Staff would've objected to a lot of measures. That would've changed the overall environment.

Lynn: Your experience sounds very consistent with what I saw, and it's a reflection of just how unusual the circumstances are that we're facing that the non-GAAP measures didn't proliferate because so many people often turn to those as a way to try to promote a rosier picture of their situation. Part of it, at least in the initial phase, and perhaps things will evolve now as we go through time, but in the initial phase, after the first quarter of 2020, everyone was in the same boat. It was an "all bets are off" scenario. That may have had something to do with the fact that people just decided that "Well, it's not really worth it to try to adjust out all of this because I don't really know what's going to happen, and it may not make any difference in terms of how investors are going to evaluate it."

It will be interesting to see what happens as we approach more towards the end of the year, and people are looking at that. Another factor that could possibly contribute to why there wasn't a lot of changes is the fact that people either withdrew or suspended their guidance. In terms of the forward projections that are often non-GAAP measures that we see companies present, they just got taken off the table entirely, so trying to explain or adjust or make comparability changes there wasn't as necessary because of that dynamic.

Kronforst: That's a good point, David. I think adjustments that were normally acceptable that are related to the pandemic, such as impairments or restructuring are still fine. It's not the case that because those are driven by the pandemic, those are somehow questionable at this point. That's not the case; those adjustments are still being made, and they will continue to be made.

Nallengara: We are seeing, on the debts, on the bank lending, and on the bond side, we are seeing adjusted EBITDA calculations that are starting to back out some reflection of the impact of COVID. I'm interested to see how that will impact companies that are participating in those markets. These are not your investment grade issuers, but the tier below, how to the extent that they're reflecting those non-GAAP disclosures that are intended to mimic compliance covenants, how they will go about approaching that and whether we'll see some reaction from the Staff.

In the past, the Staff has accepted a presentation of adjusted EBITDA, for example, that is consistent with your debt covenant, but I'm wondering how that will get navigated through the Staff comment process.

Kronforst: Lona, you are right, there is guidance that says if it is a debt covenant, it would have to be a liquidity measure, and then it would have to be disclosed in that section of the MD&A. They will restrict its use and make sure it's not presented as a general performance measure. Should we move onto what the Staff has been commenting on with respect to non-GAAP?

Issues of Frequent Staff Comment

Kronforst: The Staff has continued to issue non-GAAP comments over the past year. This is one of the most common area of comment for the Staff. It's usually in the top three. It does sometimes get knocked down by new accounting standards or unprecedented events perhaps, but for the most part, it's always at or near the top. One of the reasons is because of the concept of "individually tailored accounting principles," which is in the guidance but not defined. The concept has been around since 2016 and it was originally used in a situation where a company would recognize revenue over a period of time, but the company would bill up-front and they would do non-GAAP results as if the revenue was also recognized up front. That was the original objection, that led to this concept of individually tailored accounting principles.

What that means generally is that anytime recognition or measurement is changed in a non-GAAP measure then the Staff is likely to challenge that and ask why it is not an individually tailored accounting principle. As of now, there are certain things that are untouchable, so to speak. Revenue, for the most part, cannot be touched. Also, if there is an equity investee, the amounts for that equity investee will be in one line item. A presentation cannot be provided that expands that out into the rest of the line items, almost looking like a proportionate consolidation. That's another individually tailored accounting principle.

There have been some challenges by the Staff on companies selling a part of their business that did not qualify as a discontinued operation, which would allow retrospective adjustment of the financial statements that would show all the periods without that business. Companies have gotten some questions when they have adjusted disposals out in periods when they did not get that retroactive application under GAAP.

The big one right now is new accounting standards, and they're just not going to tolerate the unwinding of those. Now, there are some disclosures that are made in connection with the FASB standards themselves, but a company cannot unwind the standard. There were news stories about some companies that did get some comments about the New Credit Impairment Standard, but it's not just related to credit impairment. I would say anytime there's a new accounting standard, think very, very carefully as to whether you're going to make a non-GAAP adjustment related to that at all. The Staff have spoken about it numerous times and that's the one item that I would say is definitely on their radar and one to watch out for.

Lynn: The individually tailored accounting principle concept has really been the focus of a lot of the Staff's comment since 2016. I find it to be somewhat challenging, maybe because I'm not an accountant, to understand the contours of it. I definitely have read all of the guidance that the Staff has put out and seen the different variations of it, but I always feel a little like it's a "we know it when we see it" kind of a situation on the part of the Staff. I'm always afraid of that "gotcha" element of it. Mark, am I wrong in that perception, or is there something I can put my hands around whenever a client says, "Well isn't that every non-GAAP financial measure because I'm adjusting it for something I don't like about GAAP?" That's what I always struggle with.

Nallengara: Right, aren't all non-GAAP adjustments individually tailored accounting principles?

Kronforst: I can address that partially, but probably in an unsatisfactory manner. You are correct that every non-GAAP measure is a form of individually tailored accounting principle, because even something like EBITDA, which is mentioned in the original rules, is an accounting principle where you do not have to depreciate anything, for example, or record any taxes. That is definitely a tailored accounting principle if you take the definition to its extreme.

What I'm talking about here is more when you're taking a principle, like I mentioned, with revenue, and you're changing it. So you're not completely excluding it, but you're taking it and you're choosing another recognition model to use, meaning GAAP would say "over time" and you say, "No, I'd like that up front, and then, I'll do results from that." That's what it is. It's a change.

Now to your point, Dave, about what you can do to get your hands around it and what's the framework, I don't really have any good recommendations for you. Perhaps the Staff will come up with the framework, but my sense is that part of the goal here was to keep this a fluid because they just didn't know what might happen and what creative new measures might be used. And the more they provide a clear framework, the less ability they might have to pivot when things change. I hold out hope for some more clarity on a framework, but I certainly understand if that doesn't come. And so really, at this point, it's just something where you have to put your heads together with an accountant and work through it.

Lynn: Fair enough. I'll turn it over to Lona to talk about disclosure controls and procedures.

Fine-Tuning Disclosure Controls & Procedures

Nallengara: Thanks, Dave. I think that everyone knows that Section 302 Certification for Disclosure Controls and Procedures necessarily applies to your 10-K and 10-Q, but the Commission has said in the release that it applies to ensure that information that you include in a current report is timely and complete.

The same questions that you have to ask with respect to non-GAAP measures still apply to key performance indicators. You have to make sure that, as part of your disclosure controls and procedures process, you're asking questions. Is the non-GAAP measure or the key performance indicator, are you following the rules? Are you providing the appropriate disclosures related to that measure? Is it not just technical compliance, but are you also clear and transparent about the measure you're using, and why you have chosen the measure, and how you're describing it.

The second thing you should consider is whether you have a methodology to ensure that you are consistent in the way you're using and the way you're describing your non-GAAP measures and your key performance indicators. You shouldn't be vacillating in your practices from period to period. And if you do, you should have a reason for it and you should be able to explain why you're doing it. You have to have a mechanism to ensure that you're getting the correct information. There has to be accuracy in the measures you are using, how they're calculated, and the inputs that go into it.

There should be proper oversight over the measure. It's not simply just the financial reporting. Legal should be involved and there should be some elevation. Management, from a senior level, should understand the measures that are being used, and be able to validate that they are those measures that management uses to monitor and evaluate the performance of the business.

The audit committee should be involved. They shouldn't be involved in the calculation of the measure, but they should understand what measures are being used and why those measures are being usd to monitor and evaluate performance of the company. That should cover it for just a review of disclosure controls and procedures.

What To Do Now

Lynn: Great. Thanks, Lona. The inevitable question after going through all of our topics is what do I do now with my non-GAAP financial measures and my key performance indicators and other operating metrics? I'll offer a few thoughts on that. First off, I am wary and would advise people to be wary of the individually tailored accounting principles concept. It's a tough concept to get your head around, outside of the specific examples that we've seen, the revenue example and tax and some of the other things that Mark mentioned. The Staff is saying these measures are per se misleading, and that's why they can't be included in the documents. You really don't want to be in a situation where the Staff comes back and concludes the comment process by saying that what you have is, in fact, an individually tailored accounting principle. That is something definitely to be avoided.

Particularly in the situation where you have a new non-GAAP measure being considered, it really should be evaluated through the prism of this individually tailored accounting principle framework, so that you can say definitively, at least without having the benefit of the Staff weighing in, is this something that has a risk associated with it? So, my checklist of things to do when I come across new non-GAAP financial measures, is just to have that conversation, unless it's something that's completely obvious and wouldn't trigger the ITAP principle.

The second thing I'd say to do is to not only be concerned about the Staff coming after you for non-GAAP financial measures or issues with your key operating metrics, but also to worry about plaintiffs' lawyers that are out there lurking around. In the last year and a half or two years, I've seen several instances of plaintiffs' lawyers coming forward with demand letters that highlight some technical compliance problem with non-GAAP financial measures. Certainly now, with the framework the SEC articulated in the January 2020 release, potentially we could see the same claims with respect to key performance indicators.

What they're trying to do is say, "we highlighted this disclosure problem for you, and now please pay us to go away so we won't file a lawsuit." These are very annoying to have come along when you're a company and advisors to the company. People want to avoid that sort of thing being pointed out in litigation and so it's just another incentive to be very attentive to all of the requirements in the non-GAAP financial measure rules and the new standards that we have for key performance indicators. I would definitely encourage people to double check their work just so the plaintiffs' lawyers don't get an advantage.

Nallengara: Dave, on the plaintiffs' lawyer comment, just for a moment, I don't know if surprisingly, but they're not incorrect in the mistake they're pointing out. You are certainly right, they're very minor. But that small gap can result in, not significant payouts, but it does take time and attention and money to resolve. It reminds us of the importance of the controls you have over the non-GAAP measures used and the importance of it, not just as a focus in your standard '34 Act Reporting, but in press releases and whatever you're doing. When you're talking about non-GAAP measures and making sure that you're complying with the requirements, that it's not simply legal and financial reporting, but investor relations is also part of the mix of understanding what a non-GAAP measure is, and what are the appropriate disclosures.

This depends on the size of your company, but that could mean a non-GAAP and key performance indicator policy, where you describe the measures you use and the methodology you use to calculate it and the adjustments you make and the process by which you engage to make changes to that, or it can be something much less formal. Having a process around it and the right stakeholders within the company involved can protect you against that kind of foot fault that can lead to an unfortunate circumstance.

Lynn: That's an excellent point, in that the plaintiffs' lawyers clearly know what they're doing when they're raising these issues. They clearly understand the rules and the Staff's interpretations, and have read comment letters and know exactly the issues that they are addressing. They shouldn't be ignored.

On the topic of the key performance indicators and operating metrics, to a point I had mentioned earlier, I would definitely sit down with the January 2020 release, and look at what is disclosed in the earnings release and look at the types of metrics that are included there, look at investor day presentations – review all earnings communications and investor communications – because that's something the Staff will always look at in their review process, and compare it to what I'm saying in my MD&A.

It doesn't necessarily mean that those key performance indicators or operating metrics that I have in the investor communications must go into the MD&A, because maybe I have a good story there that the disclosure adequately explains the trends or the subject of those operating metrics, or for some other reason the information communicated there is not material. But I would be very thoughtful about what type of information my MD&A has relative to my investor communications, because after the January 2020 release, I would suspect it's something the Staff may pay attention to going forward. It is an important step, and issuers are doing it, to make sure they're looking more closely at harmonizing their communications in that way.

To Lona's point on the disclosure controls, one thing that I've come across so many times when it comes to errors in earnings releases that relate to non-GAAP financial measures and probably to a lesser extent, operating metrics, is that they're computed outside of the GAAP financial statement framework. They live in somebody's spreadsheet and somebody always copies a formula wrong in the spreadsheet or doesn't update one of the cells and it ends up resulting in an earnings release that has incorrect numbers.

I can't emphasize enough how important it is to get a handle on those spreadsheet sources and impose the sort of controls that you have on every other item of information that's making up your disclosure. If you have done the exercise I was just talking about and say, "Okay, I need to have this key performance indicator now included in my MD&A," I would redouble my efforts around how that key performance indicator gets calculated, so that I can make sure it's in a sufficient, controlled environment and so that I have reasonable assurance that number's going to be correct when it shows up in my MD&A.

Then the last point I'll make is, be prepared for that pendulum swing. We're in the presidential election year this year, and that means that there are changes to the Commission. There will be change to the SEC Staff. History has taught us that when there are those kind of changes, you sometimes see different priorities. This might be an area that, when the next crop of folks arrive, the Commission will look to and revisit, or it may be one that they're not as interested in. It's always good to be prepared. Things could change rapidly, no matter what the outcome of the election, just because new people become involved.

Dunshee: Good point. Thank you, Mark, Lona, and Dave for sharing your insights today. That was truly valuable. Thanks to everyone who joined us. The audio archive for this program will be available shortly, and then we will post a transcript of the program in a few weeks. Have a great day.