MAYER • BROWN

Best Practices for Public Companies

August 1, 2018

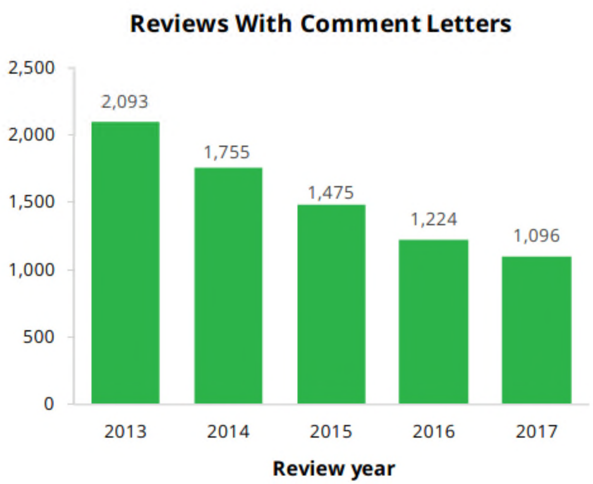
Agenda

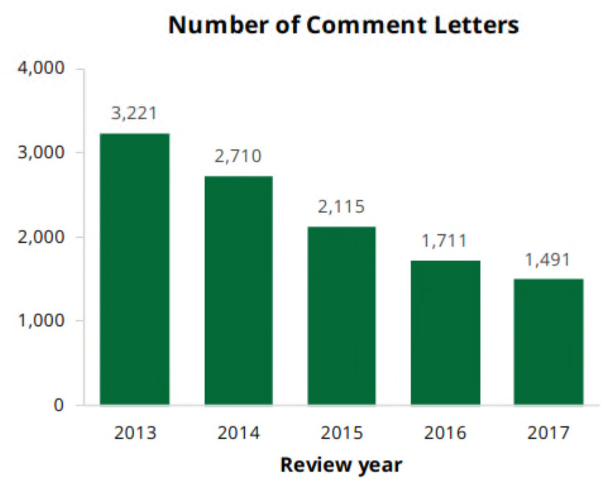
- During today's session we will focus on areas that public company SEC reporting staff, boards and audit committees should consider:
  - Overall trends in SEC comment letters and risk factor disclosures
  - Non-GAAP financial measures
  - Cyber breach risks and assessments relating to the impact of known breaches and disclosures
  - Disclosures of perks
  - Implementation of new accounting standards

COMMENT LETTER TRENDS

Overall Trends

- The charts below provide some indication of overall trends relating to SEC staff reviews and comments issued:





Source: Deloitte LLP

MAYER • BROWN

Areas of SEC Comment

- In recent years, as evidenced by the charts, the number of SEC comment letters issued to SEC-reporting companies has declined
  - The number of reviews with comment letters has declined
  - Roughly 51% of issuers are reviewed annually but the focus has changed to a risk-based approach with attention concentrated on larger issuers
  - The number of comment letters issued has also declined
- In addition to a continuing focus on the use of non-GAAP measures, SEC comment letters have concentrated on
  - **Management's Discussion and Analysis:** The Staff continues to emphasize the need for SEC-reporting companies to provide insight for investors regarding changes in line items, the reason for the changes, known trends, material uncertainties, loss contingencies

Areas of SEC Comment *(cont'd)*

- *Sample SEC Comments*

  - Please discuss in greater detail why the underlying expense elements increased, addressing any known trends, risks, or uncertainties that impacted the change in the relationship between costs and revenues, or income from operations, as a result of the acquisitions or otherwise... Please refer to Commission Release 33-8350 and Item 303(a)(3)(ii) of Regulation S-K.
  - ...Also provide a discussion of any known trends, demands or uncertainties relating to your liquidity as a result of your policies of indefinitely reinvesting earnings outside the United States. Refer to Item 303(a)(1) of Regulation S-K.
  - In future filings, please expand this section to discuss any known material trends, events or uncertainties that have had or are reasonably expected to have a material impact on your liquidity, revenues or income from continuing operations... Please discuss whether you expect these trends to continue and the short and long-term actions that you are taking to address any such trends. In this regard, your discussion should address your past and future financial condition and results of operation, with particular emphasis on the prospects for the future. See Item 303(a) of Regulation S-K and SEC Release No. 33-8350. Please tell us what this disclosure will look like.
  - In future filings, please provide a comprehensive discussion and analysis of any known trends or uncertainties that you reasonably expect will have a materially favorable or unfavorable impact on your operating results and financial condition as well as any specific material risk factors disclosure. see Item 303(a)(3)(ii) of Regulation S-K

Other Areas of SEC Comment *(cont'd)*

  - The SEC Staff has begun to comment on "repetition" and "duplicative" disclosures, especially as it relates to Critical Accounting Policies
  - On quantification, the SEC Staff has urged registrants to quantify and explain fully the impact of factors that cause fluctuations in line items from period to period

Sample SEC Comment

- In future filings, when individual line items disclosed in your statements of operations materially fluctuate in comparison to the prior period, please quantify and disclose the nature of each item that caused a material change. For example, quantify each material factor such as increases or decreases in net sales from business acquisitions or organic growth that affected your overall net sales. For factors such as organic growth, discuss the underlying material causes for the increase in growth. Refer to Item 303 and the related instructions in Regulation S-K as well as SEC Interpretive Release No. 34-48960.

  - The SEC Staff has commented on whether the registrant is able to make a reasonable estimate of the amount or range of possible losses

- **Segment reporting:** the SEC Staff has commented on the identification of segments, the analysis underlying the SEC reporting company's characterization of its segments, more transparent and detailed disclosures by segment; however, at a recent program, SEC representatives noted segment reporting may no longer be a key area of focus for the Staff

Other Areas of SEC Comment *(cont'd)*

- **Taxes:** Tax policy, treatment of foreign earnings, repatriation of foreign earnings, and deferred tax assets
- **Internal Control over Financial Reporting:** Management's assessment of control deficiencies, remediation, disclosures relating to the impact of material weaknesses, restatements, and disclosures relating to ICFR following a restatement
- **Acquisitions:** The SEC Staff has focused on purchase price allocations, the inclusion of pro forma financial information, the presentation of pro formas, and pro forma adjustments
- In addition to commenting on financial presentation and related disclosures, the SEC Staff also has commented on:
  - Sales to or activities in countries that are subject to U.S. sanctions
  - Compliance matters related to the Foreign Corrupt Practices Act
  - Cybersecurity and cyber breaches
  - The impact of Brexit
- **"New GAAP":** SEC Staff representatives noted at a recent conference that attention will shift to revenue recognition, lease accounting, and related topics

NON-GAAP FINANCIAL MEASURES

Background

- In 2015, SEC Chair Mary Jo White suggested that issuers consider:
  - Why are you using a non-GAAP measure, and how is it useful to investors?
  - Are you giving non-GAAP measures no greater prominence, as required?
  - Are your explanations of how you're using non-GAAP measures accurate and complete, and without boilerplate?
  - Are there appropriate controls over the calculation of non-GAAP measures?
- In March 2016, Chair White said that the SEC might need to use its rulemaking authority to address non-GAAP measures

Background *(cont'd)*

- The Staff stepped up its review of non-GAAP measures through 2017
  - The Staff has said that it will focus on companies that use non-GAAP measures that assume recognition of revenue earlier than allowed under GAAP
  - The Staff will also challenge companies reporting adjusted earnings on a per share basis when they appear to look too much like measures of cash flow
  - It is also expected that the Staff will comment when companies "cherry-pick" non-GAAP measures
- The Staff updated the non-GAAP measures Compliance and Disclosure Interpretations (C&DIs) in May 2016 to reflect a number of new and revised interpretive positions

What Is a Non-GAAP Financial Measure?

- A numerical measure of historical or future performance, financial position, or cash flows that either:
  - Excludes (or adjusts) amounts included in the most comparable GAAP measure; or
  - Includes (or adjusts) amounts excluded from the most comparable GAAP measure
- The following are <u>not</u> non-GAAP financial measures:
  - Operating and other statistical measures
  - Ratios or statistical measures that exclusively use GAAP financial measures; and/or
  - Operating or other measures that are not non-GAAP financial measures

Item 10 of Regulation S-K

- Applies only to non-GAAP financial measures in SEC-filed documents
- Affirmative requirements:
  - Most directly comparable GAAP measure must receive equal or greater prominence
  - Must provide a quantitative reconciliation to GAAP — if prospective, required unless unreasonable effort
    - If non-GAAP financial measure is derived from or based on a measure calculated in accordance with U.S. GAAP, the reconciliation must be to U.S. GAAP
    - If reconciliation to prospective amounts would require unreasonable effort, instead describe the anticipated differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure qualitatively
  - Disclose how management uses the measure and why management believes the measure provides useful information to investors

Item 10 of Regulation S-K *(cont'd)*

- Negative requirements
  - Cannot exclude a cash charge from a liquidity measure — except EBIT and EBITDA
  - Cannot exclude items identified as nonrecurring, infrequent, or unusual if likely to recur — two-year window (forward and backward)
  - Cannot include on the face of or in footnotes to financial statements
  - Cannot have a title that is the same as or similar to GAAP measures
- Item 10(e), however, permits foreign private issuers to use an otherwise prohibited non-GAAP financial measure if the measure:
  - Relates to home country GAAP or IFRS;
  - Is required or "expressly permitted" by the applicable standard-setter; and
  - Is included in the annual report used in its home jurisdiction for distribution to securityholders

Regulation G

- Regulation G generally applies to all public disclosures that contain non-GAAP financial measures, including press releases, investor presentations, and conference calls, whether such disclosure is made in print, orally, telephonically, by webcast, or by broadcast
- In connection with the disclosure of a non-GAAP financial measure, Regulation G requires the presentation of:
  - The most directly comparable financial measure calculated and presented in accordance with GAAP; and
  - A reconciliation of the non-GAAP financial measure to the most directly comparable GAAP measure
- For public disclosure made orally, telephonically, or by webcast, broadcast, or similar means, an issuer may post the reconciliation simultaneously to its website and announce the location to investors of the presentation that includes the non-GAAP financial measure

Inherently Misleading Non-GAAP Measures

- Question 100.01 — A performance measure that excludes normal, recurring, cash operating expenses necessary to operate the business
- Question 100.02 — A non-GAAP measure that adjusts a particular charge or gain in the current period and for which other similar charges or gains were not also adjusted in prior periods, unless the change between periods is disclosed and the reasons for it explained
- Question 100.03 — A non-GAAP measure that is adjusted only for nonrecurring charges when there were nonrecurring gains that occurred during the same period
- Question 100.04 — A non-GAAP revenue measure that backs out the effect of GAAP revenue recognition and measurement principles applicable to a company’s business

Equal or Greater Prominence

- Question 102.10 — Examples of non-GAAP presentations that fail to give "equal or greater prominence" to the comparable GAAP measure:
  - Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures
  - Presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure
  - A non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption)
  - 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
  - Providing tabular disclosure of non-GAAP financial measures without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures, or including the comparable GAAP measures in the same table

Equal or Greater Prominence *(cont'd)*

– Providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence

Sample SEC Comments

- We note your disclosure of free cash flow. Please note that when a non-GAAP liquidity measure is presented the prominent presentation of amounts for the three major categories of the statement of cash flows should be presented with the non-GAAP liquidity measure. Please revise your disclosure in future filings to comply with Item 10(e)(1)(i) of Regulation S-K and the updated Compliance and Disclosure Interpretations issued on May 17, 2016. Please note this comment also applies to earnings releases filed on Form 8-K.
- Please revise your reconciliation in future filings to begin with net income, the most directly comparable measure, ensuring that the non-GAAP measure does not receive undue prominence.
- Your non-GAAP measures of adjusted EBITDA and net adjusted EBITDA margin precede the GAAP measure. Please ensure that your non-GAAP measures do not precede the most directly comparable GAAP measures in your next earnings release.

Forward-Looking Non-GAAP Information

- Question 102.10 — More prominence is given to a non-GAAP measure when an issuer excludes a quantitative reconciliation with respect to a forward-looking non-GAAP measure in reliance on the "unreasonable efforts" exception without disclosing that fact and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence

Sample SEC Comments

- We note that you omit the most directly comparable GAAP measures and quantitative reconciliation with respect to your forward-looking non-GAAP guidance, but you do not provide the disclosures required when the reconciliation is omitted. In your next earnings release, please follow the guidance in Item 10(e)(1)(i)(A) of Regulation S-K and Question 102.10 of the updated Non-GAAP Compliance and Disclosure Interpretations issued on May 17, 2016.
- We note you omit a quantitative reconciliation with respect to your forward looking non-GAAP guidance, adjusted diluted EPS. You state it is not practicable to provide reconciliation to a forward-looking reported diluted EPS, the most comparable GAAP measure, due to unknown variables and uncertainty related to future results. Please identify the information that is unavailable and its probable significance in a location of equal or greater prominence. Refer to the next to last bullet in Question 102.10 of the updated Compliance and Disclosure Interpretations issued on May 17, 2016 in regard to Non-GAAP Financial Measures (C&DI).

Tax-Related Effects

- Question 102.11 — Disclosure of tax effects of non-GAAP measures:
  - If a liquidity measure includes income taxes, it "might be acceptable" to adjust GAAP taxes to show taxes paid in cash. If a measure is a performance measure, the disclosure should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability
  - Adjustments to arrive at a non-GAAP measure should not be presented "net of tax." Rather, income taxes should be shown as a separate adjustment and clearly explained

Sample SEC Comments

- Please expand your disclosure here, and in earnings releases filed on Form 8-K, to more clearly explain how the tax effects of the non-GAAP adjustments are calculated. Refer to Question 102.11 of the updated Non-GAAP Financial Measures Compliance and Disclosure Interpretations issued on May 17, 2016.
- Please clarify whether you made the determination that the company is not and is not expected to be a taxpayer for the foreseeable future in certain jurisdictions, such as the U.S., based on your GAAP or non-GAAP net income (loss). In this regard, we note that you have reported cumulative non-GAAP net income of approximately $784 million since fiscal 2014. Pursuant to Question 102.11 of the non-GAAP C&DIs, you should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. Please explain further your non-GAAP tax adjustments or revise as necessary.

Liquidity vs. Performance Measures; Per Share Presentation

- Question 102.05 — With regard to the prohibition on presenting non-GAAP liquidity measures on a per share basis, the Staff notes that the prohibition applies based on whether a non-GAAP measure *can be used as a liquidity measure, even if management presents it solely as a performance measure*
- When analyzing these questions, “the Staff will focus on the substance of the non-GAAP measure and not management’s characterization of the measure”
- In Questions 102.08 and 103.03 of the C&DIs, the Staff now emphasizes that free cash flow, EBIT, and EBITDA must not be presented on a per share basis

Business Combinations

- In October 2017, the Staff issued two additional C&DIs clarifying that:
  - Financial measures provided to a financial advisor, including financial measures included in forecasts used in connection with a business combination transaction, are excluded from the definition of non-GAAP financial measures, and not subject to Item 10(e) of Regulation S-K and Regulation G, if and to the extent: (1) the financial measures are included in forecasts provided to the financial advisor for the purpose of rendering an opinion that is materially related to the business combination transaction; and (2) the forecasts are being disclosed in order to comply with Item 1015 of Regulation M-A or requirements under state or foreign law, including case law, regarding disclosure of the financial advisor's analyses or substantive work
  - The exemption from Item 10(e) of Regulation S-K and Regulation G for non-GAAP financial measures disclosed in communications relating to a business combination transaction does not extend to the same non-GAAP financial measures disclosed in registration statements, proxy statements, and tender offer statements

Business Combinations *(cont'd)*

- In April 2018, the Staff issued two more C&DIs (C&DIs 101.02 and 101.03) that clarify that:
  - A registrant can rely on the exemption discussed on the immediately prior slide if the same forecasts provided to its financial advisor are provided to its board of directors or a committee thereof, and
  - Financial measures in forecasts provided by the registrant to bidders in business combinations are excluded from the definition of a non-GAAP measure, if forecasts are material and disclosed in compliance with securities law requirements

Other Frequent Non-GAAP Staff Comments

- Reasons for non-GAAP measures
  - Additional details about usefulness and uses of non-GAAP measures
  - No boilerplate
- Non-GAAP financial measure titles
  - Titles may not accurately reflect amounts reported
  - Confusingly similar (or the same as) GAAP measures or common accepted non-GAAP measures (e.g., free cash flow, EBIT, EBITDA)
- Reconciliation to most directly comparable GAAP measure
  - Reconciling to wrong GAAP measure
- Characterization of adjustments
  - Whether characterization of adjustments as “nonrecurring,” “unusual” or “infrequent” is consistent with definitions of those terms in Item 10(e)(i)(ii)(B)

Moving Forward with Non-GAAP Measures

- Transitioning away from non-GAAP measures?
- If not:
  - Ensure presentation of non-GAAP measures is not misleading
  - Ensure presentation of non-GAAP measures provides equal or greater prominence for GAAP measures, including in forward-looking disclosures
  - Ensure no per share presentations of liquidity measures are presented
  - Ensure income tax effects on non-GAAP measures are appropriately adjusted
- Involve the Audit Committee in discussions relating to the use of non-GAAP measures that management believes are important to the company's planning, as well as to research analysts, the investment community, and stockholders
  - Document which non-GAAP measures are used and why these measures are used
  - Document the calculation of these measures

CYBERSECURITY

Cybersecurity Guidance

- The Staff published guidance on cybersecurity in 2011, CF Disclosure Guidance: Topic No. 2, Cybersecurity
- In February 2018, the Commission published an interpretive release
  - The release reaffirms the prior guidance
  - A registrant should consider disclosures in:
    - Risk Factors
    - Management's Discussion and Analysis (MD&A)
    - Business (regulatory and legal proceedings)
    - Financial statements
- Registrants should consider whether cybersecurity risks are material
  - Materiality of risks may depend on company's industry sector and business model, the harm that a breach may have on Company's reputation, effect on financial performance, risk of regulatory investigations, litigation risk, customer and vendor relationships, and reputational risk

Cybersecurity Guidance *(cont'd)*

  - How does management and the board manage the risks?
- Tailored disclosures, not generic disclosures
  - Disclosures should reference actual breaches to the extent these have occurred

Sample SEC Comment

We note your disclosure that you continue to face a host of cyber threats; your disclosure that cyber-crimes and denial of service attacks have increased; and your identification of cyber-attacks as a key risk. Please clarify whether you have knowledge of the occurrence of any such attacks in the past. If attacks have occurred, and were material either individually or in the aggregate, revise to discuss the related costs and consequences. Also, describe the particular aspects of your business and operations that give rise to material cybersecurity risks and the potential costs and other consequences of such risks to those businesses and operations. For additional guidance, please refer to CF Disclosure Guidance Topic No. 2 on Cybersecurity.

Cybersecurity Guidance *(cont'd)*

  - When does a duty to update or correct arise?
  - What are the triggers for a disclosure?
    - Are there specific regulations requiring disclosure of a breach even while a company is still investigating and assessing?
- MD&A disclosures should address financial consequences such as:
  - Loss of customer relationships
  - Costs related to remedial efforts
  - Costs associated with investigations
  - Loss contingencies

Sample SEC Comment

> With respect to the cyber-security incident and related assessments and litigation, please tell us your consideration of the requirement in ASC 450-20-50-4.b. to disclose an estimate of the possible loss or range of loss or to disclose that such an estimate cannot be made.

Cybersecurity Guidance *(cont'd)*

- The SEC has focused on enforcement in connection with cybersecurity
  - Failure to adequately disclose a cybersecurity breach
    - Risk factors that were generic and spoke to future or possible risks were misleading given actual breach had occurred
    - MD&A discussion omitted disclosures relating to consequences of breach
    - Failure of disclosure controls and procedures
  - Insider trading – trading while in possession of material non-public information regarding a cybersecurity incident
    - Boards and audit committees should consider disclosure controls and procedures, duties to disclose, and the application of Regulation FD

PERK DISCLOSURES

Perk Disclosures

- The SEC has recently announced two enforcement actions relating to disclosure failures for perquisites (“perks”)
  - Business purpose test for taxes versus the SEC’s rules for executive compensation disclosures
  - SEC guidance
    - An item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive’s duties
- In a second case brought by the SEC that involved undisclosed and improper loans to an executive officer, the SEC also found proxy disclosure violations
  - Failure to disclose perks, personal expenses and other items of value paid to an executive without disclosing such items as compensation in the company’s proxy statement

NEW ACCOUNTING STANDARDS

Implementation of New Accounting Standards

- CECL, or Current Expected Credit Loss, standard
  - Changes how registrants estimate credit losses
  - Registrants must transition from an “incurred loss” model to estimating the amount of credit losses expected over the life of a receivable
    - Expected to result in a more timely recognition of credit losses
  - Will also require new disclosures, including disclosure of credit quality indicators
  - Companies can early adopt for fiscal years beginning after December 15, 2018
- Lease accounting standard
  - A new definition of a lease – a contract is or contains a lease if the contract conveys the right to control the use of identified property, plant or equipment for a period of time in exchange for consideration
  - Updates lease classification – either an operating lease or a financing
  - Standard will generally be effective on January 1, 2019

FREE WRITINGS +

Perspectives

The **Free Writings & Perspectives**, or FW&Ps, blog provides news and views on securities regulation and capital formation. The blog provides up to the minute information regarding securities law developments, particularly those related to capital formation. FW&Ps also offers commentary regarding developments affecting private placements, mezzanine or "late stage" private placements, PIPE transactions, IPOs and the IPO market, new financial products and any other securities related topics that pique our and our readers' interest.

To subscribe to FW&Ps, please visit: www.freewritings.law.