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The SEC's Continued Focus on Non-GAAP Financial Metrics

A discussion of the publicly available information concerning the SEC's enforcement efforts against the manipulative use of non-GAAP financial metrics, and how the SEC might address these metrics going forward in an anti-fraud context.

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Accounting fraud and related issues will always be a priority for the U.S. Securities and Exchange Commission (SEC or the Commission). Though the SEC has recently emphasized its focus on issues such as protecting retail investors and addressing cyber risks, it continues to bring new accounting fraud enforcement actions each year. In that context, one issue that has become even more important to the SEC is how companies treat and report financial metrics prepared outside of United States Generally Accepted Accounting Principles (GAAP), more commonly known as "non-GAAP" metrics.

As defined by SEC regulations, a non-GAAP financial measure is a numerical metric of a company's historical or future financial performance, financial position, or cash flows that includes or excludes amounts from the most directly comparable GAAP measure. 17 C.F.R. §244.101(a)(1). Commonly used non-GAAP measures include earnings before interest and tax (EBIT), earnings before interest, taxes, depreciation, and amortization (EBITDA), and adjusted revenues. While in 1996, approximately 60% of S&P 500 companies reported at least one non-GAAP earnings-per-share figure, today, that number has increased to 97%. Jessica McKeon, Audit Analytics, **Long-Term Trends in Non-GAAP Disclosures: A Three-Year Overview** (Oct. 10, 2018).

This article explores the publicly available information concerning the SEC's enforcement efforts against the manipulative use of non-GAAP financial metrics, and

**U.S. Securities and Exchange Commission building in Washington, D.C.
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how the SEC might address these metrics going forward in an anti-fraud context. While recent SEC activity in this area has focused on the form of non-GAAP metrics disclosure, a renewed area of enforcement is the application of anti-fraud rules to statements made about non-GAAP figures.

Non-GAAP Regulations and Guidance

Although non-GAAP measures can be helpful to investors in any number of ways, the SEC has grown concerned about the potential for abuse of these metrics. In 2003, as part of the agency's implementation of the Sarbanes-Oxley Act, the SEC adopted Regulation G and Item 10(e) of Regulation S-K to address those concerns. Regulation G applies to all public disclosures by reporting companies that contain non-GAAP measures. 17 C.F.R. §244.100(a). Item 10(e) of Regulation S-K, in contrast, applies to non-GAAP financial measures included in documents filed with (but not furnished to) the SEC. Id. §229.10(e)(1).

These regulations lay out requirements for non-GAAP metrics to ensure they are useful to investors and not used to obscure information from more traditional metrics. For example, both regulations require that any non-GAAP financial measures be accompanied by a presentation of the most directly comparable GAAP financial measure and a reconciliation of the differences between such measures. Id. §§244.100(a), 229.10(e)(1)(i)(A)-(B). In SEC filings, this GAAP financial measure must be presented with "equal or greater prominence" than the non-GAAP measure. Id. §229.10(e)(1)(i)(A). Further, Item 10(e) of Regulation S-K requires disclosure of the reasons why the company's management believes that such non-GAAP financial measures provide useful information to investors and any additional purpose for providing those measures. Id. §229.10(e)(1)(i)(C)-(D). Rule 100(b) of Regulation G also expressly prohibits the use of a non-GAAP financial measure that "contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure … not misleading." Id. §244.100(b).

SEC Staff has promulgated various additional interpretative guidance as to their view on compliance with these regulations. The Staff has issued Compliance & Disclosure Interpretations (C&DIs) that focus particularly on the issue of what prominence must be attached to non-GAAP measures relative to comparable GAAP measures and how non-GAAP measures can be misleading. SEC, **Non-GAAP Financial Measures CD&Is** (last updated April 4, 2018). Most recently, on January 30, 2020, the Commission issued guidance regarding the use of metrics in Management's Discussion and Analysis (MD&A), reminding companies to—among other things—consider the existing regulatory framework when using non-GAAP financial metrics. SEC, **Commission Guidance on MD&A of Financial Condition and Results of Operations**, No. 33-10751 (Jan. 30, 2020).

Scrutiny of Non-GAAP Financials

SEC scrutiny of non-GAAP financial measures is not new. The first civil enforcement action brought and settled by the Commission pursuant to Regulation G occurred in 2009 against SafeNet, Inc. Among other things, the Commission alleged that SafeNet represented to investors that its non-GAAP earnings results excluded certain non-recurring expenses, when, in fact, the company had misclassified and excluded a significant amount of recurring, operating expenses from its non-GAAP earnings in order to meet quarterly earnings per share targets. Press Release, SEC, **SEC Charges SafeNet Inc. and Two Former Senior Officers in Earnings Management and Options Backdating Schemes** (Nov. 12, 2009).

The SEC and its Staff, however, have signaled repeatedly over the past few years that they intend to apply closer scrutiny to the use of non-GAAP financial measures. In a December 2015 speech, then-SEC Chair Mary Jo White acknowledged the value of non-GAAP measures but emphasized that the topic "deserves close attention, both to make sure that our current rules are being followed and to ask whether they are sufficiently robust in light of current market practices." Chair White cautioned companies to carefully consider usefulness of non-GAAP measures to investors, as well as their accuracy and completeness. Mary Jo White, SEC, **Keynote**

Address at the AICPA National Conference (Dec. 9, 2015); *see also* Mary Jo White, SEC, **Keynote Address at International Corporate Governance Network Annual Conference** (June 27, 2016) (discussing non-GAAP metrics). This focus on non-GAAP financials has continued into the current administration. At a conference in December 2018, SEC Chair Jay Clayton emphasized the importance of consistency in reporting non-GAAP numbers. Ken Tysiac, J. Accountancy, **SEC Urges Consistency in Non-GAAP Reporting** (Dec. 10, 2018).

SEC Staff has matched these statements with action. The percentage of SEC comment letters referencing non-GAAP measures has increased sharply since 2015. Of these non-GAAP comment letters, the Staff's most common objection was that the company presented non-GAAP metrics with undue prominence. Nicole Hallas & Olga Usvyatsky, Audit Analytics, **Trends in SEC Non-GAAP Comment Letters 2016-2018** (Oct. 16, 2018).

Recent Enforcement Actions

Over the past few years, the Commission has filed several enforcement actions regarding the use of non-GAAP financial metrics, several of which have focused on the issue of prominence. In January 2017, advertising company MDC Partners agreed to settle charges that it misrepresented the amount it paid in personal perks to its CEO. Of relevance, the company also settled charges that it failed to afford equal or greater prominence to GAAP measures in earning statements and failed to reconcile its "organic revenue growth" non-GAAP metric to GAAP revenue. **MDC Partners, Inc.**, Securities Act Release No. 10283 (Jan. 18, 2017). Additionally, in December 2018, the SEC settled a case against ADT Inc., an alarm security company, for disclosing non-GAAP financial measures in two filed earnings releases without giving equal or greater prominence to comparable GAAP financial measures. **ADT Inc.**, Exchange Act Release No. 84956 (Dec. 26, 2018).

Prominence, however, is not the Commission's only focus: it has signaled that it will not hesitate to investigate potential fraud cases against companies when it believes non-GAAP metrics are being used in a misleading way. Most recently, in August 2019, the SEC and DOJ brought an enforcement action against Brixmor Properties Group, a publicly-traded real estate investment trust (REIT), for allegedly manipulating a key non-GAAP metric. Unlike in the MDC and ADT cases, the SEC in Brixmor focused solely on the fraudulent manipulation of non-GAAP metrics.

As is common with REITs, Brixmor highlighted a non-GAAP metric designed to show the performance of the properties on a year-over-year basis. One of Brixmor's key non-GAAP metrics, same property net operating income (SP NOI), represented the net income pool of properties owned by the REIT as of the end of both the current reporting period and the same reporting period in the prior year, and excluded net operating income attributable to properties that were acquired, constructed, or disposed between parties. The SEC alleged that Brixmor emphasized the importance of SP NOI and then engaged in a series of fraudulent techniques designed to ensure that its SP NOI showed consistent growth. Brixmor ultimately settled the charges for $7 million. **Brixmor Prop. Grp. Inc.**, Exchange Act Release No. 86538 (Aug. 1, 2019).

As the SEC's case against Brixmor demonstrates, the agency's playbook in cases involving non-GAAP metrics will not differ markedly from its usual playbook in building an accounting fraud case. For decades, the SEC has brought cases based on companies' alleged manipulation of metrics through various tactics to manage earnings or revenue. To the extent companies use the same tactics to smooth their numbers for non-GAAP purposes, it should come as no surprise that the SEC will respond similarly. While recent activity and commentary in this area has focused on the form of non-GAAP metrics disclosure, the SEC has also (and will likely continue) to bring antifraud actions when it believes that non-GAAP financial metrics highlighted by an issuer have been manipulated.