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Keep Your Eye On The Non-GAAP Ball

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A recent [enforcement action](#) by the SEC against ADT, Inc. shows that compliance with Non-GAAP financial measure regulations still needs some work and that the SEC is still closely watching the area. The SEC has been very focused on improving compliance in this area since at least 2015 when a flurry of public statements by SEC leadership emphasized that compliance was not what the SEC expected and that measures would be taken to improve the situation. Then in May 2016 the SEC released a new set of CD&Is intended to provide clearer guidance on a variety of Non-GAAP financial measure compliance issues. Around the same time, the SEC Enforcement Division sent a large number of comment letters inquiring about compliance with these regulations. Comment letters from the Corporation Finance Division on various types of filings also saw a sharp increase in comments relating to Non-GAAP financial measures.

There was good reason for this compliance initiative by the Commission, as the rules relating to Non-GAAP financial measures are complex and less than clear in many instances. Until this initiative, it was not uncommon for issuers to cut corners in this area because strict compliance required major changes from prior practice for many companies. There also was a pervasive perception that less than strict compliance was justified because nobody else was doing any better, and there were plenty of examples of blatant non-compliance to support this attitude.

The primary area of emphasis by the Commission in the CD&Is and in comment letters was the “equal or greater prominence” rule, which is intended to ensure that the comparable GAAP measure is at least as prominent as the Non-GAAP measure being presented. While the equal prominence rule has been in Regulation G since it was adopted in 2003, much greater specificity as to the implications of the term was provided in the 2016 CD&Is. The new guidance clarified that the Commission considered the following practices, among others, to give undue prominence to Non-GAAP measure:

- having a Non-GAAP measure proceed the comparable GAAP measure;
- including a Non-GAAP measure in a headline or a caption without the comparable GAAP measure appearing first, or emphasizing the Non-GAAP measure over the comparable GAAP measure in any manner, such as putting it in boldface or in a larger font; and
- describing a Non-GAAP measure with a superlative, such as “record performance,” or “exceptional,” without some descriptive characterization of the comparable GAAP measure.

The broad-based effort by the SEC to improve compliance with Non-GAAP financial measure regulations was generally thought to have been very successful, with many companies and their counsel gaining a much better appreciation for the complexity of the rules and establishing processes to insure compliance with them. In the last year, numerous SEC officials have publicly said they thought issuers were basically “getting it right” in the Non-GAAP area.

Despite this progress, the recent cease and desist order from the SEC against ADT, Inc. shows that the equal prominence rules can still be tricky, and that the SEC is willing to pursue enforcement proceedings in this area where appropriate. ADT is a very substantial business that completed a \$1.5 billion IPO in January 2018. Its first earnings release as a new public company in March 2018 and its next one in May 2018 both contained very comprehensive, thoughtful and effective disclosures regarding the company's usage of Non-GAAP financial measures. These disclosures included discussions of how each measure was defined, the rationale for and limitations on their usage, and full reconciliations to the comparable GAAP measure. But ADT stumbled with the headlines for each release, which contained multiple Non-GAAP financial measures with no disclosure of the comparable GAAP measure, thus clearly violating the equal prominence guidance in the CD&Is.

ADT is represented by a prominent Wall Street law firm with vast expertise in sophisticated securities matters and the quality of the disclosures that were included in the releases amply demonstrate that ADT's financial disclosure staff was fully versed in Non-GAAP financial measure regulations. So it seems apparent that this was just a case of a clear technical requirement somehow falling through the cracks. There are several important practical takeaways from this situation.

Careful review of materials containing Non-GAAP measures is still essential

Every earnings release, earnings call deck, or other document or oral communication that includes Non-GAAP financial measures must have close advance review of experts in Non-GAAP financial measure regulations. It is also essential that these experts be given adequate time to complete a careful review. Insertion of a new Non-GAAP measure the day of, or even just hours before, an earnings release should no longer be acceptable practice.

The SEC is still watching compliance in the Non-GAAP area

ADT's securities disclosures had just been scrubbed by the SEC in its IPO when the problematic press releases were issued. There does not appear to have been any other SEC inquiry or investigation where these violations may have been picked up. So it appears that this enforcement action resulted from a standalone review of ADT's earnings releases by the SEC Staff. This should not be surprising as the Commission has broadly publicized the fact that it regularly reviews a wide variety of public disclosures by issuers, including earnings releases, other press releases and earnings conference call transcripts. No doubt this case, the first enforcement action involving Non-GAAP financial measures in Chairman Clayton's tenure, presented a good

opportunity for the SEC to forcefully demonstrate to public companies that it is still closely watching this area.

The SEC is more interested in teaching a lesson than in exacting a pound of flesh

The penalties imposed on ADT in the matter were noteworthy for their mildness. ADT had only to agree to cease and desist from future violations of the disclosure regulations and pay a \$100,000 penalty. Given the quality of the Non-GAAP financial measure disclosures in the body of these earnings releases, it seems likely that ADT was able to make a strong showing that the omissions in the headlines were an unfortunate inadvertent oversight in what was an otherwise more than sufficient compliance program. Since its focus on this area began in 2016, the SEC has said many times that its goal is not to penalize issuers but rather to guide the market to voluntarily improve compliance, and the treatment of ADT in this case confirms this approach.