

Easing the burden

Foreign private issuers should remember best practices for complying with the SEC's non-GAAP rules as they prepare their earnings releases and SEC filings

While the US financial reporting community has been actively immersed in recent efforts by the staff of the US Securities and Exchange Commission (SEC) with respect to non-generally accepted accounting principles (GAAP) financial measures, much less attention has been paid to how foreign private issuers (FPIs) registered with the SEC need to comply with the SEC's non-GAAP rules. As such, there is a need to look at the SEC's non-GAAP rules, and how they apply to FPIs. It also provides timely practice points for FPIs to keep in mind as they prepare their earnings releases and SEC filings and notes work by other international regulators relating to non-GAAP measures.

SEC's basic non-GAAP framework

Prior to the Sarbanes-Oxley Act of 2002, the SEC did not have specific rules relating to the use of non-GAAP measures. Even so, the SEC sought to police misleading non-GAAP disclosures through bully-pulpit speeches by SEC officials and, ultimately, enforcement cases in particularly egregious cases brought under its broad anti-fraud authority.

Under section 401(b) of the Sarbanes-Oxley Act, Congress directed the SEC to adopt rules regulating what were then called pro forma financial measures, which are now widely referred to as non-GAAP financial measures. These rules were adopted in 2003 and create a three-tier framework that applies different requirements depending on where and how a particular non-GAAP measure is published: in an earnings release, in general corporate communications, or in an SEC filing. At the proposal stage for the non-GAAP rules, the SEC received many comments that FPIs should have some latitude in the presentation of non-GAAP measures. Although portions of the final non-GAAP rules apply to them in full, FPIs will find useful accommodations that are designed to ease compliance burdens, especially for issuers that are listed in two countries and that report under international financial reporting standards (IFRS).

1 MINUTE READ

SEC-registered foreign private issuers are subject to many of the same rules as US issuers relating to their disclosure of non-GAAP financial measures.

The SEC has provided a number of helpful accommodations for some foreign private issuers that give additional flexibility in crafting these disclosures. SEC staff comments on issuers' disclosures of non-GAAP financial measures are similar whether the issuer is a US or foreign issuer. SEC-registered foreign private issuers should be prepared to support their non-GAAP disclosures when the SEC staff raises comments. International regulators are also interested in non-GAAP disclosures and foreign private issuers should expect continued interest in these disclosures.

Earnings releases

US companies almost always publish a press release disclosing recent financial results shortly after the end of each fiscal quarter. Although SEC rules do not require these earnings announcements, the SEC does require that they be filed on a form 8-K if a company does indeed publish them. When an earnings release contains non-GAAP financial measures (as many do), the SEC also requires that the non-GAAP disclosures comply with portions of its non-GAAP rules.

regardless of where or how they are made. Regulation G could apply to websites, investor presentations, interviews with senior officers and social media postings.

Although regulation G applies to SEC-registered FPIs, the SEC crafted a limited exemption for FPIs that are listed on a non-US stock exchange, release information outside the US, and whose non-GAAP financial measures are not derived from US GAAP. When these conditions are satisfied, the exemption will still be available even if: (a) the written non-GAAP information is released

GAAP measures, such as non-GAAP liquidity measures (other than Ebit and Ebitda);

- prohibits non-GAAP measures on the face of the financial statements or in the notes;
- prohibits use of non-GAAP titles that are similar to GAAP titles;
- prohibits the characterisation of adjustments as nonrecurring if there has been a similar adjustment (or one is reasonably likely to occur) within two years; and
- requires that the most directly comparable GAAP measure be presented with equal or greater prominence⁷.

FPIs are able to avoid these prohibitions if they can demonstrate that (1) the non-GAAP measure relates to the GAAP used in the issuer's primary financial statements, (2) the measure is included in its home country annual report or sent to its shareholders, and (3) the measure is required or expressly permitted by the home country GAAP standard-setter. Under this provision, it is not enough that a home country regulator not prohibit or passively permit a particular non-GAAP measure or format. It must be 'expressly permitted'. The SEC staff interprets this permission very narrowly, and issuers seeking to rely on it should be prepared to provide specific evidence of express permission.

The SEC is not alone in being interested in the use of non-GAAP measures in financial reporting. The IASB has also questioned 'whether IFRS standards provide sufficient criteria by which performance can be judged by users of financial statements'

Many US-listed FPIs, which are not subject to quarterly reporting, also publish press releases announcing recent financial results on either a quarterly or semi-annual basis. FPIs are exempt from filing form 8-K reports, but they are not necessarily free from the SEC's non-GAAP rules with respect to their earnings releases. When US-listed FPIs publish an earnings release, many will furnish them to the SEC through a form 6-K filing, and if the form 6-K is incorporated by reference into a prospectus under the Securities Act of 1933, then the earnings release is subject to all of the rules discussed below for SEC-filed documents.

in the US at the same time that it is released outside of the US; (b) journalists (including US journalists) have access to the information; (c) the information appears on a freely available website that is not in some way targeted to US investors; or (d) the information is included in a form 6-K filing.

From a planning perspective, FPIs should keep the conditions of the regulation G exemption in mind when contemplating a US initial public offering. An FPI that uses IFRS for its primary financial statements (and there are about 500 FPIs that do so), and that lists securities outside the US (and there are many that do so), will be able to present non-GAAP measures with more flexibility.

General corporate communications

SEC regulation G applies to any public communication by an SEC-registered company of material information that includes a non-GAAP financial measure. Regulation G requires the presentation of the most directly comparable financial measures presented in accordance with GAAP, and a quantitative reconciliation of the differences between the non-GAAP measure and the most directly comparable GAAP measure. The breadth of regulation G is very broad and includes any written or oral communications

SEC filings

The most prescriptive requirements under the SEC's three-tier non-GAAP regime relate to information presented in SEC filings, such as annual reports and offering prospectuses. Found under item 10(e) of SEC regulation S-K, the rules require compliance with all of the requirements of regulation G, and impose specific provisions relating to prominence and a requirement to provide an explanation of the usefulness of the information.

In addition to regulation G, item 10(e):

- prohibits the presentation of certain non-

IFRS, US GAAP and local GAAP

In the context of US issuers, the term non-GAAP is always expressed in relation to US GAAP. For FPIs, GAAP refers to the accounting principles under which the primary financial statements are prepared. As noted above, for many FPIs, this means IFRS as issued by the International Accounting Standards Board (IASB). Also, if an FPI provides a non-GAAP measure derived from or based on a US GAAP figure, then US GAAP is an appropriate benchmark.

SEC staff comments

The SEC staff may review any report filed by a US or foreign company for compliance with the SEC's accounting and disclosure rules. For many years, the staff's review has focused on non-GAAP disclosures, and from time to time it has provided formal and informal guidance on how issuers should prepare their non-GAAP disclosures.

Most recently, in May 2016, the staff published more stringent guidelines as to what it would accept as a proper non-GAAP measure and related disclosures. Since then, it has given non-GAAP disclosures special scrutiny in light of this new guidance and has commented on the non-GAAP disclosures contained in the filings of hundreds of companies.

In its review process, the staff has not overlooked the non-GAAP disclosures that FPIs file. To the contrary, the staff frequently raises the same types of questions when reviewing form 20-F annual reports filed by FPIs as it asks US issuers. Some of the main areas of the staff's concern have included whether:

- There is sufficient explanation of the usefulness of the non-GAAP measures.
- The non-GAAP measures are properly labelled.
- There is undue prominence for the non-GAAP measures when compared with the corresponding GAAP measure – for example, where the non-GAAP measure is presented before the corresponding GAAP measure.

In some instances, when the historical comment letters indicate that the staff and the FPI had come to an earlier agreement on how specific non-GAAP measures should be disclosed, the staff appeared to be reopening that agreement by asking the issuer to reassess its disclosures in light of the updated guidance.

The staff will also ask substantive questions about the reconciliation presented relating to non-GAAP measures, inquiring as to whether certain adjustments are appropriate. Although it may not be common, the SEC staff has commented on non-GAAP disclosures in form 6-Ks as well as statements made in earnings phone calls that an FPI holds. Even with the flexibility allowed under the SEC's non-GAAP rules, FPIs that are registered with the SEC should be mindful of the SEC's guidance and be prepared to support that their non-GAAP disclosures provide investors with worthwhile insight into

their operations, earnings and prospects.

International efforts

The SEC is not alone in being interested in the use of non-GAAP measures in financial reporting. Last year, IASB chairman Hans Hoogervorst spoke about non-GAAP measures and questioned 'whether IFRS standards provide sufficient criteria by which performance can be judged by users of financial statements'. He noted that little guidance is provided with respect to formatting an income statement prepared under IFRS, and that IFRS gives issuers considerable freedom in presenting the components of profit and loss. He offered the view that securities regulators should be primarily responsible for prescribing practices in this area, although the IASB should have a role in looking into revisions to improve comparability of IFRS financial statements among issuers.

In June 2016, the International Organization of Securities Commissions (Iosco) issued its own statement on non-GAAP financial measures. The statement was unusual for an Iosco document, which are generally directed towards securities regulators themselves. In contrast, Iosco directed its non-GAAP statement towards issuers with the aim to help issuers provide clear and useful disclosure of non-GAAP measures and reduce the risk that such measures are presented in a way that could be misleading. The statement, which is based on Iosco members' collective

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experience, articulates 12 elements that compose a frame of reference for the disclosure of non-GAAP financial measures. By and large, the IOSCO non-GAAP statement is consistent with the SEC's non-GAAP rules and demonstrates a large commonality of approach among national securities regulators.

Many other regulators have published their own guidelines on non-GAAP measures. For instance, in January 2016, the Canadian Securities Administrators updated their guidance to issuers on the disclosure of non-GAAP measures. Likewise, in June 2015, the European Securities and Markets Authority published its Guidelines on Alternative Performance Measures, and the UK Financial Reporting Council in May 2016 issued responses to various frequently asked questions on those Guidelines.

Whether the new leadership at the SEC will continue its interest in looking at non-GAAP financial measures is unclear. Regardless, in light of the broad international attention, as well as interest among investors, the financial press and other constituencies, FPIs should expect continued focus on robust disclosures of non-GAAP measures.

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