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GLOBAL PUBLIC COMPANY ACADEMY

FINANCIAL REPORTING DEVELOPMENTS, INCLUDING NON-GAAP

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Agenda

- Non-GAAP Financial Measures
- Cybersecurity Disclosure
- Acquisitions/Dispositions
- New Lease Accounting Standard

SECTION 01

NON-GAAP FINANCIAL MEASURES

Non-GAAP Financial Measures

“A non-GAAP financial measure is a numerical measure of a registrant’s historical or future financial performance, financial position or cash flows that:

- i. Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the issuer; or
- ii. Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented.”

Regulation G - Rule 101(a)(1)

Non-GAAP Financial Measures - Three Levels of Restrictions

1. Regulation G

- “Whenever a registrant, or a person acting on its behalf, publicly discloses material information that includes a non-GAAP financial measure”
 - accompany the disclosure with the most directly comparable GAAP measure; and
 - accompany the disclosure with a reconciliation
- Oral or Webcast Disclosure - GAAP measure and reconciliation can be disclosed on issuer’s website so long as the location is made public in the presentation
- Exceptions apply

Non-GAAP Financial Measures - Three Levels of Restrictions

2. Earnings Releases

- Form 8-K, Item 2.02
- Instruction 2 to Item 2.02 refers to Regulation S-K, Item 10(e)(1)(i), which requires:
 - Presentation of the most directly comparable GAAP measure with **“equal or greater prominence”**
 - Reconciliation
 - Statement of Usefulness
 - Statement of Additional Purposes

Non-GAAP Financial Measures - Three Levels of Restrictions

3. SEC Filings

- Same Four Requirements as Earnings Release/Form 8-K (S-K 10(e)(1)(i)) plus
- Substantive Prohibitions (S-K 10(e)(1)(ii))
 - Excluding items requiring cash settlement from liquidity measures
 - Identifying certain items as “non-recurring, infrequent or unusual”
 - Presenting non-GAAP financial measures on the face of financial statements
 - Presenting non-GAAP financial measures on the face of pro forma financials
 - Using titles that are the same or “confusingly similar” to the comparable GAAP measure

Non-GAAP Financial Measures – Recent SEC Staff Guidance

- **2016 CDI's** – 12 CDI's issued or revised May 17, 2016
- Question 102.10 addressed “undue prominence.” Examples include:
 - Full non-GAAP income statement
 - Use in headlines/captions
 - Larger font; boldface type
 - Disclosing the non-GAAP measure first
 - Using certain descriptions inconsistently: “record performance,” “exceptional”
 - Tabular disclosure of Non-GAAP (without GAAP table preceding it)
 - Excluding a quantitative reconciliation from forward looking without sufficient explanation of “unreasonable efforts”
 - Greater discussion and analysis of Non-GAAP

Non-GAAP Financial Measures - Recent SEC Staff Guidance

- Other notable 2016 CDI's clarified position on:
 - Identifying certain items as "non-recurring, infrequent or unusual" (102.03)
 - Non-GAAP per share performance and liquidity measures (102.05)
 - The use of "Free Cash Flow" (102.07)
 - Disclosing tax effects (102.11)

Non-GAAP Financial Measures - Recent SEC Staff Guidance

- **2017 CDI's** - Two on October 17, 2017
 - Disclosure of Non-GAAP financial measures included in forecasts provided to financial advisors excluded from definition in certain circumstances (101.01)
 - Exception for Non-GAAP financial measures related to business combinations limited to certain communications (101.04)
- **2018 CDI's** – Two on April 4, 2018
 - Disclosure of financial measures included in forecasts to financial advisors and the Board of Directors excluded from definition in certain circumstances (101.02)
 - Disclosure of Non-GAAP measures in forecasts provided to bidders in connection with business combinations excluded from definition in certain circumstances (101.03)

Non-GAAP Financial Measures – Recent SEC Comment Letters

- Purpose and Use by Management
 - Avoid boilerplate; substantive and specific to measure used and to company's business and industry
 - SEC Staff will question adjustments seemingly inconsistent with use/purpose
 - Compensation, allocation of resources, management of business, debt covenants
- Clear Descriptions
 - Consistent and clear use of titles and descriptions of measures and adjustments
 - Similarity to titles or descriptions of GAAP measures; "Adjusted", "Pro forma"
 - Non-recurring
 - Provide context
- Non-GAAP Liquidity Measures
 - Reconciliation to most directly comparable GAAP measure (performance or liquidity measure)
 - No per share figures
 - No adjustments for items requiring cash settlement

Non-GAAP Financial Measures – Recent SEC Comment Letters

- Nature of Adjustments
 - Recurring expenses settled in cash – e.g., professional fees, management fees, legal settlements
 - “Tailoring” adjustments creating non-GAAP version of revenue or other GAAP recognition and measurement principles (e.g., proportionate consolidation of equity investments)
 - Inconsistent presentation in different fiscal periods or different treatment of similar items (“cherry picking”)
 - Income tax effects
 - Separately present income tax impact of adjustments and disclose how tax adjustments were calculated
 - Constant currency measures – describe basis
- KPIs
 - SEC Staff looking for similar disclosure to that for non-GAAP measures
 - Clearly define; describe assumptions/limitations; balanced discussion; clearly describe how related to current or future results of operations; use and purpose to investors/management
 - Discussed/used outside of periodic SEC filings

SECTION 2

CYBERSECURITY DISCLOSURE

Interpretative Guidance and Chairman's Letter

- Interpretive guidance issued February 21, 2018
- Accompanied by statement of SEC Chairman Jay Clayton:
 - “providing the Commission’s views on these matters will promote clearer and more robust disclosure about cybersecurity risks and incidents, resulting in more complete information being available to investors”

New Components of Guidance

- Cyber Disclosure Controls and Procedures
 - A company's disclosure controls should include controls and procedures to ensure that information about cybersecurity risks and incidents are processed and reported to appropriate personnel to enable senior management to make disclosure decisions and certifications.
 - Controls and procedures should:
 - enable companies to identify cybersecurity risks and incidents;
 - assess and analyze their impact on a company's business;
 - evaluate the significance associated with such risks and incidents
 - provide for open communications between technical experts and advisors
 - make timely disclosures regarding such risks and incidents

Open communications – what happens in IT shouldn't stay in IT

New Components of Guidance

- Policies to Prevent Insider Trading Based on Nonpublic Cyber Information
 - Companies to consider implementing policies to prevent insider trading on the basis of material nonpublic cybersecurity-related information.
 - Review insider trading policies, codes of ethics and codes of conduct
 - Controls with respect to opening and closing trading windows

New Components of Guidance

- Improving Cyber Disclosure
 - Belief of Commission and Staff that current company disclosures concerning cybersecurity risk and incidents can and must improve

Disclosure of Cybersecurity Issues

- Should consider materiality of cybersecurity risks and incidents when preparing disclosure, with focus on particular circumstances
- Risk Factors
 - occurrence, frequency and severity of prior incidents
 - probability and potential magnitude of incidents
 - adequacy of preventative steps to reduce risks
 - company or industry specific risks
 - costs of protective efforts
 - potential for reputational harm
 - existing laws and regulations

May need to describe past incidents to provide context and understanding of cyber risk

- MD&A – ongoing costs and costs of incidents
- Business – cyber risks and incidents that materially affect products, services, relationships or competitive conditions
- Legal Proceedings
- Board Risk Oversight – S-K Item 407(h) and Item 7 of Schedule 14A

Content and Timing of Disclosure of Cybersecurity Issues

- Avoid generic disclosure
- Timely disclosure
 - Recognition of need for internal investigation and potential need to deal with law enforcement or other authorities, however:
 - “ongoing internal and external investigation – which can often be lengthy – would not on its own provide a basis for avoiding disclosures of a material cybersecurity incident”
- Regulation FD

SECTION 3

ACQUISITIONS/DISPOSITIONS

Financial Reporting – Acquisitions/Dispositions

- Financial statements of an acquired business can be required in the **buyer's** Exchange Act Reports and Securities Act Registration Statements
- Regulation S-X, Item 3-05 or Item 8-04 (Smaller Reporting Companies)
- Form 8-K, Items 2.01 and 9.01
- Form 10-K, Part II, Item 8

Financial Reporting – Acquisitions/Dispositions

- Business combination has **occurred** or is **probable**
- Is a **“business”** being acquired?
 - “sufficient continuity” of operations (S-X 11.01(d))
 - revenue-producing activity
 - physical facilities
 - employees
 - distribution
 - sales force
 - customer base
 - operating rights
 - production techniques
 - trade names
- The acquired business is **“significant”** (S-X 1-02(w))
 - Investment test
 - Asset test
 - Income test

Financial Reporting – Acquisitions/Dispositions

- Periods to be Presented
 - Significance 20% or less – no financials
 - Greater than 20% but no more than 40% - one year (plus interim)
 - Greater than 40% but not more than 50% - two years (plus interim)
 - Greater than 50% - three years (plus interim)
- If securities are being registered to be offered to security holders of business to be acquired – full three years
- Exceptions apply

Financial Reporting – Acquisitions/Dispositions

- Delayed filing
 - Significance does not exceed 50%
 - Form 8-K disclosing the acquisition is filed with 4 business days and then amended within 71 calendar days to include the required historical (and pro forma) financials.
 - Not available for “shell company”
- Termination of Obligations
 - Once operating results have been included for a full year

Financial Reporting – Acquisitions/Dispositions

- Pro forma requirements (Regulation S-X, Article 11)
 - Along with historical financial statements, pro forma financials for last completed fiscal year plus applicable interim period
 - Combination of entities under common control – three years required
- Same delayed filing rules apply
- No longer required after operating results have been included for a full year – but optional inclusion is permitted

Financial Reporting – Acquisitions/Dispositions

- Pro Forma financial statements required in the **seller's** Form 8-K
 - Disposition has occurred
 - “Business” test is met
 - Significant at 10% level
 - Due: Four business days after closing – **extension only available to buyer**
- Historical financial statements not required in seller's Form 8-K
 - Could be required in proxy statement if stockholder approval of sale is required

SECTION 4

NEW LEASE ACCOUNTING STANDARD

Prior GAAP

- Operating Leases – not recognized on balance sheet as asset or liability, rent treated as operating expense on income statement
- Capital Leases – capital lease asset and liability on balance sheet, capital lease expense recorded as amortization expense (an operating expense) and interest expense on income statement

The New Lease Accounting Standard

- ASU No. 2016-02, Leases (Topic 842)
 - adopted in February 2016
 - effective (for most issuers) for fiscal years commencing after December 15, 2018
- Core principal – a lessee should recognize the assets and liabilities that arise from leases...all leases create an asset and liability
- Retains a distinction between “finance leases” and “operating leases”

Definition of a Lease

- A contract, or part of a contract, that conveys the right to control the use of identified property, plant or equipment for a period of time in exchange for consideration

Classification as Finance Lease

- Lessee shall classify a lease as a finance lease when the lease meets any of the following criteria at lease commencement:
 - a) Lease transfers ownership of asset to lessee at end of lease term
 - b) Lease grants the lessee an option to purchase underlying asset that the lessee is reasonably certain to exercise
 - c) Lease term is for the major part of the remaining economic life of the underlying asset
 - d) Present value of the sum of the lease payments and any residual value guaranteed by lessee equals or exceeds substantially all of the fair value of the underlying asset
 - e) Underlying asset is of such a specialized nature that it is expect to have no alternate use to lessor at the end of the lease term

Classification as an Operating Lease

- When none of the criteria for classification as a finance lease apply, the lessee shall classify the lease as an operating lease

Finance Leases

- Lessee is required to:
 1. Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments on the balance sheet
 2. Recognize interest on the lease liability separately from amortization of the right-of-use asset in the income statements
 3. Classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability within operating activities in the cash flow statements

Operating Leases

- Lessee is required to:
 1. Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments on the balance sheet
 2. Recognize a single lease cost, calculated so the cost is allocated over the lease term on a generally straight-line basis in the income statements
 3. Classify cash payments within operating activities in the cash flow statements

Transition Rules and Practical Expedients

- January 2018 – FASB issues practical expedient providing option to elect not to evaluate existing land easements not accounted for under previous lease standard
- July 2018 – FASB simplifies transition requirements by providing option to apply transition provisions of the new standard at the date of adoption instead of earliest comparative period presented and practical expedient
 - **Acts to permit companies to avoid need to recast prior period financial statements**

Impact of New Lease Accounting Standard

- Each company must assess whether the new standard will materially affect its results of operations, financial position or cash flows
- Will significantly expand the level of lease related disclosure
- Consider impact on covenants in existing agreements
 - Debt often defined to include any lease, which under GAAP, is required to be capitalized on the balance sheet
 - Operating leases would be treated as debt for purposes of this type of definition
 - Leverage covenants, limitations on secured debt, other financial ratios

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John T. Hood advises companies from the energy and utility industries on corporate finance, securities law, mergers and acquisitions, joint ventures, and general corporate matters. Comprising a wide variety of financial transactions including debt and equity offerings, private placements, public offerings, structured finance and bank lending transactions, John's experience also includes project financing and leveraged lease transactions of utility facilities, including nuclear power plants, coal-fired generating stations, combustion turbines, cogeneration facilities and standby reservoirs.

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