

Unusual SEC Order Has Lessons For Disclosure Committees

By **Richard Hong** (June 15, 2023)

Disclosure committees — that is, committees of public companies responsible for reviewing all proposed disclosures prior to their release — are not often involved in U.S. Securities and Exchange Commission enforcement actions.

Even less common are those that are involved in enforcement actions involving non-generally accepted accounting principles, or non-GAAP, financial measures — an alternative method, including earnings adjustments, used by many public companies to show their financial performance.



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And, of course, even rarer are the disclosure committees that are not only involved in enforcement actions, but also faulted for causing disclosure violations concerning non-GAAP financial measures.

But in March, that is precisely what the SEC expressly alleged, on a neither-admit-nor-deny basis, in its settled administrative order in the DXC Technology Company case.

DXC involved a multibillion-dollar IT service company in Ashburn, Virginia.

According to the order, DXC's disclosure committee — though no individual member from the committee was named — "negligently failed" to do its job with respect to DXC's disclosures about non-GAAP measures related to its merger, acquisitions and spinoff costs.

Given the rarity of such an allegation, as well as the news last month that the S&P 500 companies' non-GAAP earnings adjustments averaged more than a \$1 billion last year, the DXC order, imposing an \$8 million civil penalty, is worthy of another look.

What are disclosure committees?

First, some basics on disclosure committees.

While the charters of disclosure committees vary, they are usually management committees of public companies charged with reviewing for accuracy and completeness those companies' financial disclosures, prior to the required certifications by the CEOs and chief financial officers under Sections 302 and 906 of the Sarbanes-Oxley Act, or SOX.

Disclosure committees can also review and evaluate nonfinancial issues that may be subject to disclosure in their companies' financial statements. As part of their duties, disclosure committees make materiality determinations, as well as review and evaluate the companies' internal controls for reporting. In short, they serve as gatekeepers.

Since the enactment of SOX, disclosure committees have become a very common, if not an almost universal, part of public companies, particularly those listed in the S&P 500.

While there is no SEC requirement that public companies have a disclosure committee, the SEC has recommended the creation of "a committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis" under

SOX.

In addition, the SEC has sometimes recommended or requested, in the context of an undertaking in a settlement, that a company establish a disclosure committee to improve the internal controls of a settling company.

Disclosure committees vary in membership and frequency of meetings. Many disclosure committees meet more than once a quarter, while others meet once each quarter and year-end, before the issuance of the issuers' periodic reports.

Many prepare and keep the minutes of the meetings. As to membership, the SEC has recommended that the following personnel should be included: the principal accounting officer, or the controller, the general counsel or other senior legal official with responsibility for disclosure matters who report to the general counsel; the principal risk management officer; the chief investor relations officer, or an officer with equivalent responsibilities, and other officers or employees, including individuals associated with the company's business units.[1]

Outside auditors, as needed, are also invited to attend the disclosure committee meetings.

The existence of a robust disclosure committee is often touted by public companies — including by settling defendants/respondents who may be seeking waivers from the SEC under Rule 405 of the Securities Act of 1933 — as proof of their strong internal controls.

What happened in the matter of DXC Technology Company?

DXC was created through the merger of Computer Sciences Corporation and Enterprises Services business of Hewlett Packard Enterprise Company in April 2017.

After the merger, DXC adopted Computer Sciences Corporation's prior practice of reporting non-GAAP measures, which excluded merger-related costs, or transaction and integration-related costs.

About a year later, in reporting its fiscal year 2018 results, DXC amended its disclosures to include certain costs related to separation of one of DXC's businesses. Thus, DXC described these non-core business operations costs associated with its merger, acquisitions and spinoff as "transaction, separation and integration-related or TSI" costs in its SEC filings and earnings releases.

According to the SEC's order, DXC's exclusion of TSI costs from its operating income made its non-GAAP financial metrics, such as non-GAAP net income, which is closely watched by market participants such as analysts and investors, appear materially more profitable.

Such a use of non-GAAP measures is not uncommon. According to PwC, as of October 2022, "[m]ore companies now use non-GAAP measures, and the majority of the time, their non-GAAP results are better than those reported under GAAP." [2]

But the SEC's order alleged that DXC employees — within the business units and in the financial planning and analysis area — did not know what its TSI disclosure included or excluded and whether the disclosure was appropriately and consistently applied for financial reporting purposes.

According to the SEC's order, "TSI costs were ... not identified, reviewed, approved, or

disclosed in a manner consistent with a plain reading of the description of the TSI adjustment included in earnings releases and in periodic filings." [3]

Rather, the SEC stated that DXC repeatedly made subjective determinations and misclassified cost items, resulting in material overstatements of non-GAAP metrics for several quarters.

[O]n a quarterly basis [from the end of DXC's FY 2018 through the third quarter of its FY 2020], DXC materially increased its non-GAAP earnings by negligently classifying tens of millions of dollars of expenses as TSI costs and improperly excluding them in its reporting of non-GAAP measures. [4]

Like many SEC disclosure cases, DXC's original intent appeared to be benign.

After the merger, "DXC's controllership recognized the need for a non-GAAP policy that included disclosure controls and procedures specific to non-GAAP reporting" and "circulated numerous non-GAAP policy drafts internally and to DXC's independent auditor." [5]

But the SEC was quick to point out that "neither the controllership nor the disclosure committee approved or adopted a policy or disclosure controls and procedures specific to such non-GAAP measures." [6]

Thus, the SEC noted the following deficiencies, among others, regarding DXC's disclosure controls as to its TSI costs:

- DXC had no formal guidance, but just an "informal process," that its employees could consult to determine which costs could be classified as TSI;
- DXC had no documentation requirement to set forth for the reason, and to confirm the reason, for classifying a proposed expense as a TSI cost; and
- DXC had no real process for evaluating whether the classification of TSI costs that had been proposed or made was consistent with its TSI disclosures. [7]

Perhaps what made the SEC even more alarmed is that even after DXC's former Assistant Corporate Controller for External Reporting, repeatedly complained about the disclosure issues as to TSI costs, DXC apparently did little to alleviate those concerns.

The assistant controller requested in writing, quarter over quarter, additional details about the use of TSI costs and supporting documentation for them, but "DXC still did not implement a policy for the classification of TSI costs or for non-GAAP disclosures." [8]

Later, the alleged "enhanced" process that DXC undertook was no more than half-measures, as "DXC's review and approval of the classification of TSI costs continued to be untethered from the plain language of the company's description of those costs in its public disclosures." [9]

In fact, the SEC expressed a systemic concerns about DXC's disclosure failures: "Both the controllership and the disclosure committee failed even to recognize that, for years, DXC did not have a non-GAAP policy and adequate disclosure controls and procedures." [10]

For such conduct, the SEC alleged that DXC violated (1) non-scienter anti-fraud provisions, or Section 17(a)(2) and (a)(3) of the Securities Act, (2) reporting and disclosure control provisions, or Section 13(a) of the Securities Exchange Act of 1934, Rules 13a-1, 13a-11, 13a-13 and 12b-20 thereunder, and Rule 13a-15(a) of the Exchange Act, and (3) a provision governing non-GAAP disclosures under Rule 100(b) of Regulation G of the Exchange Act. [11]

In addition, DXC, which the SEC acknowledged as providing "substantial cooperation during the course of the investigation," which presumably contributed to the SEC not seeking a higher civil penalty than \$8 million, agreed to the following specific undertaking as to the disclosure committee:

[U]ndertake to develop and implement policies and disclosure controls and procedures ... for its disclosure committee, or other charged committee, to review and document, on periodic basis, the company's non-GAAP policy to assess consistency with its non-GAAP disclosures and its publicly-reported non-GAAP financial performance measures. [12]

What guidance does DXC provide about disclosure committee's role in reviewing and evaluating non-GAAP financial measures?

Non-GAAP financial measures are here to stay.

According to PwC, a study by the Center of Audit Quality showed that in the first calendar quarter of 2020, 94% of the S&P 500 companies included at least one non-GAAP financial measure in their earnings releases. [13]

The use of non-GAAP financial measures, according to a 2018 study by Audit Analytics, has undergone an "explosive growth" for more than 20 years, with approximately 96% of the S&P 500 companies in 2016 using an average of 7.45 non-GAAP financial measures in their 8-K earnings releases and 10-K filings. [14]

Public companies like using non-GAAP financial measures, such as adjusted net income, EBITDA and EPS, because they believe that these measures reflect management's views of the companies' financial performances more clearly.

As DXC explained, non-GAAP financial measures "allow investors to better understand the financial performance of DXC exclusive of the impacts of corporate-wide strategic decisions ... [and provide] investors with additional measures to evaluate the financial performance of our core business operations on a comparable basis from period to period." [15]

Apart from the DXC matter, the SEC has increasingly become more concerned about the use of non-GAAP financial measures.

For example, Dec. 13, 2022, the SEC's Division of Corporation Finance issued the latest version of its guidance, Compliance & Disclosure Interpretations, on non-GAAP financial measures. Among other things, the SEC stated in the update that "certain adjustments, although not explicitly prohibited, result in a non-GAAP measure that is misleading."

For example, the SEC explained, "[p]resenting a non-GAAP performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business is one example of a measure that could be misleading."

On May 31, The Wall Street Journal reported that "[l]arge U.S. companies last year booked earnings adjustments topping more than \$1 billion on average compared with official [GAAP] earnings, the highest sum in years, as regulators look to crack down on earnings manipulation." [16]

Given these recent developments, the need for effective and responsible disclosure committees in public companies remains paramount.

To that end, the SEC's DXC order — while lacking detailed accounts of the actions or inactions of the disclosure committee — sheds light on what the disclosure committees should consider for reviewing and assessing non-GAAP financial measures and their related disclosure controls.

In particular, four fundamental guidelines can be gleaned.

Enlist competent members.

Disclosure committees should have members who have competency in recognizing, reviewing and evaluating non-GAAP financial measures.

Create, document and implement non-GAAP policy/guidance and procedure and establish and maintain their related disclosure controls.

Disclosure committees should assure that an up-to-date and formal non-GAAP policy or guidance and procedure — and their related disclosure controls for business units and controllership — are established, documented, implemented and maintained to assess consistency with its non-GAAP disclosures and its publicly-reported non-GAAP financial performance measures.

Review and assess non-GAAP disclosures and related disclosure controls.

Disclosure committees should review and assess periodically — and as necessary — non-GAAP disclosures, with "clear labels and description," as recommended by the SEC's Compliance & Disclosure Interpretations, to assure consistency with its publicly-reported non-GAAP financial performance measures, and should review and assess disclosure controls for the non-GAAP measures.

Periodically review and reassess non-GAAP policy/guidance and procedure and their application.

Disclosure committees should review and reassess periodically — and as necessary — whether non-GAAP policy or guidance and procedure and their application are effective and whether any changes are necessary.

Conclusion

In closing, only time will tell whether the SEC will institute more enforcement actions like DXC, but drawing some lessons from that matter would be useful in potentially avoiding a

costly and reputation-damaging SEC enforcement action embroiling the disclosure committee and/or its members.

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[1] Because of the presence of in-house counsel, some have suggested that the matters discussed in the disclosure committees are privileged. Those arguments have generally not gained traction with the SEC.

[2] PwC, Non-GAAP measures: The role of the audit committee at 5 (available at <https://www.pwc.com/us/en/services/governance-insights-center/assets/pwc-gic-gaap-non-gaap>).

[3] DXC Order ¶ 5 (available at <https://www.sec.gov/litigation/admin/2023/33-11166.pdf>).

[4] Id. ¶ 1.

[5] Id. ¶ 9.

[6] Id.

[7] See id. ¶¶ 9-14.

[8] Id. ¶ 20.

[9] Id.

[10] Id. ¶ 4.

[11] Id. ¶¶ 30-33.

[12] Id. ¶¶ 35, 37.

[13] PwC, Non-GAAP measures: The role of the audit committee at 5.

[14] Jessica McKeon, Audit Analytics, Long-Term Trends in Non-GAAP Disclosures: A Three-Year September 2020. Overview, October 10, 2018 (available at <https://blog.auditanalytics.com/long-term-trends-in-non-gaap-disclosures-a-three-year-overview>).

[15] DXC Order ¶ 8.

[16] Mark Maurer, CFO Journal: Earnings Adjustments Topped an Average of \$1 Billion for Big Companies Last Year, Wall Street Journal, May 31, 2023

(<https://www.wsj.com/articles/earnings-adjustments-topped-an-average-of-1-billion-for-big-companies-last-year-aeebaed2>).