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TOP TAKEAWAYS

Audit Committee Hot Topics

1. **Be aware of the prominence given to Non-GAAP financial information.**

   In May 2016 the SEC updated guidance in its Compliance and Disclosure Interpretations ("CD &Is") to provide clarification with respect to the use of Non-GAAP financial information. The detailed guidance focused on the prominence of the disclosure of Non-GAAP information. Non-GAAP information must be correctly labeled and should not be more prominent than GAAP financial information, including that the Non-GAAP information should not appear first in either headlines or the Management Discussion and Analysis.

2. **There has been a significant uptick in the use of Non-GAAP financial information.**

   Studies indicate that in 2015 88% of the S&P 500 utilized non-GAAP measures, that they were higher than the nearest GAAP equivalent in 82% of the cases, and that the difference between the GAAP and non-GAAP earnings per share was approximately 30%. The equivalent number for 2014 was 12%. The most common adjustments to GAAP net income were stock compensation costs, restructuring charges, acquisition related items, debt costs and legal costs. The non-GAAP measures are often provided in earnings statements, in Form 8-Ks, on earnings calls, on websites, or in periodic filings, in the Business, Selected Financial Data and MD&A sections. Such information may not be included in the financial statements or notes thereto.

3. **The SEC is keenly interested in the use of Non-GAAP measures**

   Since May 2016, The SEC Division of Corporate Finance has issued over 200 comment letters to registrants on their use of non-GAAP measures, mostly on pre-May 2016 press releases, disclosures and filings. The SEC Division of Enforcement has sent a number of broadly worded requests for information, focused on pre-2016 disclosures and filings, seeking information on "equal or greater prominence" issues. In September the SEC filed an enforcement action against a REIT involving fraudulent accounting for a Non-GAAP cash flow yardstick, "adjusted funds from operations".

4. **As a best practice, public companies should document their policies with respect to Non-GAAP financial information.**

   The Audit Committee must be involved in the discussion regarding the presentation of Non-GAAP financial information. Audit Committee members should review and discuss adjustments and whether such adjustments are defensible. There should be a policy regarding the procedure, calculation and review process for Non-GAAP financial information. Management and the Audit Committee should spend time understanding these financials and ensuring that they are not given more prominence or weight than GAAP financial information. Audit Committee should be vigilant and strict with respect to the prominence of Non-GAAP financial information. By the Form 10-K filing season, companies should be compliant with SEC guidance.

5. **Audit Committee members should keep in mind five things when reviewing Non-GAAP financial information.**

- The Non-GAAP financial information should not be misleading;
- The Audit Committee should provide a reconciliation for the Non-GAAP information- reconcile performance measures to the statement of operations, and liquidity measures to the statement of cash flows;
- All non-GAAP financial information should be clearly labeled as Non-GAAP;
- There should be a balanced usage of GAAP financial information and Non-GAAP financial information; and
- All Non-GAAP financial information, especially net income and earnings per share and all adjustments thereto should be reviewed and have final sign-off from the Audit Committee.

6. The Audit Committee should be mindful of earnings conference call scripts and prepared Q&A.

The Audit Committee should try to anticipate questions from analysts and investors and be mindful of how Non-GAAP information will be presented during events with analysts and investors. The Audit Committee should be comfortable with the responses and review them to ensure that the financials are accurate and fairly presented. Furthermore, companies should involve their auditors in the review process. The SEC has been listening in on such calls to determine whether its guidance is being followed.

7. All public entities should be working on transition to the new Revenue Recognition Rule.

The new Revenue Recognition Rule, ASC 606, becomes effective for public entities for annual reporting periods after December 15, 2017. The Rule provides two transition options which will cover fiscal years 2016, 2017, 2018. The SEC, AICPA and PCAOB have all warned companies about the amount of work needed to transition to, apply and adopt the Rule and that this work should have begun already.

8. The new Revenue Recognition Rule will require numerous accounting and disclosure judgments

For each contract with a customer, judgments must be made on explicit and implicit terms, collectability, future purchase options, warranty features, principal versus agent considerations, fixed and variable consideration, payments made to customers, non-cash consideration, discounts and rebates, measuring progress over time, nature of licenses, repurchase obligations and customer acceptance of performance.

9. The new Revenue Recognition Rule will impact many parts of the entity and may have collateral impact on other obligations.

Implementation of the new Rule requires evaluation and possible changes to policies, processes, systems and controls throughout the entity on a global basis, and through all of its IT and ERP systems. When effective, the Rule may well impact the entities' reported revenues up or down, employee incentive agreements, loan covenants, tax liability and deferred tax assets, and MD&A disclosures.

10. Audit Committee members must be cognizant of the New York Stock Exchange Overboarding Rule.

    If an audit committee member simultaneously serves on the boards of more than three public companies, then the board of each such company that is listed on the New York Stock Exchange must determine that such service would not impair the ability of such member to serve on the company's audit committee and must disclose that determination. Factors include whether the audit committee has full time employment as an officer or employee elsewhere, the dates that the various boards' committees meet throughout the year and whether they conflict, and whether the member serves as a chair or member of each such committee.

For more information on Audit Committee Hot Topics, please feel free to contact the moderators directly:

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