

SEC Levies \$8M Fine for Misleading Non-GAAP Disclosures and Disclosure Control Failures

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On March 14, DXC Technology Company (DXC) settled charges alleged by the Securities and Exchange Commission (SEC) for \$8 million. The SEC claimed that DXC made misleading disclosures and lacked adequate disclosure controls about its non-GAAP financial performance measures in several quarterly and annual reports filed with the SEC from 2018 until early 2020. The SEC [order](#) continues to highlight that the SEC remains focused on companies' non-GAAP disclosures and offers a reminder of the importance of having effective disclosure controls and procedures in place to avoid non-GAAP disclosure issues.

The Order

As outlined in the order, over several quarters beginning in 2018 and continuing through early 2020, DXC reported erroneous non-GAAP net income and non-GAAP diluted earnings per share (EPS). DXC disclosed that it excluded transaction, separation, and integration-related (TSI) costs from its non-GAAP net income and non-GAAP diluted EPS. TSI costs were described as costs related to the integration of DXC in its present form, following a merger creating the present corporation in April 2017. However, as the order outlined, DXC's internal controls and procedures failed to ensure that its expense classifications were consistent with its own public description of TSI costs, while also neglecting to adequately and consistently review costs attributed to TSI. As a result, the SEC charged that DXC negligently misclassified millions of dollars of expenses as TSI costs, improperly excluding them and resulting in non-GAAP net income and non-GAAP diluted EPS that were materially misleading.

According to the order, DXC's non-GAAP disclosure controls and procedures were inadequate. DXC did not have a non-GAAP policy, nor did it have any formal guidance that employees could rely upon to determine which costs should be appropriately attributed to TSI, and thus excluded in the company's publicly disclosed non-GAAP measures. Instead, DXC had an informal process that permitted its financial planning and analysis (FP&A) employees to make subjective determinations about TSI costs without any mechanisms to ensure that costs marked as TSI aligned with DXC's public descriptions of such TSI costs. The order found that DXC did not require documentation of TSI costs, and company discussions about TSI costs were often addressed orally without a record showing how decisions were made. Additionally, previously approved TSI costs were not reassessed to determine if continued classification was appropriate. As such, the FP&A team, when aggregating TSI costs to send to DXC's controller, did not evaluate whether such costs were consistent with their stated description. Owing to the lack of formal procedures, DXC wound up in a situation where its FP&A team believed its role involved limited or no oversight, and the controller's team was responsible for determining appropriate TSI costs. Meanwhile, the controller's team thought that the FP&A team had a more robust process in place for analyzing and vetting TSI costs than it actually did before sending the aggregated costs to the controller.

Although DXC's controller's office raised concerns about the inclusion of certain measures in TSI costs and whether the TSI costs complied with the SEC's non-GAAP requirements, its concerns went unaddressed. Nevertheless, the controller's office ultimately certified the TSI costs for inclusion in the company's publicly disclosed non-GAAP measures.

The order found that by failing to adequately review matters marked as TSI costs, millions of dollars were inappropriately classified, leading DXC to make materially misleading statements about TSI costs in its quarterly reports. This misclassification of expense led to an overstatement of non-GAAP net income of at least \$29 million in the second fiscal quarter of 2019, at least \$30 million in the fourth fiscal quarter of 2019, and at least \$24 million in the first fiscal quarter of 2020.

While charging DXC with violations of Sections 17(a)(2) and (3) of the Securities Act of 1933, as amended (Securities Act) for making false statements and Section 13(a) of the Exchange Act of 1934, as amended (Exchange Act) for filing misleading disclosures, the SEC also charged the company with violating Rule 100(b) of Regulation G, which forbids companies from making public non-GAAP measures that contain an untrue statement of material fact, or omit a material fact necessary to make such non-GAAP measures not misleading.

Key Takeaways

The order demonstrates that the SEC's focus on non-GAAP financial measures continues. It further highlights the importance for companies to have a non-GAAP policy or adequate disclosure controls and procedures in place specific to the use of non-GAAP measures. The order also shows that it is important that any non-GAAP disclosures comply with the relevant rules and regulations and fall within the parameters of relevant SEC guidance.

The order further highlights the importance of cooperation once the SEC identifies an issue. It makes clear that the SEC took into account DXC's substantial cooperation and implementation of remedial measures, including undertaking a robust review of its TSI practices, reviewing and supplementing its procedures concerning non-GAAP adjustments and reporting, and proactively enhancing its disclosures of TSI costs. Subsequent to the relevant period, DXC also reduced the volume of its TSI costs and replaced nearly all of its senior executive and financial leadership personnel who were present during the relevant period.

Strong Disclosure Controls and Procedures Are Critical

In DXC's internal review, many problematic issues were flagged as concerning, and questions were raised as to whether items were properly being marked as a TSI cost and included in DXC's non-GAAP measures. Yet, these concerns remained unresolved. The company did not perform a closer analysis or assess prior TSI costs as appropriate. As a result, DXC ended up with materially misleading disclosures.

We believe the order highlights that had DXC's internal processes been more robust and formalized, it likely may have avoided this situation altogether. Had there been a non-GAAP policy in place, would the FP&A team have had to resort to informal processes? If there had been robust disclosure controls and procedures specific to the use of non-GAAP measures, would the concerns of the employees in the controller's office been properly routed or escalated? The order highlights how easy it is for items to fall through the cracks when preparing complex and

detailed disclosure documents, pointing to why strong policies and procedures are essential to a company's protections.

Mind the Guidance

The SEC Division of Corporation Finance published "[Compliance & Disclosure Interpretations on Non-GAAP Financial Measures](#)" (Non-GAAP C&DI) that offer companies valuable insights into how to craft non-GAAP disclosures that will comply with the rules.

An eye-opening passage from the order quotes a former DXC employee who wrote, "I have asked again for supporting information to address the non-[GAAP] adjustments and how they meet the [C&DI] to ensure compliance with the non-GAAP SEC Regs."

In DXC's case, the employee was likely referring to Non-GAAP C&DI Questions 100.01 and 100.02, as both specifically warn against practices that occurred at DXC. Non-GAAP C&DI Question 100.01 prohibits the use of adjustments that make a non-GAAP measure misleading. In fact, Question 100.01 was recently amended to explicitly state the division's long-held position that the presentation of a non-GAAP disclosure 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." In DXC's case, it was including as TSI costs normal operating expenses unrelated to its TSI category. By so doing, DXC backed out expenses that it should not have, causing its non-GAAP measures to be misleading by incorrectly stating its financial position.

Non-GAAP C&DI Question 100.02 cautions against presenting non-GAAP measures inconsistently across periods. As noted in the order, the failure of DXC's disclosure controls and procedures resulted in a process where measures were included as TSI costs on a subjective basis that varied from quarter to quarter, and previously approved TSI-costs were not reassessed to determine if continued classification was appropriate or consistent.

The Non-GAAP C&DIs also offer a variety of additional insights into how the division views non-GAAP presentations and can serve as a valuable tool in crafting disclosures.

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