

Smith Anderson
Securities Law Breakfast Series

Preparing for 10-K and Proxy Season

November 30, 2016

December 1, 2016

Form 10-K: Recent SEC Focus SEC Comment Letter Trends

Form 10-K: Recent SEC Focus

SEC Comment Letter Trends

- Non-GAAP Financial Measures
 - Non-GAAP financial measures are a major focus of the SEC Staff
 - New C&DIs were released in May 2016
 - The SEC issued comments to 166 companies through August 5, 2016
 - An increase of 13% from the same period in 2015
 - Considerations:
 - Supplement, don't replace, financial information
 - Are the non-GAAP measures misleading?
 - Are the measures reconciled to the appropriate GAAP measures?
 - Are GAAP and non-GAAP financial measures given equal prominence?

Non-GAAP Financial Measures: Response to SEC Guidance

- Wall Street Journal
 - Over 25% of the companies in the S&P 500 *shifted* their presentations to put GAAP numbers at the top of their quarterly earnings releases
 - 81% made GAAP numbers more prominent, compared with only 52% in the prior quarterly earnings releases
 - Some companies have dropped non-GAAP measures altogether
- For non-GAAP measures that are more integral to a company's disclosure, the SEC has noted that it will allow a short time for transition, but it is not clear how long the SEC will allow for companies to transition to be in compliance with the SEC guidance

Non-GAAP Financial Measures: Internal Controls

- With the SEC's attention to non-GAAP measures, companies should have controls and procedures to help ensure clear and accurate disclosure of these measures.
- One potential starting point would be a written non-GAAP policy that
 - clearly describes the nature of allowable adjustments to GAAP measures,
 - defines the non-GAAP measure(s) to be used under the policy, and
 - explains how potential changes in the inputs, calculations, and adjustments will be evaluated and approved.
- Implement procedures for the CFO/controller in considering, calculating and presenting non-GAAP measures and for the audit committee in overseeing the use of non-GAAP measures

Non-GAAP Financial Measures: Proxy Statements

- Executive compensation plans frequently combine GAAP, non-GAAP, and operational metrics, and in the current climate, a company may want to consider its use of non-GAAP measures
- When discussing compensation targets in a proxy statement, companies need only explain how non-GAAP compensation targets are calculated (without the required reconciliation to GAAP).
- If non-GAAP financial measures are used for any other purpose in discussing compensation, the requirements of Regulation G and Item 10(e) of Regulation S-K continue to apply (i.e. not misleading, equal prominence)
- Current trends
 - It is still too early to tell whether companies will modify their use of non-GAAP measures. Nonetheless, some companies continued to use modified non-GAAP metrics even between their different SEC filings during the 2016 proxy season
 - The SEC has commented on numerous occasions asking for clarity on how a non-GAAP measure is calculated if used in CD&A

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SEC Comment Letter Trends

- Management's Discussion & Analysis
 - Key area for comment was around critical accounting estimates
 - Supplement, don't repeat, disclosure from the significant accounting policies footnote in the critical accounting estimates in MD&A
 - In the financial statements footnote, describe the method used to apply an accounting principle
 - In MD&A, provide insight into the uncertainties involved in applying the principle at a given time and the variability that is reasonably likely to result from its application

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- Segment Reporting
 - Companies should regularly assess their segment reporting conclusions and evaluate whether internal controls are designed to ensure that the Chief Operating Decision Maker (CODM), operating segments and reportable segments are correctly identified
 - The SEC Staff has focused on the process that the CODM uses to identify segments and required that a company provide detailed information on the CODM's direct reports, how often the CODM met with those direct reports, who is accountable for the financial results of each segment, etc.
 - The SEC recently settled an enforcement action on matters related to inadequate segment reporting
 - Regular review of peer company comments & responses can be a very valuable exercise

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- Loss Contingencies
 - The topic of loss contingencies was an increased focus of SEC Staff in 2016
 - Need to provide a clear estimate
 - Specifically, the SEC staff focused on disclosures about reasonably possible losses as well as the clarity and timeliness of loss contingency disclosures and accruals when there were no early-warning disclosures
 - The SEC staff's comments address companies' failure to make required footnote disclosures when losses are considered reasonably possible or to disclose the range of reasonably possible losses, including when there is a reasonable possibility of a loss in excess of the amount accrued

SEC Comments on Loss Contingencies

Example – SEC Comment, April 1, 2016

“We note in your disclosure on page 27 that \$36 million of the \$42 million increase in your insurance reserves relates to years prior to 2015. We further note on page 76 that your general liability reserve increase was due in part to an increase in the number of premises liability claims from earlier years reported to you subsequent to the 2014 actuarial evaluations. Please provide additional details regarding the nature, amount and timing associated with these additional claims to clarify why recognition occurred during 2015 and was not required in 2014.”

Example – SEC Comment, March 11, 2016

“We note your disclosure related to the TCPA litigation that the ultimate outcome of this proceeding is uncertain, but may be material to your results of operations and cash flows. Please note that the guidance in ASC 450-20-50-4 requires that if there is at least a reasonable possibility that a loss or additional loss may have occurred and either an accrual is not made for a **loss contingency**, or an exposure to loss exists in excess of the amount accrued, an estimate of the possible loss or range of loss should be disclosed, or a statement made that such an estimate cannot be made. Please revise accordingly.”

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- Revenue Recognition
 - Focused on understanding the analysis performed by companies to support their conclusion that gross or net revenue reporting is appropriate. In particular, companies should support their conclusions as to whether revenue obtained is obtained as a principal (likely report gross revenue) or an agent (likely report net revenue)
 - As the effective date approaches (in 2018), disclosure about the quantitative and qualitative effects of the new standards should become more robust and not just include boilerplate language. Companies should also consider adding disclosure on status of the processes for implementing the new standards and the significance of any implementation matters yet to be addressed in those processes

Form 10-K: Recent SEC Focus

SEC Comment Letter Trends

- Risk Factors

- Take a hard look at these, and obtain internal input early
- Some S&P 500 companies, in an effort to make their Form 10-Ks easier to understand, have started to group risk factors by strategic, operational, financial, and legal and compliance risks
- SEC really wants to cut down on repetitive/generic risks
 - Some companies are beginning to delete risk factors that are generic, such as “We are subject to litigation which, if determined adversely to us, could harm our business.”
 - NVIDIA Corporation between its 2013 10-K and 2014 10-K reduced total risk factors from 34 risk factors requiring 9500 words to 18 risk factors requiring 4500 words
- Consider whether to make additional disclosures to address the current and future implications of Brexit to the extent it is expected to impact your business

Disclosure Effectiveness

Disclosure Effectiveness

- The SEC has released its Regulation S-K concept release and proposed amendments to “eliminate redundant, overlapping, outdated, or superseded provisions, in light of subsequent changes to Commission disclosure requirements, US GAAP, IFRS and technology.”
- Analysts suggest the amount of disclosure will likely remain about the same
- Some companies are beginning to think about how they can present information in a way that is easier for investors to understand

Disclosure Effectiveness: MD&A

- Discussing most significant information from management's perspective first and increasing use of bullet points, as Google does:

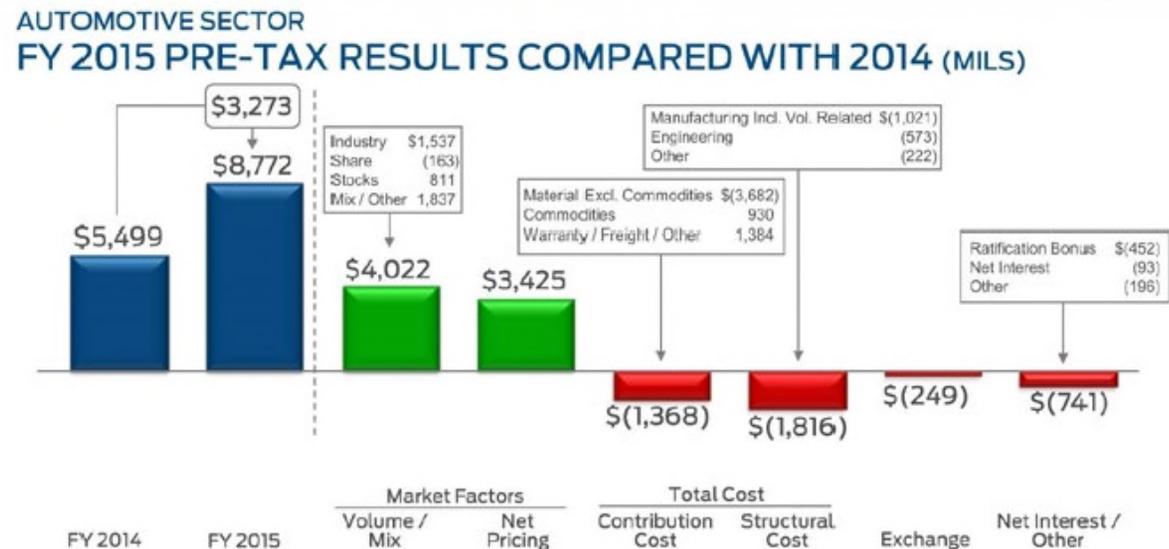
Executive Overview of Results

Here are our key financial results for the fiscal year ended December 31, 2014:

- ▶ Consolidated revenues increased 18.9% to \$66.0 billion, primarily driven by an increase in advertising revenues generated by Google websites and an increase in other revenues, and to a lesser extent, an increase in advertising revenues generated by Google Network Members' websites.
- ▶ Revenues from the United States, the United Kingdom, and Rest of World were, \$28.1 billion, \$6.5 billion, and \$31.4 billion, respectively.
- ▶ Cost of revenues was \$25.7 billion, consisting of traffic acquisition costs of \$13.5 billion and other cost of revenues of \$12.2 billion. Our traffic acquisition costs as a percentage of advertising revenues was 22.9%.
- ▶ Operating expenses (excluding cost of revenues) were \$23.8 billion, primarily driven by labor and facilities-related costs for our research and development and sales and marketing functions, advertising and promotional expenses, and stock-based compensation expense.
- ▶ Income from operations was \$16.5 billion.
- ▶ Effective tax rate was 19.3%.
- ▶ Net income was \$14.4 billion with diluted earnings per share of \$21.02.
- ▶ Operating cash flow was \$22.4 billion.

Disclosure Effectiveness: MD&A

- Using charts and graphs to depict changes in key measures such as revenues and margins, as Ford did:



Form 10-K Summary

- On June 1, 2016, the SEC approved a new interim rule that explicitly allows companies to provide a summary of their business and financial information in their Form 10-Ks
- No current requirements on length or content
- Each item must be presented fairly and accurately and include an electronic cross-reference, or hyperlink, to the related detailed disclosures contained in the Form 10-K
- The summary should refer only to Form 10-K disclosures included in the Form 10-K at the time it is filed. It is unclear whether companies will adopt this practice

Annual Report to Shareholders

- No need to mail Glossy Annual Reports to SEC or NYSE
 - The SEC will now accept a company posting its annual report on its website in lieu of mailing seven copies of the annual report to the SEC
 - NYSE also no longer requires that listed companies provide it with copies of the annual report. Companies must provide copies of their proxy materials (including the proxy card), but NYSE has apparently taken the position that the annual report is not part of a company's "proxy materials"

Proxy Statements – Major Topics

Proxy Statement – Audit Committee

- Investors are pushing for greater disclosure on the audit committee and some companies are complying voluntarily
 - United Brotherhood of Carpenters' Pension Fund campaign asked for six specific disclosures on the responsibilities of the audit committee over the selection, retention and supervision of the auditor.
 - In the past five years, 63 companies have agreed to disclose all requested items
- The SEC issued a concept release in 2015 requesting comments on possible revisions to audit committee disclosures, focusing on three main areas of disclosure:
 - Oversight of the auditor
 - Process for appointing or retaining the auditor
 - Consideration of the qualifications of the audit firm and certain members of the engagement team
- The PCAOB has also re-proposed changes to the auditor's report, which would, among other things, remove boilerplate and include disclosure on matters that are most significant for management to consider

Proxy Statement – Say on Pay

- 2016 Results
 - Only 31 Russell 3000 companies (1.7 percent) experienced a failed say-on-pay vote in 2016. In 2015, 61 Russell 3000 companies experienced a failed say-on-pay vote
 - The average vote in favor of say-on-pay proposals through October 2016 was 91 percent
 - Six percent of Russell 3000 companies received favorable votes at a level below 70 percent in 2016
 - Smaller companies are performing just as well as S&P 500 companies

Proxy Statement – Say on Pay

- Consequences of a “Failed” or Significant Opposition Vote
 - A Say-on-Pay vote is advisory—the company must consider but need not adjust its compensation to NEOs
 - Proxy Advisory Firms such as ISS and Glass Lewis will consider recommending a vote against compensation committee members if there is significant shareholder opposition (i.e. less than 70% approval)
 - Include additional disclosure if deemed necessary to support compensation decisions
- If you receive a negative ISS/GL recommendation
 - ISS/GL are more likely to target smaller companies
 - Reach out to shareholders to discuss the company’s compensation decisions and the basis for those decisions and address the shareholders’ concerns
 - Be careful to limit what you say during such shareholder outreach to what is contained within the proxy OR
 - Consider filing a proxy supplement with additional information and potentially even holding a webcast to discuss compensation.

Proxy Statement – Say on Frequency

- Given the timing of certain regulations, many public companies will be required to include an agenda item for their 2017 annual meetings asking shareholders if the say-on-pay vote should occur every one, two or three years
- This will need to be done even if the company is already conducting its say-on-pay vote annually and intends to continue this practice
- SRCs may not have to conduct a vote during the upcoming annual meeting (due to when various rules were phased in)
- The Form 8-K reporting voting results will need to disclose not only the results of the say-on-frequency vote, but also the frequency with which the company intends to conduct the say-on-pay vote in light of the results of the advisory frequency vote

Proxy Statement – Golden Leash

- Nasdaq “Golden Leash” Disclosure
 - Effective August 1, 2016
 - Requires companies listed on Nasdaq to publicly disclose benefits given by investors or other third parties to directors or director nominees in connection with their candidacy or service as a director
 - Implemented to avoid conflicts of interest, perception of impropriety or biased decision-making among directors
 - The required disclosure can be accomplished on or through the company’s website or in the proxy statement
 - Update the D&O questionnaire to capture these arrangements

Proxy Statement – Proxy Access

- Recent Trends
 - Through July 1, 2016 – 79 proxy access proposals went to shareholders, 41 passed (52%)
 - 2015 – 88 proxy access proposals went to a shareholder vote, 52 passed (59%)
 - 2014 – 18 proxy access proposals went to a shareholder vote, 5 passed (28%)
 - As of August 31, 2016, 39 percent of the S&P 500 companies provide proxy access rights

Proxy Statement – Proxy Access

- There is a trend of companies adopting proxy access bylaws voluntarily, and there is growing consensus on what is market
 - A shareholder or a group of up to 20 shareholders who have owned 3 percent or more of the Company's common stock continuously for at least three years may nominate director candidates constituting up to 20 percent of the board)
 - Only 16 companies who adopted proposals in 2015 and 2016 had more restrictive basic features
 - In 2016, a number of companies were able to exclude shareholder proxy access proposals by submitting their own proxy access provisions, even if the proxy access provisions proposed by the company are not the same as those provided by the shareholder. The issue is whether the company had “substantially implemented” the proposals
- The focus going forward will largely be on “secondary features” of proxy access bylaws, i.e. counting loaned shares as owned or eliminating restrictions on the re-nomination of proxy access nominees

Proxy Statement – Pay Ratio

- Must annually disclose:
 - the median annual total compensation of all employees (including all worldwide employees, part-time employees, temporary employees and seasonal employees)
 - the annual total compensation of the CEO
 - the ratio of these two amounts
- Can use any reasonable “consistently applied compensation measure” (CACM) to identify the annual compensation of employees
- Identify the median employee from that population using either annual total compensation or another CACM.
- Effective Date
 - Must provide disclosure for the first full fiscal year beginning on or after January 1, 2017 = filings in 2018
 - We suggest a dry run with 2016 numbers
 - Compensation Committees will want to see the results

Proxy Statement – New Policy Guidelines from Proxy Advisory Firms

- **The 2017 guidelines include updates on the following issues:**
 - Restrictions on Binding Shareholder Proposals
 - Governance Following an IPO or Spin-Off
 - Director Overboarding
 - Equity Plans and Dividends Payable Prior to Award Vesting
 - Non-Employee Director Compensation Proposals
 - Stock Distributions: Splits and Dividends

Proxy Statement – Proposed Rules

- Other pending proposed rules
 - Clawback Listing Standards
 - Pay-for-Performance Disclosure
 - Hedging Disclosure
 - Political Contributions (No current proposed rule, but mounting pressure from shareholder advocacy groups and members of Congress)

Some Potential Action Items

- Review all channels (press releases, social media, etc.) for consistency
- Consider whether and how the company will treat non-GAAP measures and consider reviewing disclosure from peer companies and potentially discussing the topic with other players in your industry
- Consider if there are ways to make your 10-K more readable
- Begin analyzing and discussing trends in MD&A and the need for new risk factors (such as trends or risks related to Brexit)
- Monitor progress on moving towards the new revenue recognition standard
- Analyze results of recent say-on-pay votes and, if the vote in favor has been relatively low, consider changes to compensation or reaching out to institutional investors before proxy season
- Analyze whether and how to disclose any “Golden Leash” arrangements if listed on Nasdaq
- Consider whether to expand audit committee disclosures
- Consider whether to do a Pay Ratio dry run with 2016 numbers

Questions?

Thank You

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