ALERT MEMORANDUM

# Q2 Reporting: How Should a U.S. Public Company Quantify the Impact of COVID-19?

*July 1, 2020*

U.S. public companies are thinking about how to quantify the effects of COVID-19 in their second-quarter public disclosures. Unlike the first quarter, they have now seen three full months of COVID-19 impact, with complex effects that varied within the period and across geographies and segments. The effects are important for understanding Q2 results, and for anticipating results going forward – which in turn implicates a host of issues, including liquidity, funding, covenant compliance, impairment testing and going concern analysis.

So there are good reasons to try to quantify the impact of COVID-19, and the SEC has encouraged "robust disclosure and engagement" in the COVID-19 context, with particular emphasis on the need for forward-looking disclosures.[1]

On the other hand, providing quantified disclosures raises tricky questions of regulatory compliance and risk. In this note, we will focus on five questions an issuer should ask about its approach to these disclosures.

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[1] Click *here* for our alert memo on Disclosure Guidance Topic No. 9 and *here* for our alert memo on Chairman Clayton's and Director Hinman's statement on the importance of disclosure.

## Question 1: Does the proposed disclosure provide a non-GAAP financial measure (“NGFM”)?

An initial question in connection with any numerical Q2 disclosure about the impact of COVID-19 is whether it should be considered an NGFM, subject to the presentation and reconciliation requirements for NGFMs under Regulation G and Item 10(e) of Regulation S-K (the “Non GAAP Rules”). Just because a number is not a GAAP measure does not mean it is an NGFM; it might be an operating or other statistical metric, which the definition of NGFM expressly excludes. It might also be measuring an impact on or input to financial performance without constituting an alternative to GAAP measures of performance or liquidity. A few examples illustrate these points.

**Example A: Due to government shutdown orders, in the second quarter of 2020, we closed 25 stores, which had accounted for $50 million of operating expenses in the second quarter of 2019.**

In this example, 25 stores is an operating metric, and $50 million of operating expenses in the prior period is quantifying an element of financial performance but not presenting an NGFM. These metrics may be relatively easy for a company to identify and quantify. However, investors may feel they provide an insufficiently detailed look at the impacts of COVID-19 on the business and fall short of a “normalized” picture of the company’s financial position.

**Example B: Operating expenses adjusted for COVID-19 were $1.3 billion in the second quarter of 2020.**

This example presents a GAAP measure (operating expenses) that excludes certain items (adjustments for COVID-19), and thus is clearly an NGFM. A company that presents a COVID-impact quantification such as this must provide the reconciliations and disclosures required for NGFMs under the Non GAAP Rules, which are discussed in more detail in Question 3 below.

**Example C: Without the impact of COVID-19, operating expenses would have decreased 11% compared to the second quarter of 2019.**

This example is not quite as clear, however, it could be viewed as similar to Example B: the 11% decrease shows the change in a GAAP measure excluding certain items, and therefore the comparison implicitly conveys an NGFM. The text in the example therefore should be modified to eliminate the risk (e.g., by making it more similar to Example D) or it should be accompanied by the disclosures needed to comply with the Non GAAP Rules.

Many companies may find themselves grappling with COVID-impact quantifications that may at first glance appear not to present NGFMs (and therefore do not require compliance with the Non GAAP Rules) but on further examination may actually be NGFMs (which do). Thoughtful attention to the presentation of these quantifications can eliminate the need for additional disclosure required by those rules and the risk of non-compliance.

**Example D: Operating expenses declined 20% compared to the second quarter of 2019, 11% of which was due to foreign exchange and 9% of which was due to COVID-19.**

This example conveys the same type of information as Examples B and C but uses a presentation that clearly avoids the presentation of an NGFM.

## Question 2: Is the proposed NGFM prohibited?

A company that uses an NGFM to show the impact of COVID should consider positions taken by the SEC under the Non GAAP Rules. In particular, management should bear in mind:

— Lost revenue may not be an appropriate non-GAAP adjustment as the SEC may view this as an "individually tailored" accounting principle. For example, an adjusted revenue measure that attempts to quantify what the company's revenue would have been had COVID-19 not impacted the business may be considered misleading.[2] It may also be particularly difficult for a company to isolate and quantify a lost revenue adjustment – other factors beyond just COVID-19 may have been involved.

— The exclusions and inclusions in an NGFM should be balanced to avoid a misleading measure. For example, an Adjusted EBITDA metric that includes an addback for the expense of COVID-related personal protective equipment, but does not reflect savings on fuel costs, may be considered misleading.

— For any adjustments the company is characterizing as "non-recurring," the company should confirm that the nature of the adjustment truly is non-recurring, infrequent or unusual. That confirmation should involve consideration of the long-term implications of COVID-19 and whether some part of its impact may represent a permanent change to the company's business model.

## Question 3: How should a COVID-impact NGFM be presented in Q2 disclosures?

— Compliance with S-K Item10(e) (for presentation in the earnings release and Form 10-Q) requires equal or greater prominence of the GAAP measure and reconciliation of the NGFM to the GAAP measure, together with appropriate disclosure as to how the NGFM is calculated and why management believes it is useful for investors. Compliance with Regulation G requires the same reconciliation required by S-K Item 10(e).

— A stand-alone COVID-related adjustment will likely need to be presented as an individual line item in the relevant reconciliation. On the other hand, if the COVID-related adjustment is being included within a broader non-GAAP adjustment, the company should include footnote disclosure that explains and quantifies the COVID impact.

— In the SEC's view, NGFMs (including COVID-impact NGFMs) should be used to reflect how management and the board view the company, including the current and potential impact of COVID-19. These measures must also be subject to the company's rigorous disclosure controls and procedures. The quantification and presentation of COVID-impact NGFMs (and the related disclosure) should be carefully considered and discussed with the audit committee and external advisors, particularly in the absence of further guidance from SEC staff about the use of COVID-related NGFMs.

— If the company is providing a new NGFM, or is revising the presentation of an existing measure, it should refer to the SEC's prior guidance on this topic.[3]

## Question 4: Is the COVID-impact disclosure accurate and verifiable?

Not all adjustments are created equal. Adjustments stemming from fairly objective charges, such as COVID-related contract terminations or purchases of personal protective equipment, are easier to isolate,

[2] Click *here* for the SEC's C&DI's on the use of NGFMs; in particular, Question 100.04.
[3] Click *here* for our alert memo on the SEC's guidance for key performance metrics in MD&A. Among other things, this guidance states that if a company revises the presentation or calculation of a specific metric, to the extent such change is material, it should include disclosure explaining the difference between the revised and former metric, the reasons for effecting such change and, if the context requires, recast the presentation for prior periods to allow for comparison.

quantify and support than charges related to supply chain interruptions and operational inefficiencies, which may reflect drivers beyond COVID-19. The more judgment calls that are needed in a company's assessment of an adjustment, the more the company should consider its assumptions (see Question 5 below). The SEC may be more likely to question the accuracy of the disclosure during its normal-course review of the company's periodic filings, and there is also litigation risk surrounding COVID-impact disclosure that contains a misstatement or is otherwise inaccurate or unsupportable. In addition, it may be difficult for auditors to comfort such an adjustment in an underwritten offering.

## Question 5: Is the disclosure misleading?

A reasonable basis is needed for a company's estimates of the impacts of COVID-19 and its calculation methodology. The impact of an event with far-reaching implications such as COVID-19, which has many direct and indirect effects on both revenue and cost, may not be susceptible to easy, or easily explainable, quantification. To the extent assumptions underlying these estimates are material and would be unfamiliar or not obvious to the reader, these should also be disclosed to reduce the risk of a claim of inaccuracy, as the reasonableness of both the estimates and the underlying assumptions will be judged in hindsight.

If a company is trying to quantify or describe what the business would have been in the absence of COVID-19, management should consider whether such a statement is meaningful, as this may inherently imply that the company could go back to its pre-COVID baseline and also involves a "crystal-ball" type of thinking that may not be supportable. While a return to "business as usual" may be the case for discrete operations or metrics, given the all-encompassing and prolonged nature of the crisis, the pre-COVID baseline may not be a viable reference point, especially for companies that have made structural changes to the way management runs the business. For example, if a company closed a certain number of stores and is now reopening them, providing that operating metric is appropriate – however, the underlying revenue model for those stores may have fundamentally changed.

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