SEC Charges Company for Key Performance Indicator Disclosure Failures

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Diageo Enforcement Proceeding

On February 19, 2020, the Securities and Exchange Commission ("***SEC***") announced charges against Diageo plc ("***Diageo***") for failing to disclose known trends relating to the shipment of excess products by Diageo's subsidiary, Diageo North America ("***DNA***"), to distributors. According to the SEC's order, facing declining market conditions, DNA employees pressured distributors to purchase products in excess of demand in order to meet internal sales targets, which resulted in higher growth in certain key performance indicators ("***KPIs***") that were closely followed by investors and analysts. Pursuant to the SEC's order, Diageo failed to disclose trends related to the shipment of unnecessary products and the resulting elevated distributor inventory levels, the positive impact such "overshipments" had on Diageo's sales and profits, and the negative impact that the unnecessary increase in inventory would have on future growth, leaving investors with the misleading impression that the growth in certain KPIs resulted from regular customer demand.

The SEC charged Diageo for violating the antifraud provisions of Section 17(a)(2) and (3) of the Securities Act of 1933, as amended, as well as certain reporting provisions of the federal securities laws. Without admitting or denying the findings in the SEC's order, Diageo agreed to cease and desist from further violations and to pay a $5 million penalty. The full text of the SEC's press release may be accessed here.

MD&A Interpretive Guidance

The SEC announced the charges against Diageo shortly after releasing interpretive guidance regarding the disclosure of KPIs and similar metrics in Management's Discussion and Analysis of Financial Condition and Results of Operations ("***MD&A***"). Although the interpretive guidance, which was released on January 30, 2020, does not materially alter existing disclosure obligations, it reemphasizes that the SEC expects companies to disclose in MD&A the key variables and other factors that management uses to manage the business, which may constitute KPIs and other metrics, to enable investors to view the company "through the eyes of management." The guidance also serves as a reminder that companies should consider what additional information might be necessary in order to provide adequate context for an investor to understand presented metrics.

The SEC stated that it generally expects, based upon the facts and circumstances, the following disclosures to accompany KPIs:

- a clear definition of the metric and how it is calculated;
- a statement indicating the reasons why the metric provides useful information to investors; and
- a statement indicating how management uses the metric in managing or monitoring the performance of the business.

The SEC's guidance also provides that companies should consider whether there are estimates or assumptions underlying the metric or its calculation, and whether disclosure of such estimates or assumptions is necessary for the metric not to be materially misleading.

The SEC also stated that if a company changes the method by which it calculates a metric, it should consider whether to disclose, to the extent material, the following information:

- the differences in the way the metric is calculated or presented compared to prior periods;
- the reasons for such changes;
- the effects of any such change on the amounts or other information being disclosed and on amounts or other information previously reported; and
- such other differences in methodology and results that would reasonably be expected to be relevant to an understanding of the company's performance or prospects.

Depending on the significance of the change and the effects thereof, the SEC also cautioned that it may be necessary to recast prior metrics to conform to the current presentation and place the current disclosure in an appropriate context. The guidance also advises companies with material KPIs to consider whether they have effective controls and procedures in place to process information related to the disclosure of such metrics to ensure accuracy and consistency.

The full text of the SEC's interpretive guidance regarding KPIs may be accessed here.

Conclusion

In light of the enforcement proceedings and the SEC's guidance, companies should review their MD&A disclosures of KPIs and other metrics and consider whether existing metrics should continue to be disclosed and whether the presentation of additional metrics may be warranted. Earnings release disclosures often present additional metrics concerning a company, some of which may constitute KPIs and may be appropriate to disclose in MD&A. It may also be prudent for companies to revisit existing KPI disclosures and consider whether additional context for such disclosures, including definitions and explanations for the use of the metrics, should be provided. Companies may also use this as an opportunity to review their disclosure controls and procedures and consider whether any updates may be necessary to ensure consistency and accuracy of their disclosures of KPIs and other metrics.

For additional information, including guidance regarding disclosure obligations, please contact any member of Haynes Boone's Capital Markets and Securities practice group.