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BNA Insights: Practical Implications of the SEC's Recent Guidance on Non-GAAP Financial Measures

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It is no secret that use of non-GAAP financial measures, which are financial measures that are neither calculated nor presented in accordance with US generally accepted accounting principles (GAAP), has been on the radar of the US Securities and Exchange Commission (SEC) in recent months. In December 2015, SEC Chair Mary Jo White called this an area that ''deserves close attention, both to make sure that our current rules are being followed and to ask whether they are sufficiently robust in light of current market practices'' (available at https://www.sec.gov/news/speech/keynote-2015-aicpa-white.html). In March 2016, *The Wall Street Journal* reported that Chair White told a conference of finance and business lobbyists that the SEC is looking into whether the SEC needs to rein in the current manner of use of non-GAAP financial measures by regulation (available at http://www.wsj.com/articles/sec-scrutinizing-use-of-non-gaap-measures-by-public-companies-1458139473). Wesley R. Bricker, the SEC's deputy chief accountant, observed in a speech in May 2016 that non-GAAP financial measures are a recurring topic on which the SEC's Division of Corporation Finance issues comments when reviewing SEC filings, with comments focusing ''on a company's disclosure as to why their non-GAAP measures are useful; apparent cherry picking adjustments within a non-GAAP measure; and adjustments to remove normal, cash operating expenses'' (available at https://www.sec.gov/news/speech/speech-bricker-05-05-16.html). On May 17, 2016, the SEC's Division of Corporation Finance provided new guidance on the use of non-GAAP financial measures by issuing a dozen new and updated Compliance and Disclosure Interpretations (C&DIs) in this area (available at https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm).

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Background

Regulation G permits public companies to disclose material information that includes a non-GAAP financial measure but only if that measure, whether or not in an SEC filing, is accompanied by a presentation of the most directly comparable GAAP financial measure and by a reconciliation of the differences between the non-GAAP financial measure and the comparable GAAP financial measure. Rule 100(b) of Regulation G prohibits the use of ''a non-GAAP financial measure that, taken together with the information accompanying that measure and any other accompanying discussion of that measure, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading.''

Item 10(e) of Regulation S-K governs the use of non-GAAP financial measures included in SEC filings. It requires that a non-GAAP financial measure be accompanied by a presentation, with equal or greater prominence, of the most directly comparable GAAP financial measure, with a reconciliation to such measure. The filing must disclose the reasons why management believes that presentation of the non-GAAP financial measure provides useful information to investors. Also, there must be a statement disclosing the additional purposes, if any, for which management uses the non-GAAP financial measure. Item 10(e) also contains some express prohibitions on the calculation and presentation of non-GAAP financial measures.

New and Updated C&DIs on Non-GAAP Financial Measures

The new and updated C&DIs provide insight into what the staff of the Division of Corporation Finance (Staff) considers to be misleading use of non-GAAP financial measures and what is considered unacceptable prominence of a non-GAAP financial measure presentation, as well as a few other issues.

Misleading Use of Non-GAAP Financial Measures. The Division of Corporation Finance has added four new C&DIs addressing violations of the prohibition on misleading non-GAAP financial measures contained in Rule 100(b).

C&DI 100.01 makes it clear that, even if certain adjustments are not explicitly prohibited by Regulation G, they can result in a non-GAAP financial measure that is misleading and therefore a violation of Rule 100(b). To illustrate this point, this C&DI states that the presentation of a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a company's business could be misleading. The Staff cross-referenced this new C&DI in C&DI 102.03, which discusses Item 10(e)'s prohibition on adjusting non-GAAP measures to eliminate or smooth out non-recurring items that are likely to recur or have occurred within two years, making such treatment of non-recurring items a general Regulation G concern, rather than just a matter impacting non-GAAP financial measures appearing in documents filed with or furnished to the SEC.

C&DI 100.02 specifies that a non-GAAP measure can be misleading if it is presented inconsistently between periods, such as a measure that adjusts a particular charge or gain in the current period when other, similar charges or gains were not also adjusted in prior periods. According to this C&DI, depending on the significance of the change, it may be necessary to recast prior measures to conform to the current presentation and place the disclosure in the appropriate context.

The Staff has indicated that a non-GAAP financial measure can be misleading if it excludes charges but does not exclude gains. C&DI 100.03 notes that Rule 100(b) may be violated if a non-GAAP measure is adjusted only for non-recurring charges when non-recurring gains occurred during the same period.

C&DI 100.04 addresses the presentation of a non-GAAP performance measure that is adjusted to accelerate revenue recognized ratably over time in accordance with GAAP as though it earned the revenue when customers are billed. This C&DI concludes that such a measure cannot be presented in documents filed with or furnished to the SEC or provided elsewhere, such as on a company's website, because that type of non-GAAP measure substitutes individually tailored revenue recognition and measurement methods for GAAP methods, which could violate Rule 100(b) of Regulation G. This C&DI also specifies that other measures that use individually tailored recognition and measurement methods for financial statement line items other than revenue may also violate Rule 100(b) of Regulation G.

Impermissible Prominence of Non-GAAP Financial Measures. While noting that whether a non-GAAP financial measure presentation is more prominent than the comparable GAAP measure is a question of facts and circumstances, revised C&DI 102.10 provides the following eight examples of presentations in which the Staff would consider the non-GAAP disclosures to be impermissibly prominent:

- Presenting a full income statement of non-GAAP measures or presenting a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures;
- Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures;
- Presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure;
- A non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption);
- Describing a non-GAAP measure as, for example, ''record performance'' or ''exceptional'' without at least an equally prominent descriptive characterization of the comparable GAAP measure;
- Providing tabular disclosure of non-GAAP financial measures without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table;
- Excluding a quantitative reconciliation with respect to a forward-looking non-GAAP measure in reliance on the ''unreasonable efforts'' exception in Item 10(e)(1)(i)(B) without disclosing that fact and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence; and
- Providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence.

Prohibitions on Per Share Presentations of Non-GAAP Financial Measures. C&DI 102.05 confirms that certain non-GAAP earnings per share measures may be permissible if they are *performance measures* that are reconciled to GAAP earnings per share but emphasizes

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that a non-GAAP *liquidity measure* that measures cash generated must not be presented on a per share basis in documents filed with or furnished to the SEC. The Division of Corporation Finance updated this C&DI to warn that when the Staff analyzes the question of whether a financial measure can be reported on a per share basis, it will focus on the substance of whether the non-GAAP measure could be used as a liquidity measure and not management's characterization of it solely as a performance measure.

The Staff clarified two other C&DIs in light of revised C&DI 102.05. The Staff supplemented C&DI 102.07 to specify that free cash flow is a liquidity measure that must not be presented on a per share basis. The Staff also updated C&DI 103.02, which discusses the GAAP performance measure to which EBIT or EBITDA should be reconciled, to specify that EBIT and EBITDA must not be presented on a per share basis.

Funds from Operations. The revised C&DIs address per share presentations in the context of funds from operations (FFO) per share as a non-GAAP measure in earnings releases and materials that are filed with or furnished to the SEC. C&DI 102.01 accepts the FFO definition of the National Association of Real Estate Investment Trusts (NAREIT) that was in effect as of May 17, 2016 as a performance measure and does not object to a per share FFO presentation when FFO is presented based on the NAREIT definition. While C&DI 102.02 recognizes that FFO can be presented other than as defined by NAREIT, adjustments for such an FFO presentation must comply with the requirements of Item 10(e) for a performance measure or a liquidity measure, and some of those adjustments may trigger the prohibition on presenting this measure on a per share basis.

Income Tax Effects. Revised C&DI 102.11 specifies that companies should provide income tax effects on non-GAAP measures depending on the nature of the measures. For example, if a measure is a *liquidity measure* that includes income taxes, the C&DI specifies that it might be acceptable to adjust GAAP taxes to show taxes paid in cash. The C&DI indicates that if a measure is a *performance measure*, the company should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. C&DI 102.11 provides that adjustments to arrive at a non-GAAP measure should *not* be presented ''net of tax.'' Rather, income taxes should be shown as a separate adjustment and clearly explained.

Practical Considerations

Importance of Prompt Review and Implementation of New Guidance. The new and updated C&DIs on non-GAAP financial measures provide current guidance from the Division of Corporation Finance in an area that the SEC has previously signaled as being of concern. Therefore, public companies should review these new interpretations carefully and as soon as possible in light of both current and future use of non-GAAP financial measures.

Because the new interpretations apply immediately, including with respect to recently, or soon to be, closed fiscal periods, public companies should review their use of non-GAAP financial measures in public documents and communications to determine whether they need to make any changes to conform to the Staff's guidance and, in the case of inconsistency between periods, to consider recasting those in prior periods. If a revised approach is advisable based on any of the new or updated C&DIs, it would be helpful for the company to prepare and review revised presentations well ahead of the date they will be used. Companies should allow sufficient time to work through in advance any disclosure issues in earnings releases or SEC filings that might arise from compliance with the new interpretations.

While the C&DIs reflect Staff positions rather than formal SEC rule amendments, public companies should expect that the Staff will be using these recent interpretations when issuing comment letters involving the use of non-GAAP financial measures. *The Wall Street Journal* reported that Mark Kronforst, the chief accountant of the Division of Corporation Finance, predicted an ''uptick'' soon in the number of SEC comments due to mounting concerns regarding non-GAAP metrics and stated that ''next quarter will be a great opportunity for companies to self-correct'' (available at http://www.wsj.com/articles/sec-tightens-crackdown-on-adjusted-accounting-measures-1463608923). Companies should make an effort to incorporate the guidance of the new and updated C&DIs into non-GAAP presentations that they use in their next SEC filings and earnings releases.

In particular, public companies using non-GAAP financial measures should evaluate whether any of the ways they present non-GAAP financial measures (including earnings releases, investor presentations and SEC filings) could be considered misleading or, to the extent included in documents filed with or furnished to the SEC, as having too great a prominence in light of the new Staff guidance. Companies that have been providing non-GAAP financial measures on a per share basis should determine whether their presentations are consistent with the revised C&DIs on that subject.

The addition of Section 100 to the non-GAAP C&DIs, with each question in that series addressing issues of misleading non-GAAP financial measures under Regulation G, is indicative of concerns that the SEC has with respect to the calculation of non-GAAP financial measures, especially with respect to treatment of recurring and non-recurring items. The impact of these new C&DIs may be especially strong because they affect the use of non-GAAP financial measures without regard to whether they are contained or incorporated in documents filed with or furnished to the SEC. In this regard, companies should keep in mind that the SEC may issue comments on non-GAAP financial measures that are not part of SEC documents, such as earnings call transcripts.

Considering the New Guidance in Context. In conjunction with reviewing the new guidance on non-GAAP financial measures, it would be useful for companies to evaluate their reasons for using particular non-GAAP financial measures, as well as to consider whether they have adequate controls in place with respect to the use of such measures. It would be a good idea for companies to double check that their presentations of non-GAAP financial measures generally comply with the applicable rules and pre-existing guidance for non-GAAP financial measures. For example, some comments that were issued before the new guidance was released addressed basics relating to disclosure of non-GAAP financial measures, such as providing required reconciliations to GAAP, disclosing the reasons that management believes the presentation provides useful information to investors, and describing the purposes for which management uses the non-GAAP financial measures being presented. When reviewing the use of non-GAAP financial measures, the Staff will consider whether the disclosure complies with long-standing rules, as well as application of the new guidance.

Many recent comment letters on non-GAAP financial measures have focused on non-GAAP measures that are given titles that are the same or confusingly similar to titles used for GAAP measures, noting, for example, that non-GAAP adjusted amounts should be given titles such as *adjusted* revenues or *adjusted* operating income. Since publicly available comment letters indicate that the Staff is on the alert for non-GAAP financial measures titled in ways that may be considered confusingly similar to GAAP financial measures, it would be productive for companies to confirm that the titles they assign to their non-GAAP measures are clearly distinguishable from GAAP measures.

A review of SEC comment letters issued during the period leading up to the issuance of the new C&DIs may provide insights into the concerns underlying the recent guidance. For example, while C&DI 102.10 now contains a litany of examples of undue prominence of non-GAAP measures, previously this C&DI only referenced the presentation of a full non-GAAP income statement. Recent comment letters addressing full non-GAAP income statements have further explained what the Staff sees as problematic—the full non-GAAP income statement may give the impression that the non-GAAP income statement represents a comprehensive basis of accounting. While some companies have simply acquiesced to the Staff's request for full non-GAAP income statements to be removed, there have been some instances where companies have pushed back to negotiate changes to the presentations short of complete deletion. Companies facing this issue may find the discussions in such letters helpful. However, the comment letters and the new guidance make clear that the Staff is likely to object if a presentation is susceptible to being characterized as a full non-GAAP income statement.

With the predicted ''uptick'' in SEC comments on non-GAAP financial measures, on a going-forward basis, companies should review comment letters that their peer companies and other issuers receive on this topic. SEC comment letters, and company responses to them, become publicly available on the SEC's EDGAR website no earlier than 20 business days or more after the Staff has completed the review process or declared the registration statement effective. Because many companies will be self-policing their non-GAAP financial measures at this time, it is useful to monitor peer company earnings releases, investor presentations and SEC filings as they become available to see how others in their industry are revising non-GAAP presentations.

Involvement of Various Corporate Departments. The SEC's new guidance is relevant not only to the legal team and the accounting team responsible for drafting SEC filings. Because some of the C&DI positions expressly apply to non-GAAP financial measures presented in press releases, companies should also have representatives from their public relations and investor relations departments review this new guidance.

Some of the C&DI guidance relates to design elements, particularly C&DI 102.10. C&DI 102.10 not only provides guidance as to how information should be presented in the body of a press release, but in the caption as well. Therefore, all key persons involved in the preparation of earnings releases should be made aware that non-GAAP measures must not be included in a headline or caption without the comparable GAAP measure also appearing in that headline or caption and that the non-GAAP measure cannot appear before the comparable GAAP measure, including in the headline or caption of the press release. Key persons must also understand that the non-GAAP financial measure cannot be emphasized, for example, through the use of boldface or larger font.

Foreign Private Issuers. The impact of the new guidance on non-GAAP financial measures on foreign private issuers is nuanced. For example, Regulation G provides an exemption for foreign private issuers if specified conditions are satisfied. Although Item 10(e) of Regulation S-K applies to foreign private issuers that include non-GAAP financial measures in a filing with the SEC, prohibitions on the use of non-GAAP financial measures specified by Item 10(e)(1)(ii) of Regulation S-K do not apply to foreign private issuers when specified conditions are met. In addition, for Canadian issuers subject to the Multi-Jurisdictional Disclosure System, previously issued C&DI 106.04 specified that information included in a Form 40-F is *not* subject to Regulation G or Item 10(e). Foreign private issuers will need to carefully consider their particular circumstances to determine the extent to which the new guidance is applicable to them. Even when compliance is not technically necessary, foreign private issuers may wish to evaluate the extent to which their investors in the United States may expect their non-GAAP measures to conform to the SEC's latest interpretations.

Audit Committee Involvement. Public companies should update their audit committees on the Division of Corporation Finance's new positions with respect to non-GAAP financial measures and the extent to which such interpretations may affect their SEC filings and earnings releases. Given the public scrutiny that non-GAAP financial measures have received recently, culminating in the new and expanded C&DIs, some audit committees may choose to increase their oversight of non-GAAP presentations.

