SEC Update
June 2, 2016

# SEC staff issues important new guidance on use of non-GAAP financial measures

On May 17, the SEC's Division of Corporation Finance issued new and revised Compliance and Disclosure Interpretations (C&DIs) on the use of non-GAAP financial measures by public companies. The publication of the updated interpretations followed recent statements by SEC officials expressing concern over the ways in which some companies are using non-GAAP financial measures. The issuance of the new guidance signals a renewed focus by the SEC on compliance with its rules regulating these non-GAAP disclosures.

The updated C&DIs are available here and are identified by their issue date of May 17, 2016.

## Background

Public companies have long used non-GAAP financial measures in their SEC filings and other public disclosures to enhance investor understanding of their business and operating results. Over the years, the SEC and its staff have reminded companies that disclosure of non-GAAP financial measures is subject to the anti-fraud provisions of the federal securities laws. The staff has issued advice cautioning companies that the use of non-GAAP financial measures could mislead investors, particularly when companies do not clearly disclose the adjustments made to GAAP financial measures or when non-GAAP measures present a materially different picture of the company's performance than GAAP measures.

In 2003, as required by the Sarbanes-Oxley Act, the SEC adopted Regulation G and Item 10(e) of Regulation S-K to implement the statutory mandates that publicly disclosed non-GAAP financial measures be presented in a manner that is (1) not materially misleading and (2) reconciled with GAAP. Following the staff's issuance in 2003 of "frequently asked questions" about the new rules, there was little published staff guidance on the use of non-GAAP financial measures until the Division of Corporation Finance issued C&DIs on the rules in January 2010. The 2010 guidance reflected a more flexible approach by the SEC staff on a number of interpretive issues.

The guidance issued on May 17 should be considered against the background of recent statements by Commissioners and the SEC staff expressing concern over increasingly widespread non-GAAP disclosure practices that they view as inconsistent with the requirements of Regulation G and Item 10(e). In speeches delivered in December 2015 and March 2016, SEC Chair Mary Jo White said that CEOs "love the non-GAAP measures because they tell a 'better' story" than GAAP results and that the use of non-GAAP measures "deserves close attention" to ensure that the SEC's rules are being followed and that those rules are "sufficiently robust in light of current market practices." The Chief Accountant of the Division of Corporation Finance subsequently indicated that the SEC intends to "crack down" on the use of non-GAAP measures. He added that "the pendulum has swung" from the generally more deferential approach to the disclosure of non-GAAP financial measures which the SEC staff has observed since it issued the 2010 guidance.

## Regulation G and Item 10(e)

Regulation G and Item 10(e) define a "non-GAAP financial measure" as a numerical measure of a company's historical or future financial performance, financial position or cash flows that:

- Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the company; or
- Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable GAAP measure so calculated and presented.

The application of Regulation G and Item 10(e) varies with the nature of the public disclosure in which a company presents non-GAAP financial measures. A company must consider the application of three progressively more comprehensive compliance requirements:

- *Regulation G (all public disclosures)* . Regulation G applies whenever a company, or a person acting on its behalf, publicly discloses material information, whether orally or in written or electronic form, that includes a non-GAAP financial measure. Accordingly, Regulation G applies not only to SEC filings and earnings releases furnished under Form 8-K, but also to investor presentations and other documents publicly disclosed by a company. Under the two key mandates of Regulation G, the company must present (1) each non-GAAP financial measure in a way that is not false or misleading to investors and (2) the most directly comparable GAAP financial measure, together with a clearly understandable quantitative reconciliation of the non-GAAP measure to the GAAP measure.
- *Item 10(e)(1)(i) of Regulation S-K (furnished earnings releases)* . Non-GAAP disclosure contained in earnings releases "furnished" (rather than "filed") under Item 2.02 of Form 8-K must comply with the requirements of paragraph (1)(i) of Item 10(e) in addition to Regulation G. Under the Item 10(e) requirements, the company must disclose (1) a presentation, with "equal or greater prominence," of the most directly comparable GAAP financial measure or measures and (2) a statement that discloses (a) the reasons why management believes the non-GAAP presentation provides useful information to investors and (b) to the extent material, any additional purposes for which management uses the non-GAAP measures.
- *Item 10(e) of Regulation S-K (SEC filings).* With limited exceptions, the full requirements of Item 10(e) apply to non-GAAP disclosures contained in reports, registration statements and other information filed with the SEC. In addition to the affirmative disclosure requirements of paragraph (1)(i) discussed above, Item 10(e) specifically prohibits specified adjustments to GAAP measures and other presentation practices considered to be misleading.

## New and revised C&DIs

The 12 C&DIs issued by the SEC staff on May 17 provide insight into the types of non-GAAP financial measures the staff considers to be potentially misleading. The staff also summarizes its views on the application of the "equal or greater prominence" requirement of Item 10(e)(1)(i), the use of non-GAAP per share measures, the disclosure of funds from operations, and the calculation and presentation of income tax effects related to adjustments.

The new guidance largely represents a summary of staff positions expressed over the years in comment letters issued by the SEC staff in connection with its review of non-GAAP financial measures disclosed in filed documents and earnings releases. Like the staff comment letters, the C&DIs consist of conclusory observations that provide little in the way of reasoned elaboration or any sustained engagement with the central concepts underpinning the guidance.

***New guidance on non-GAAP financial measures that could be misleading.*** The SEC staff identifies in four new C&DIs a number of non-GAAP financial measures that in its view "could" be misleading and therefore "could" or "may" violate Rule 100(b) of Regulation G. Rule 100(b) states that a company may not present 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." Given the facts-and-circumstances evaluation generally required for materiality determinations, the staff stops short of concluding that the non-GAAP financial measures highlighted in its guidance necessarily are misleading. It appears, however, that any company departing from this guidance could bear a significant burden in convincing the staff that its presentation is not misleading within the meaning of Rule 100(b).

The staff highlights in the C&DIs the following non-GAAP financial measures that it believes could be misleading:

- *Certain adjustments, even if not explicitly prohibited.* The staff indicates that "certain" adjustments to GAAP measures, even though not explicitly prohibited by Regulation G, may violate Rule 100(b) "because they cause the presentation of the non-GAAP measure to be misleading." The staff cites, as one example of a problematic adjustment, the presentation of a performance measure that excludes normal, recurring cash operating expenses necessary to operate a company's business. (Question 100.01) The staff has added a reference to this guidance in a C&DI issued in January 2010 in which the staff indicates that, subject to Regulation G and applicable requirements of Item 10(e), a company is not precluded from adjusting a GAAP measure for a charge or gain by the fact that the company cannot describe the charge or gain as non-recurring, infrequent or unusual. (Question 102.03)
- *Non-GAAP adjustments presented inconsistently between periods.* Companies using non-GAAP measures sometimes expand the number and type of adjustments over time as new events occur that they believe warrant an adjustment to provide investors with a more meaningful picture of the company's operating performance. The staff cautions that a company could be providing misleading disclosure if a non-GAAP measure is presented inconsistently between periods, such as where a non-GAAP measure adjusts a particular charge or gain in the current period but other, similar charges or gains were not also adjusted in prior periods. The staff indicates that the company can address the potentially misleading nature of such an inconsistent presentation by disclosing the change between periods and explaining the reasons for the change. The staff adds, that, "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." (Question 100.02) As a result of this guidance, when deciding to make an adjustment to a non-GAAP measure for a particular period, companies should consider whether they intend to make similar adjustments for future periods, a decision that should take into account the guidance discussed below with respect to excluding charges without excluding gains.
- *Exclusion of charges without exclusion of gains*. The staff warns that a non-GAAP measure could be misleading if it excludes charges, but does not exclude any gains. The staff indicates that a non-GAAP measure could violate Rule 100(b) of Regulation G if it is adjusted only for non-recurring charges when there were non-recurring gains that occurred during the same period. (Question 100.03)
- *Presentation of individually tailored recognition and measurement methods.* The staff identifies as potentially misleading any non-GAAP measure that substitutes "individually tailored revenue recognition and measurement methods" for those of GAAP. The staff specifically finds troublesome a non-GAAP performance measure that is adjusted to accelerate revenue recognized ratably over time in accordance with GAAP as though the company earned revenue when its customers are billed. The staff emphasizes that a company could violate Rule 100(b) of Regulation G by using individually tailored recognition and measurement methods for financial statement line items other than revenue. (Question 100.04)

***New guidance on presentation of GAAP measures with "equal or greater prominence."*** Paragraph (1)(i) of Item 10(e) requires companies disclosing non-GAAP financial measures in SEC filings and in earnings releases furnished in a Form 8-K report to present the most directly comparable GAAP financial measure "with equal or greater prominence." In the absence of published guidance on the types of presentations that would comply with this requirement, market practice has evolved to encompass a wide variety of approaches, particularly in the context of highlighting non-GAAP results in earnings releases. The SEC staff has questioned some of those approaches in the comment letter process. Now, in a new C&DI, the staff has assembled a list of the presentations that it considers non-compliant.

The staff prefaces its guidance on this presentation issue with the statement that whether a non-GAAP measure is more prominent than the comparable GAAP measure generally depends on the facts and circumstances in which the disclosure is made. The staff then indicates that, notwithstanding this facts-and-circumstances analysis, it "would consider the following examples of disclosure of non-GAAP measures as more prominent" than the comparable GAAP measures and therefore as failing to comply with the "equal or greater prominence" requirement:

- 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 that disclosure with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table; and
- Providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location of equal or greater prominence. (Question 102.10)

The SEC staff also identifies as non-compliant a presentation that excludes a reconciliation of a forward-looking non-GAAP measure in reliance on the "unreasonable efforts" exception in Item 10(e)(1)(i)(B) without disclosing the exclusion and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence. This aspect of the C&DI refers to the provision in Item 10(e), which is also found in Rule 100(a) of Regulation G, that permits a company to present a forward-looking non-GAAP measure without providing a reconciliation to the most directly comparable forward-looking GAAP measure if reconciling information is not available without "unreasonable efforts." The guidance refers to the SEC's statement in its 2003 release (No. 34-47226) adopting Regulation G and Item 10(e) that a company relying on the exception must identify the reconciling information that is unavailable and disclose the probable significance of that information. Many companies that use forward-looking non-GAAP measures do not provide reconciliations to the comparable forward-looking GAAP measures and include only limited references to the unavailability of reconciling information. While this C&DI focuses companies on where to disclose such information, it also provides a reminder of the nature of the disclosure required to rely on the "unreasonable efforts" exception, particularly with respect to the probable significance of the unavailable information.

***Other guidance.*** The SEC staff also issued interpretations relating to a number of other common compliance issues.

- *Non-GAAP per share measures*. The staff has updated its guidance concerning the circumstances in which a company may use non-GAAP per share numbers in documents filed or furnished with the SEC. The staff confirms, consistent with its prior guidance, that although companies may use non-GAAP per share *performance measures* (which should be reconciled to GAAP earnings per share), they may not present non-GAAP *liquidity measures* (characterized in the updated guidance as numbers that "measure cash generated") on a per share basis, because such per share measures are specifically prohibited in financial statements under GAAP. The staff clarifies that whether per share data are prohibited depends on whether the non-GAAP measure "can be used as a liquidity measure" even if management presents the measure solely as a performance measure. The staff indicates that, in evaluating use of a non-GAAP per share measure, it will not defer to management's characterization, but instead will focus its review on the substance of the measure and whether the measure can be used as a liquidity measure. (Question 102.05)

  Consistent with positions it has expressed in comment letters, the SEC staff also has updated its guidance to confirm that it views free cash flow, EBIT and EBITDA as liquidity measures that must not be presented on a per share basis. (Questions 102.07, 103.02) This position does not preclude the use of EBIT or EBITDA as a performance measure that should be reconciled to net income.
- *Funds from operations (FFO).* The adopting release for Regulation G and Item 10(e) provides that companies may use the non-GAAP financial measure styled as "funds from operations" (FFO), a measure commonly used by real estate investment trusts, on a per share basis. The SEC has updated its guidance on this measure to note that it accepts the National Association of Real Estate Investment Trusts (NAREIT) definition of FFO in effect as of May 17, 2016 as a performance measure and does not object to the presentation of FFO on a per share basis. (Question 102.01)

  The staff also clarifies the limits to presentation of FFO on a basis other than that defined by NAREIT as of May 17, 2016. Any adjustments to FFO as so defined by NAREIT must comply with the requirements of Item 10(e) for a performance measure or a liquidity measure (depending on the nature of the adjustments), and the resulting non-GAAP measure must not be misleading in violation of Rule 100(b) of Regulation G. Referring to its revised guidance on the prohibition of non-GAAP per share measures that can be used as liquidity measures, the staff indicates that some of the adjustments may trigger a prohibition on presenting the adjusted FFO measure on a per share basis. (Question 102.02)
- *Income tax effects related to adjustments*. The SEC staff has withdrawn a prior C&DI stating that companies may present an adjustment "net of tax" when reconciling a non-GAAP performance measure to the most directly comparable GAAP measure so long as they also disclose how they calculated the tax effect. A new C&DI states that companies should not present as "net of tax" adjustments made to arrive at a non-GAAP measure, but instead should show income taxes as a separate adjustment and clearly explain the adjustment. The staff also indicates that a company "should provide income tax effects on its non-GAAP measures depending on the nature of the measures." The staff explains that, if a measure is a liquidity measure that includes income taxes, it "might be acceptable" to adjust GAAP taxes to show taxes paid in cash. 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. (Question 102.11)

## Looking ahead

Taken together, the recent remarks from the SEC and its staff and the new and revised C&DIs reflect a renewed intention of the staff to keep close tabs on the use of non-GAAP financial measures and to hold companies accountable for presentations the staff considers to be misleading. The Chief Accountant of the Division of Corporation Finance stated at a meeting of the Public Company Accounting Oversight Board's standing advisory group on May 18, 2016 that the SEC staff believes it will issue an increased number of comments objecting to the use or presentation of non-GAAP measures in the coming months. Although the SEC official clarified that this ramp-up will not take place overnight, companies nevertheless should begin now to evaluate their approach to compliance with the requirements of Regulation G and Item 10(e) in light of the staff's updated guidance. The Chief Accountant observed that "this next quarter will be a great opportunity for companies to self-correct." With thoughtful application of the new guidance, companies should continue to be able to present non-GAAP financial measures that are important to their investors in a manner that satisfies legal requirements.

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