Non-GAAP Financial Measures: New SEC Scrutiny

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Senior ***SEC*** officials have recently expressed concerns with some public companies' disclosure practices relating to non-GAAP financial measures.[1] For example, SEC Chair White recently spoke of having significant concerns about issuers who take non-GAAP measures "too far and beyond what is intended and allowed by [the SEC's] rules." Such concerns appear to have prompted, at least in part, the staff of the SEC's Division of Corporation Finance (Staff) to issue in May 2016 four new and eight updated compliance and disclosure interpretations regarding non-GAAP measures, which are available here. The Staff's guidance addresses what Chair White called "troublesome practices which can make non-GAAP disclosures misleading."

Recent studies show that the use of non-GAAP measures has increased sharply. Media reports claim that issuers use non-GAAP measures to "steer investors to … massaged calculations that produce a better outcome" in "today's freewheeling accounting world."[2] In the media spotlight, inappropriate disclosure of non-GAAP measures may risk reputational harm as well as SEC scrutiny.

To comply with the new and updated Staff guidance, issuers that plan to disclose non-GAAP financial measures in their earnings releases, investor presentations and periodic reports and on their websites may need to modify their disclosure practices. SEC Chair White recently strongly urged issuers to consider the Staff's updated guidance and "revisit their approach to non-GAAP disclosures."

Issuers should expect the Staff to intensify their issuance of comments on non-GAAP disclosures. Staff comments may challenge the use or calculation of non-GAAP measures, and, in the future, an issuer may need to correct any disclosures of non-GAAP measures in its SEC filings that the Staff views as violating the non-GAAP rules in addition to discontinuing such disclosures in future filings and other investor communications. Chair White and others have indicated that non-GAAP disclosures that do not comply with SEC rules could result in enforcement actions[3] and that the SEC may adopt "further rulemaking if necessary to achieve the optimal disclosures for investors and the markets."

This client alert summarizes the Staff's recent guidance and briefly reviews the basic requirements of Regulation G and Item 10(e) of Regulation S-K.

The Basics: SEC Non-GAAP Financial Measure Disclosure Requirements

Regulation G. Regulation G governs an issuer's public disclosure of material information that includes a non-GAAP financial measure in any context, whether orally or in writing (and whether or not filed with or furnished to the SEC). Under Regulation G, disclosure of a non-GAAP measure must be "accompanied" by:

- *Disclosure of the comparable GAAP measure:* disclosure of the most directly comparable financial measure calculated and presented in accordance with GAAP; and
- *Reconciliation:* a reconciliation of the differences between the non-GAAP measure and the GAAP measure, which must be quantitative for (1) historical non-GAAP measures presented and (2) to the extent "available without unreasonable efforts," for forward-looking information.

As an overriding requirement, Regulation G also provides that a non-GAAP measure, taken together with the accompanying information, must not be misleading.[4]

Regulation S-K. In addition to requiring disclosure of the comparable GAAP measure and a reconciliation, Item 10(e) requires that non-GAAP measures disclosed in documents filed with the SEC or furnished to the SEC under Item 2.02 of Form 8-K (including in earnings releases furnished under that item) must also include:

- *Prominence:* a presentation of the most directly comparable GAAP measure with a prominence equal to or greater than that of the non-GAAP measure;
- *Statement of reasons:* a statement of the reasons why the issuer's management believes disclosure of a non-GAAP measure provides useful information to investors about the issuer's financial condition and results of operations; and
- *Other uses:* if material, a statement of any additional purposes for which the issuer's management uses the non-GAAP measure.

Item 10(e) expressly prohibits issuers from engaging in the following practices in documents filed with the SEC:

- *Cash-settled amounts:* excluding charges or liabilities that required or will require cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP liquidity measures other than EBIT and EBITDA;
- *"Non-recurring" or "one-time" items:* adjusting non-GAAP performance measures to eliminate or "smooth" items identified as non-recurring, infrequent or unusual items if the nature of the gain or charge so identified is such that it or a similar item is reasonably likely to recur within the next two years or has occurred within the past two years;
- *Financial statements:* presenting non-GAAP measures in GAAP historical or *pro forma* financial statements and the accompanying notes; and
- *Confusing titles:* using titles for non-GAAP financial statements that are the same as, or

confusingly similar to, the titles of GAAP measures.

Recent Staff Guidance

Certain non-GAAP financial measures are potentially misleading (Questions 100.01 - 100.04). Four new interpretations focus on whether disclosures of non-GAAP financial measures may be misleading in violation of Regulation G. Potentially misleading practices singled out by the Staff include:

- *Exclusion of necessary cash expenses:* making certain adjustments, even though not explicitly prohibited, such as adjusting a performance measure to exclude normal, recurring, cash operating expenses necessary to operate the issuer's business;

- *Inconsistent calculations:* presenting non-GAAP measures that are calculated in an inconsistent manner between periods, such as adjusting for a particular charge or gain in one period and not for a similar charge or gain in a comparable prior or subsequent period, unless the issuer discloses the change in calculation methods between periods and explains the reasons for the change;[5]

- *Unbalanced adjustments:* adjusting a non-GAAP measure by excluding a non-recurring charge and including a non-recurring gain in the same period (a practice Chair White refers to as "cherry-picking");

- *Modifications to revenue recognition:* disclosing a non-GAAP measure adjusted to accelerate revenue recognized ratably over time in a manner inconsistent with GAAP revenue recognition standards; and

- *Customized calculation methods:* disclosing other non-GAAP measures calculated using individually tailored recognition and measurement methods for financial statement line items other than revenue.

Certain disclosure practices may involve an impermissible presentation of a non-GAAP measure with greater prominence than the most directly comparable GAAP measure (Question 102.10). The Staff has identified practices that improperly provide greater prominence for the non-GAAP measure than for the most directly comparable GAAP measure in violation of Item 10(e), including:

- *Order of presentation:* having the non-GAAP measure precede the most directly comparable GAAP measure, including in an earnings release headline or caption;

- *Omission from title:* omitting the comparable GAAP measure from an earnings release headline or caption that includes a non-GAAP measure;

- *Style:* using a style of presentation to emphasize a non-GAAP measure over the comparable GAAP measure, such as presenting the non-GAAP measure in boldface type or a larger font size than the GAAP measure;

- *Narrative (non-numeric) description:* describing a non-GAAP measure as, for example, "record performance" or "exceptional" without making at least an equally prominent descriptive characterization of the comparable GAAP measure;

- *Tabular disclosure:* presenting tabular disclosure of a non-GAAP measure without preceding it with an equally prominent tabular disclosure of the comparable GAAP measure or including the comparable GAAP measure in the same table;

- *Forward-looking statements:* relying on the "unreasonable efforts" exception in Item 10(e)(1)(i)(B) to exclude a quantitative reconciliation of a forward-looking non-GAAP measure with the most directly comparable GAAP measure without disclosing, in a location that is of equal or greater prominence, that reliance and identifying the unavailable information and its probable significance;

- *Disproportionate discussion and analysis:* providing discussion and analysis of a non-GAAP measure without providing a similar discussion and analysis of the most directly comparable GAAP measure in a location of equal or greater prominence; and

- *Full non-GAAP income statement:* 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.

Some of the Staff's recent positions appear to expand the prominence requirement beyond the scope of Item 10(e).

Item 10(e)'s prohibition on adjustments to eliminate or smooth items identified as non-recurring, infrequent or unusual is based on the description, not the nature, of the adjustment (Question 102.03). Staff guidance affirms that Item 10(e) prohibits *describing* an item used to adjust a non-GAAP measure as being "non-recurring, infrequent or unusual" if such item is reasonably likely to recur within two years or a similar charge or gain occurred within the past two years. However, as long as the adjustment is not inappropriately characterized as non-recurring, infrequent or unusual, the item may be used to adjust a non-GAAP measure that otherwise meets the SEC's non-GAAP requirements.

Certain non-GAAP performance measures, but not non-GAAP liquidity measures, may be presented on a per share basis (Question 102.05). Issuers may not disclose non-GAAP liquidity measures on a per share basis in materials filed with or furnished to the SEC even if such measures are labeled as performance measures. However, true performance measures (other than EBIT, EBITDA and other per share measures specifically prohibited under GAAP and other SEC rules) can be disclosed on a per share basis if reconciled to GAAP earnings per share. The Staff will analyze per share disclosures based on the substance of the non-GAAP measure disclosed and whether the measure can be used as a liquidity measure, not based on management's characterization of the measure. This position prohibiting per-share liquidity measures is a common area for Staff comment letters.

Issuers may disclose "free cash flow," but not on a per share basis (Question 102.07). Free cash flow, which is often calculated as net cash provided by operating activities net of capital expenditures, cannot be presented on a per share basis in documents filed with the SEC. When disclosing a free cash flow measure, an issuer should clearly describe the method of calculation and avoid "potentially misleading" statements as to the usefulness of free cash flow in assessing financial performance. In particular, an issuer should not imply that free cash flow represents residual cash flow available for discretionary expenditures if the issuer does not deduct its required expenditures (for example, mandatory debt service) in calculating the measure.

Income tax effects should be provided for in the calculation of a non-GAAP measure depending on the nature of the particular non-GAAP measure (Question 102.11). If a non-GAAP liquidity measure includes the effect of income taxes, the Staff noted that it "might be acceptable" to adjust GAAP taxes and show taxes paid in cash. Non-GAAP performance measures "should include" both current and deferred income tax expense commensurate with the non-GAAP measure of profitability. Adjustments of the non-GAAP measure should not be shown in the reconciliation "net of tax," but rather the income tax adjustment should appear on a separate line in the reconciliation with an explanation.

EBIT or EBITDA presented as a performance measure should be reconciled to GAAP net income, not operating income, and cannot be presented on a per share basis (Question 103.02). Presentations of EBIT and EBITDA as performance measures are an exception to the principle that performance measures can be presented on a per share basis. Because EBIT and EBITDA make adjustments for items (for example, income tax and interest expense) that are not included in the calculation of operating income, the Staff takes the position that reconciliation should be made to GAAP net income rather than operating income.

REITs may disclose funds from operations (FFO) on a per share basis subject to compliance with the SEC's non-GAAP requirements (Questions 102.01 and 102.02). The Staff accepts the National Association of Real Estate Investment Trusts' (NAREIT) definition of FFO in effect as of May 17, 2016 as a performance measure (rather than a liquidity measure) and does not object to its presentation on a per share basis. Issuers may present FFO on a basis other than as defined by NAREIT as of May 17, 2016, provided that the measure is not misleading and any adjustments to the measure comply with Item 10(e) for a performance measure or a liquidity measure. However, any adjustments made to NAREIT's FFO definition may trigger the prohibition on presenting the measure on a per share basis (that is, if the adjustments could result in FFO being used as a liquidity measure).

Practical Considerations

Discuss the Staff's guidance with management and the audit committee. Senior SEC officials have expressly highlighted the need for more audit committee oversight of non-GAAP disclosures. An issuer's management and audit committee should be briefed on the rules and Staff interpretations as applied to the issuer's particular disclosures of non-GAAP measures, including the methodologies used for the measure's calculation and the nature of the adjustments made in calculating the non-GAAP measures, and whether the issuer uses a particular non-GAAP measure as a liquidity or performance measure.

- *NYSE rules.* In particular, a NYSE-listed issuer should consider the commentary to NYSE Listed Company Manual Section 303A.07(b), requiring the audit committee to review "the type and presentation of information to be included in earnings press releases (paying particular attention to any use of 'pro forma,' or 'adjusted' non-GAAP, information), as well as review any financial information and earnings guidance provided to analysts and rating agencies."

- *Quarterly review and reassessment.* The quarterly financial review before filing the Form 10-Q affords a regular opportunity for management and the audit committee to reassess appropriateness and compliance of non-GAAP measures.

Take a fresh look at all non-GAAP disclosures. The Staff's updated guidance is not exhaustive, especially the examples of practices deemed to be misleading or to violate Item 10(e)'s prominence requirement. Accordingly, issuers should reassess all of their disclosures containing non-GAAP measures in whatever contexts those disclosures appear (for example, in their earnings call talking points, proxy statements and issuer websites, as well as in earnings releases). Issuers should benchmark their disclosures against the requirements of Regulation G and, for SEC filings and earnings releases, applicable requirements of Item 10(e), as well as the Staff's guidance, to ensure compliance. In such a reassessment, issuers should:

- *Consider whether non-GAAP disclosures might be viewed as misleading.* Non-GAAP disclosures might be viewed as misleading even if they do not involve any explicitly prohibited adjustments or other rule violations. Specific descriptions of how non-GAAP measures are calculated, their purpose and their usefulness (avoiding boilerplate) may reduce the risk that non-GAAP disclosures are later claimed to be misleading.

- *Consider the Staff's broad interpretation of the prominence requirement.* Some examples cited by the Staff as violating the prominence requirement are fairly common in current practice. For example, issuers that disclose a non-GAAP measure as "record performance" or "exceptional" (without any numerical amounts) should now make at least an equally prominent descriptive characterization of the comparable GAAP measure. Although the prominence requirement of Item 10(e) generally applies only to SEC filings and earnings releases, other public disclosures inconsistent with Item 10(e)'s prominence requirements might nonetheless be deemed to be misleading in violation of Regulation G.

- *Confirm that non-GAAP performance or liquidity measures are consistent with the manner in which the issuer earns revenue, incurs expenses and generates cash flow.* For example, an adjusted EBITDA measure should be calculated consistently using the same principles of revenue and expense recognition used in the issuer's GAAP financial statements.

- *If a quantitative reconciliation of forward-looking information has been excluded in reliance on the "unreasonable efforts" exception, prepare a file to support your position if challenged by the Staff.* The "unreasonable efforts" exception does not eliminate the requirement to identify the most directly comparable forward-looking GAAP measure. For this reason, issuers face a high hurdle for demonstrating to the Staff that the preparation of a quantitative reconciliation of the forward-looking non-GAAP measures would involve unreasonable efforts.

Distinguish whether a non-GAAP measure is used as a performance measure, liquidity measure, or both. In comment letters, the Staff may question whether a non-GAAP measure is, in fact, a liquidity measure that should be reconciled to the statement of cash flows. For example, a non-GAAP measure may be found to be used as a liquidity measure if the title of the measure refers to cash (or cash flows), if the measure includes upward adjustments for cash receipts recognized in the investing activities category of the statement of cash flows, or if the measure is described as being used to evaluate the issuer's ability to repay loans.

- *Additional requirements and limitations for liquidity measures*. If a measure is found to be a liquidity measure, additional requirements and limitations apply in SEC filings—in particular, the measure may not be presented on a per-share basis, and may not exclude charges or liabilities that required, or will require, cash settlement, absent an ability to settle in another manner.

- *Reconciliation to cash flows.* For liquidity measures, reconciliation must be provided to the statement of cash flows. In one of its non-GAAP compliance and disclosure interpretations, the Staff notes that an issuer should present the three major categories of the statement of cash flows when presenting a non-GAAP liquidity measure, a position also repeated in some comment letters.

Review disclosure controls and procedures. Disclosure controls and procedures should cover non-GAAP measures and address Regulation G and Item 10(e), as well as updated Staff interpretations.

1. *See* Mary Jo White, SEC Chair, Keynote Address, International Corporate Governance Network Annual Conference: Focusing the Lens of Disclosure to Set the Path Forward on Board Diversity, Non-GAAP, and Sustainability (Jun. 27, 2016), *available at* https://www.sec.gov/news/speech/chair-white-icgn-speech.html; Mary Jo White, SEC Chair, Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility (Dec. 9, 2015), *available at* www.sec.gov/news/speech/keynote-2015-aicpa-white.html; James V. Schnurr, Chief Accountant, SEC Office of the Chief Accountant, Remarks before

remarks-12th-life-sciences-accounting-congress.html.

2. Gretchen Morgenson, "Fantasy Math Is Helping Companies Spin Losses Into Profits," *N.Y. Times* (Apr. 22, 2016), *available at* http://www.nytimes.com/2016/04/24/business/fantasy-math-is-helping-companies-spin-losses-into-profits.html?_r=0.

3. SEC enforcement actions involving non-GAAP measures are not unprecedented. *See SEC v. SafeNet, Inc., et. al.*, (Litig. Release No. 21290) (Nov. 12, 2009), *available at* https://www.sec.gov/litigation/litreleases/2009/lr21290.htm (issuer and its former CEO and CFO charged with multiple securities violations, including violations of Regulation G caused by "earnings management" – reporting non-GAAP earnings that excluded certain ordinary expenses that had been improperly characterized as non-recurring charges; defendants settled by, among other things, agreeing to a $1 million civil penalty for the issuer and profit disgorgement and lesser civil penalties for the former CEO and CFO).

4. Regulation G provides that public disclosure of a non-GAAP measure, taken together with the accompanying information and discussion, shall not contain an untrue statement of material fact or omit a material fact necessary to make the presentation of the non-GAAP measure, in light of the circumstances under which it is made, not misleading.

5. For a significant change between periods, prior periods may need to be recast to conform to the current presentation and place the disclosure in the appropriate context.

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