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Alerts & Publications

SEC Remains Focused On Non-GAAP Measures; Releases 12 New or Revised C&DIs

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On May 17, 2016, the Securities and Exchange Commission's Division of Corporation Finance issued 12 new or revised Compliance and Disclosure Interpretations on the use and presentation of non-GAAP financial measures. These updated C&DIs follow repeated warnings in recent months by Chair Mary Jo White and others at the SEC regarding the disclosure of non-GAAP financial measures by public companies and, in particular, their concern that companies are increasingly misusing such measures in a manner that is misleading to investors.

For example, at the annual AICPA National Conference in December 2015, Chair White noted that the use of non-GAAP financial measures by some companies "may be a source of confusion" and warned that current rules need to be reviewed to assess whether they are being followed or are sufficiently robust. Chair White reiterated this concern at the U.S. Capital Markets Summit in March 2016 and noted that the SEC was looking into whether it needed to "rein [non-GAAP financial measures] in a bit, even by regulation." At the 12th Annual Life Sciences Accounting and Reporting Congress in March 2016, SEC Chief Accountant James Schnurr also cautioned that the SEC has concerns regarding trends in the use of non-GAAP financial measures, including the use of adjustments that are potentially misleading.

The new and revised C&DIs do not represent a formal rule change. They are, however, a warning signal to companies and highlight SEC concerns regarding the types of adjustments being made by companies to their non-GAAP financial measures and the undue prominence often given to those non-GAAP financial measures. Specifically, the C&DIs provide guidance on, among other things, instances in which disclosure of a non-GAAP financial measure could be misleading, disclosing GAAP financial measures with equal or greater prominence and conditions for presenting non-GAAP measures as measures of liquidity.

Companies would be prudent to review the non-GAAP financial measures they disclose in light of the new and revised C&DIs. Audit committees should also carefully review their companies' use of non-GAAP financial measures to understand the adjustments being made and the reasons for disclosure of the non-GAAP financial measures. As part of this review, companies should also consider the five questions below that Chair White highlighted at the December 2015 AICPA National Conference:

- Why are you using the non-GAAP measure?
- How does the non-GAAP measure provide investors with useful information?
- Are you giving non-GAAP measures no greater prominence than the GAAP measures, as required under the rules?
- Are your explanations of how you are using the non-GAAP measures – and why they are useful for your investors – accurate and complete, drafted without boilerplate?
- Are there appropriate controls over the calculation of non-GAAP measures?

In light of the new C&DIs, and consistent with recent statements by the SEC, companies should be prepared for heightened scrutiny of their non-GAAP financial measures, which will be tested initially through the Division of Corporation Finance's comment letter process. If the SEC is not satisfied that companies are taking seriously its admonitions regarding non-GAAP financial measures and adjusting their disclosures accordingly, the SEC could make good on its warnings and issue formal rulemaking further restricting the use of non-GAAP financial measures by public companies.

The discussion below summarizes the new and revised C&DIs, which can be found here. The new and revised C&DIs are dated May 17, 2016.

Non-GAAP Measures That Are Misleading [New and Revised C&DIs]

- Certain adjustments to a non-GAAP financial measure, although not explicitly prohibited, may violate Rule 100(b) of Regulation G, which prohibits disclosure of a non-GAAP measure that, taken together with the other information and discussion accompanying the measure, contains a material misstatement or omits a material fact that causes the presentation of the measure to be misleading. For example, presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a company's business could be misleading. [Question 100.01]
- Presenting a non-GAAP financial measure inconsistently between periods by adjusting a particular charge or gain in the current period where other, similar charges or gains were not also adjusted in prior periods could be misleading in violation of Rule 100(b) of Regulation G unless the change between periods is disclosed and the reasons for it explained. 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]
- A non-GAAP financial measure that excludes charges, but does not exclude any gains, can be misleading. For example, a non-GAAP measure

that is adjusted only for non-recurring charges when there are non-recurring gains that occurred during the same period may be misleading in violation of Rule 100(b) of Regulation G. [Question 100.03]

- A company cannot present (in documents filed or furnished to the SEC or provided elsewhere, such as on company websites) a non-GAAP performance measure that is adjusted to accelerate revenues recognized ratably over time in accordance with GAAP as though it earned revenue when customers are billed. Non-GAAP measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could be misleading in violation of Rule 100(b) of Regulation G. 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. [Question 100.04]

- As explained in existing Question 102.03, Item 10(e) of Regulation S-K prohibits describing an adjustment to a non-GAAP financial performance measure as non-recurring, infrequent or unusual when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years. Existing Question 102.03 was updated to add a reference to Question 100.01 above, reiterating the SEC's caution that the adjustment of certain normal, recurring items to non-GAAP financial measures can be misleading in violation of Rule 100(b) of Regulation G. [Question 102.03]

Undue Prominence of Non-GAAP Measures [New C&DI]

- Pursuant to Item 10(e)(1)(i)(A) of Regulation S-K, SEC filings (including earnings releases furnished under Item 2.02 of Form 8-K) that contain a non-GAAP financial measure must present the most directly comparable GAAP measure with equal or greater prominence. While the relevant facts and circumstances surrounding disclosure of a non-GAAP measure will generally dictate whether the non-GAAP measure is presented with undue prominence to the comparable GAAP measure, this new C&DI provides several examples of disclosures the SEC would consider as resulting in undue prominence of the non-GAAP measure:
    - 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;

  - Presenting 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. [Question 102.10]

Disclosure of Non-GAAP Measures as Measures of Liquidity [Revised C&DIs]

- The SEC prohibits presenting non-GAAP liquidity measures on a per share basis in documents filed or furnished with the SEC. In this revised C&DI, the SEC clarified that, while certain non-GAAP per share performance measures may be meaningful from an operating standpoint, whether per share data is prohibited depends on whether the non-GAAP measure can be used as a liquidity measure, even if management presents it solely as a performance measure. When analyzing these questions, the SEC will focus on the substance of the non-GAAP measure and not management's characterization of the measure. [Question 102.05]
- Existing Question 102.07 addresses the permissibility of disclosing "free cash flow," a non-GAAP measure typically defined as cash flows from operating activities as presented in the statement of cash flows under GAAP, less capital expenditures, in documents filed with the SEC. This existing Question 102.07 was updated to clarify that free cash flow is considered a liquidity measure and must not be presented on a per share basis. [Question 102.07]

Disclosure of EBIT and EBITDA [Revised C&DI]

- Consistent with new Question 102.05, neither EBIT nor EBITDA should be presented on a per share basis even if presented as a performance measure. [Question 103.02]

Income Tax Effect Adjustments to Non-GAAP Measures [New C&DI]

- The presentation of income tax effects on a non-GAAP measure depends on whether the measure is a liquidity or performance measure. For liquidity measures that include income taxes, it might be acceptable to adjust GAAP taxes to show taxes paid in cash. For performance measures, adjustments related to income tax effects should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. Adjustments to arrive at a non-GAAP measure should not be presented "net of tax." Instead, income taxes should be shown as a separate adjustment and clearly explained. [Question 102.11]

Other Guidance Applicable to Real Estate Investment Trusts (REITs) [Revised C&DIs]

- Existing Question 102.01 stated that the SEC accepted the definition of "funds from operations" ("FFO") provided by NAREIT as of January 1, 2000 as a performance measure. This C&DI was updated to make clear that the SEC accepts NAREIT's definition of FFO in effect as of May 17, 2016 as a performance measure and does not object to its presentation on a per share basis. [Question 102.01]

- A registrant may present FFO on a basis other than as defined by NAREIT, provided that any adjustments made to FFO are not misleading in violation of Rule 100(b) of Regulation G. Any adjustments made to FFO must also comply with the requirements of Item 10(e) of Regulation S-K for a performance measure or liquidity measure, depending on the nature of the adjustments, some of which may trigger the prohibition on presenting this measure on a per share basis. In addition to revising this existing C&DI to account for the new definition of FFO, the SEC added a reference to Rule 100(b) of Regulation G and a cross reference to Section 100 of the C&DIs and Question 102.05 above. [Question 102.02]

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