No, No, Non-GAAP

The SEC Warns of Problematic Uses of Non-GAAP Financial Measures
June 9, 2016

Consistent with concerns expressed recently by senior SEC officials regarding disclosure of financial measures that are not calculated in accordance with generally accepted accounting principles in the United States, referred to as non-GAAP financial measures or "NGFMs," the Staff of the SEC's Division of Corporation Finance recently updated its Compliance and Disclosure Interpretations ("CDIs") relating to NGFMs. These revised CDIs provide guidance on, among other things, instances in which the use of adjustments in NGFMs could be misleading, the requirement to disclose GAAP financial measures with equal or greater prominence and restrictions on expressing liquidity-related NGFMs on a per share basis.

The new guidance is effective immediately. Public companies should review their earnings releases and related investor decks and earnings call scripts in advance of releasing second quarter earnings to consider what revisions may be necessary in order to align the disclosures with the revised guidance. While the CDI revisions are not formal rule changes, the new guidance represents a significant shift in the Staff's views on the use and presentation of NGFMs. Companies should assume that the Staff will be reviewing SEC reports, earnings releases and other publicly available communications containing NGFMs, and potentially making recommendations for enforcement, in light of the revised guidance.

Regulation G and Item 10(e) of Regulation S-K

Companies typically disclose NGFMs to provide analysts and investors with information and views of company performance and value that may be peculiar to that company's industry or that screen out the financial impact of unusual events. Some commonly used NGFMs include: (i) earnings before interest and taxes, or EBIT; (ii) earnings before interest, taxes, depreciation, and amortization, or EBITDA; (iii) adjusted revenues; (iv) free cash flows; (v) adjusted or core earnings; and (vi) funds from operations.

In 2003, the SEC adopted Regulation G and Item 10(e) of Regulation S-K in accordance with its directive under the Sarbanes-Oxley Act of 2002. With limited exceptions, these rules apply to <u>any</u> public disclosure of NGFMs, including SEC reports, press releases, website disclosures, investor presentations and conference calls, whether such disclosure is made in print, orally, telephonically, by webcast or by broadcast, by any company that is required to file reports under the Securities Exchange Act of 1934.

Regulation G governs NGFMs other than those contained in a filing made with the SEC. These NGFMs must be accompanied by:

- A presentation of the most directly comparable GAAP financial measure; and
- A quantitative reconciliation of the NGFM to the most comparable GAAP financial measure (unless the NGFM is forward looking and the reconciliation cannot be done without unreasonable effort).

If the NGFM is disclosed in an SEC filing or in an earnings release attached as an exhibit to a Form 8-K, then Item 10(e)(1)(i) of Regulation S-K governs the disclosure. Item 10(e)(1)(i) requires that the NGFM be accompanied by:

- A presentation, with equal or greater prominence than the NGFM, of the most directly comparable GAAP financial measure;
- A quantitative reconciliation of the NGFM to the most comparable GAAP financial measure (unless the NGFM is forward looking and the reconciliation cannot be done without unreasonable effort);
- A statement disclosing the reasons why the company's management believes that presentation of the NGFM provides useful information to investors regarding its financial condition and results of operations; and

- To the extent material, a statement disclosing the additional purposes, if any, for which the company's management uses the NGFM.

The remainder of Item 10(e) prohibits (1) certain NGFMs, such as where 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, (2) the use of misleading titles, and (3) inclusion of NGFMs on the face of any required financial statements.

The use of NGFMs is also subject to the overarching rule that the NGFM, taken together with the information accompanying the NGFM and any other accompanying discussion of the NGFM, may not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the presentation of the NGFM, in light of the circumstances under which it is presented, not misleading. Discerning the difference between GAAP measures and NGFMs can be challenging for investors. The rules described above were intended to ensure that a company's presentation of NGFMs is clearly explained and does not overshadow the company's GAAP results or otherwise mislead investors.

Use of Adjustments

Four new CDIs relate to the requirement that the use of a NGFM not be misleading when viewed in context with the information accompanying it. The following new interpretations address practices that, in the Staff's view, can result in a NGFM that is misleading.

- Presenting a NGFM that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business. [CDI 100.01]
- Varying the computation of NGFMs from period to period by adjusting for a particular charge or gain in the current period when other, similar charges or gains were not also adjusted in prior periods, unless the change between periods is disclosed and the reasons for it explained. The Staff also noted that it may be necessary to recast prior measures to conform to the current presentation. [CDI 100.02]
- For companies that present NGFMs that are adjusted only for non-recurring charges, failing to adjust that NGFM for non-recurring gains that occurred during the same period. [CDI 100.03]
- Presenting a NGFM that is adjusted to accelerate revenue recognized over time under GAAP as though the company earned revenue when customers were billed or using other individually tailored revenue recognition and measurement methods. [CDI 100.04]

Equal or Greater Prominence

The new guidance also addresses the Item 10(e)(1)(i) requirement that the most directly comparable GAAP measure be presented with "equal or greater prominence." In this regard, the revised guidance interprets "equal" prominence to mean that the GAAP measure must precede any NGFM, and interprets "prominence" to refer not only to the location or ordering of GAAP measures and NGFMs, but also to apply to the manner in which GAAP measures and NGFMs are discussed and characterized and even to type style and size. CDI 102.10 provides examples illustrating when the presentation of NGFMs may not meet the "equal or greater prominence" requirement. These include:

- Presenting a full income statement of NGFMs or presenting a full non-GAAP income statement when reconciling NGFMs to the most directly comparable GAAP measures;
- Omitting comparable GAAP measures from an earnings release headline or caption that includes NGFMs;
- Presenting a NGFM using a style of presentation (e.g., bold, larger font) that emphasizes the NGFM over the comparable GAAP measure;
- A NGFM that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption);
- Describing a NGFM as, for example, "record performance" or "exceptional" without an equally prominent descriptive characterization of the comparable GAAP measure;
- Providing tabular disclosure of NGFMs 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 NGFM 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 NGFM without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence. [CDI 102.10]

Prohibitions on Per Share Liquidity Measures

It has long been the Staff’s position that liquidity-related NGFMs should not be presented on a per share basis in documents filed with or furnished to the SEC. The new guidance reiterates the Staff’s view that most per share NGFMs are acceptable so long as they are reconciled to GAAP earnings per share, but NGFMs that measure cash generated must not be presented on a per share basis. In the past, the Staff generally deferred to management’s characterization of a NGFM as a performance measure, but the guidance makes clear that the Staff will now make its own determination of whether a NGFM is a measure of liquidity. [CDI 102.05] The new guidance also makes clear that free cash flow, EBIT and EBITDA are liquidity measures that cannot be presented on a per share basis. [CDI 102.07 and 103.02]

Other Revisions

Tax Effects in Reconciliation. The new guidance modifies the manner in which income tax effects related to NGFMs should be calculated and presented. The Staff’s previous interpretations in this regard provided that companies could generally present adjustments “net of tax” when reconciling performance measures as long as the tax effect was shown parenthetically or there was a line in the reconciliation showing the tax effect. The new guidance, however, provides that the presentation depends on the nature of the NGFM. With respect to NGFM liquidity measures that include taxes, it may be acceptable to adjust GAAP taxes to show taxes paid in cash. For performance-related NGFMs, companies should include current and deferred income tax expense commensurate with the NGFM. Adjustments to arrive at a NGFM should not be presented net of tax. Instead income taxes should be shown as a separate adjustment and clearly explained. [CDI 102.11]

Funds From Operations. The new guidance makes clear that a company may disclose “funds from operations,” or FFO, as defined by the National Association of Real Estate Investment Trusts as of May 2016, as long as the disclosure does not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the presentation of the NGFM, in light of the circumstances under which it is presented, not misleading. The Staff cautioned that companies can define FFO on a basis other than as defined by NAREIT but only if adjustments made to FFO comply with the requirements of Item 10(e), and made clear that if the adjustments cause FFO to be a NGFM that measures cash generated, presentation on a per share basis would not be permitted. [CDI 102.02]

Practical Considerations

Consistent with recent statements by several senior SEC officials, companies should be prepared for heightened scrutiny of their public disclosure of NGFMs. The Staff has indicated that they will be actively reviewing earnings releases as well as investor materials presented on company websites, and will be providing comments on NGFMs where the Staff feels that any such measure does not provide useful information to investors. The *Wall Street Journal* recently reported that Mark Kronforst, the chief accountant of the SEC’s Division of Corporation Finance, predicted an “uptick” in the number of Staff comments regarding non-GAAP metrics and stated that “next quarter will be a great opportunity for companies to self-correct.”

Because the revised guidance is effective immediately, public companies should begin reviewing their use of NGFMs in public documents and communications to determine whether they need to make any changes to conform to the Staff’s guidance. Companies whose Q1 earnings presentations or releases were not strictly within the new guidelines should modify their presentations for Q2. The most common areas for revision are likely to be:

- In the earnings call script and in the headline, highlights section and first paragraph of the earnings release, the order of presentation or discussion of net income and adjusted net income may need to be reversed;
- In the first paragraph of the earnings release and in the earnings call script, the description of GAAP results may need to be expanded to include at least as much detail and have at least as many superlatives as provided for the NGFM results; and

- In the reconciliation, the method in which tax effects are presented may need modification.

In addition, management and audit committees, in consultation with outside counsel, should reexamine their reasons for using NGFMs and the related disclosure of how such NGFMs provide investors with useful information, and either confirm the need for, or discontinue, their use. Companies should also reexamine the related disclosure controls and procedures to ensure that NGFM disclosures comply with SEC rules.

Finally, when providing NGFMs on a per share basis, companies should ensure that the NGFM relates only to performance measures and not to measures of cash generated, such as EBIT, EBITDA and free cash flow.

For more information about the use or disclosure of non-GAAP financial measures, please contact the authors of this alert, Robert B. Murphy (202-906-8721) and Mark A. Metz (313-568-5434), or your Dykema relationship attorney.

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