SEC Issues Guidance on Non-GAAP Financial Measures

A large percentage of S&P 500 companies report some form of non-GAAP financial measures. The prevalence in use of non-GAAP financial measures and the often significant disparity between non-GAAP financial measures and reported GAAP results has been a recent focus of not only press reports and studies but also the U.S. Securities and Exchange Commission (SEC). Recent SEC comment letters and speeches by the SEC chair, SEC chief accountant and other high-level SEC staff have questioned whether existing rules are being followed and are sufficiently robust.

Management and audit committees should take this opportunity to re-examine how their companies calculate and present non-GAAP financial measures, and be reminded that they should not consider the prohibited practices noted in the C&DIs as being exhaustive.

On May 17, 2016, the SEC updated its Compliance & Disclosure Interpretations (C&DIs) on the use of non-GAAP financial measures in SEC filings, earnings releases and other public disclosures. The SEC added or revised 12 interpretations, reflecting a sharpened focus on the use and presentation of non-GAAP financial measures. Notably, the SEC has significantly expanded its guidance on what is required to comply with the existing SEC rule that requires that GAAP measures be shown with equal or greater prominence.

In addition, the new C&DIs make explicit certain required disclosure practices and limitations that many companies would have already considered to be necessary, or at least best practices, in light of the existing regulation's general statement that a reporting company cannot make public a non-GAAP measure that is misleading in light of the circumstances in which it is presented.

While increasing the amount of specific guidance to companies, the SEC has also explicitly cautioned in a new C&DI that certain types of adjustments, although not explicitly prohibited, may result in misleading disclosure. Management and audit committees should take this opportunity to re-examine how their companies calculate and present non-GAAP financial measures and be reminded that they should not consider the prohibited practices noted in the C&DIs as being exhaustive. The C&DIs include a number of principles that companies will need to consider in the context of their own, specific financial reporting, results and disclosures to determine whether their disclosures could be considered misleading or otherwise non-compliant. "Boilerplate" explanations of the purpose and rationale for non-GAAP presentations will likely be scrutinized more closely by the SEC, so reporting companies should take a thoughtful and fresh look at their non-GAAP disclosure to ensure they are identifying the appropriate limits and cautionary language relevant to their presentation.

The following is a summary of the SEC's newly issued C&DIs on non-GAAP measures:

Equal or Greater Prominence. Although noting that whether a non-GAAP financial measure is more prominent generally depends on the facts and circumstances, the SEC provided the following examples of non-GAAP presentations that the SEC would consider as having inappropriately greater prominence than the comparable GAAP measures:

- *Income Statements* — 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
- *Headlines* — omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures
- *Font Style* — 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
- *Placement* — a non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption)
- *Power Adjectives* — 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
- *Tables* — 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
- *Reconciliations* — 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
- *Discussion & Analysis* — 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

Misleading Adjustments to Normal Operating Expenses. The SEC also made clear that companies cannot include an adjustment to a GAAP measure that would cause the adjusted non-GAAP financial measure to be misleading, even if the specific adjustment is not explicitly prohibited. For example, a non-GAAP financial measure that excludes normal, recurring cash operating expenses necessary for a company to operate its business may be considered misleading.

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Accelerated Revenue Recognition. A company cannot present a non-GAAP financial measure that was adjusted to accelerate revenue recognition to the date a customer is billed, if GAAP requires that such revenue be recognized ratably over time. Other non-GAAP financial measures (involving items other than revenue) that similarly are adjusted for individually tailored recognition and measurement methods may also be considered misleading. These types of non-GAAP adjustments are not uncommon and, in light of the prior lack of explicit guidance from the SEC, have been considered by many practitioners to be permissible, provided the adjustment is accompanied by an appropriately detailed description of the manner in which the calculation differs from GAAP. Companies that back out the effects of GAAP revenue recognition principles need to promptly revisit this non-GAAP financial measure.

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Consistency Between Periods. Companies should not cherry-pick different adjustments in each period in non-GAAP presentations. If a company plans to change the adjustments it includes in a non-GAAP presentation, it should explain the reason for the change and, if significant, recalculate the non-GAAP financial measure for prior periods with the different adjustment(s) and include them in the presentation for comparative purposes.

Tax. A company's presentation of income tax effects on non-GAAP financial measures should depend on whether it is a liquidity measure or a performance measure. Non-GAAP liquidity measures are permitted to be adjusted to 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. Each tax adjustment must be shown as a separate line item adjustment (whereas under prior guidance the tax effect of reconciling items was permitted to be disclosed parenthetically or in a footnote). Non-tax adjustments should not be presented "net of tax".

Gains/Charges. If a company had non-recurring charges and gains during a period, or across periods, it should only adjust a GAAP measure for both or neither. Where a company adjusts out an item that could be either a gain or a charge in a particular period, it will need to accept both the positive and the negative impacts of that adjustment on the non-GAAP results.

Non-GAAP Financial Measures. The SEC confirmed the already widely adopted practices on which of the following non-GAAP financial measures can be included in SEC submissions:

- *Earnings Per Share (EPS)* — Non-GAAP EPS can be included in SEC submissions. Non-GAAP per share measures are permitted so long as they are performance (not liquidity) measures. If a per share non-GAAP measure can be used as a liquidity measure, it is prohibited, even if management presents it solely as a performance measure.

- *Free Cash Flow (FCF)* — Free cash flow, which is typically calculated as GAAP cash flow from operating activities minus capital expenditures, can be included in SEC submissions, but the SEC added that free cash flow per share cannot be included. Companies should include a description of how free cash flow was calculated, and should not suggest that it represents residual cash flow available for discretionary expenditures where non-discretionary expenditures, such as mandatory debt service, are not deducted.

EBIT/EBITDA and Free Cash Flow cannot be presented on a per share basis.

- *Funds from Operations (FFO)* — Companies can present FFO and/or FFO per share calculated in accordance with the definition formulated by the National Association of Real Estate Investment Trusts (NAREIT) in effect on May 17, 2016. FFO and FFO per share presentations that are not based on the NAREIT definition are not prohibited, but may be scrutinized more closely for compliance with Regulation G and Item 10(e) of Regulation S-K, particularly FFO per share presentations.

- *EBITDA/EBIT* — EBITDA/EBIT per share cannot be included in SEC submissions.

The full text of the C&DIs is available at:
https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland author or your regular Kirkland contact.

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