

December 19, 2022

# Non-GAAP Financial Measures

## SEC Staff Updates Guidance on Use of Non-GAAP Financial Measures

### SUMMARY

On December 13, 2022, the Securities and Exchange Commission's Division of Corporation Finance issued new and revised [Compliance and Disclosure Interpretations](#) ("C&DIs") regarding the use of non-GAAP financial measures by reporting companies in public disclosures and SEC filings. The new C&DIs note several examples of non-GAAP financial measures that the SEC staff views as potentially misleading, recognition and measurement principles inconsistent with GAAP, inadequate labels and descriptions and improper prominence of non-GAAP financial measures. In addition, in the revised guidance, the SEC clarifies that a non-GAAP measure could be misleading to such a degree that even extensive, detailed disclosure would not prevent the non-GAAP measure from being materially misleading. The updated guidance reflects the continued focus by the SEC and the Staff on public companies' use of potentially misleading non-GAAP financial measures.

### BACKGROUND

Regulation G addresses the use of non-GAAP financial measures in public disclosures by U.S. and non-U.S. reporting companies, and Item 10(e) of Regulation S-K imposes additional restrictions on the use of such measures in SEC filings (including earnings releases furnished under Item 2.02 of Form 8-K). Both Regulation G and Item 10(e) define a "non-GAAP financial measure" as a numerical measure of a reporting company's historical or future financial performance, financial position or cash flows that excludes or includes amounts that are included or excluded, as the case may be, from the most directly comparable financial measure calculated and presented under GAAP in the company's financial statements.

Regulation G requires that when a reporting company publicly discloses material information containing a non-GAAP financial measure, it must accompany the measure with a presentation of the most directly comparable GAAP measure and a quantitative reconciliation of the differences between the non-GAAP

measure and the comparable GAAP measure. Item 10(e) requires that when a reporting company discloses a non-GAAP financial measure in an SEC filing (or earnings release furnished as an exhibit to a Current Report on Form 8-K), the filing must present the most directly comparable GAAP measure with equal or greater prominence, and must include a quantitative reconciliation of the kind required by Regulation G, an explanation of the reasons why management believes the non-GAAP measure provides useful information to investors and, to the extent material, the additional purposes, if any, for which management uses the measure.

Recently, a number of senior SEC officials have expressed concern about misleading non-GAAP financial measures and have issued a number of statements relating to the potentially misleading effect of non-GAAP measures. For example, at the “SEC Speaks” conference in September, the SEC’s acting chief accountant, Paul Munter, noted that “[t]he prominence that companies give to non-GAAP numbers remains a problem.” In addition, comment letters relating to non-GAAP measures have been a focal point of the SEC staff’s accounting review of SEC filings. SEC scrutiny in this area has extended, in some cases, to enforcement investigations or actions. For example, in November 2022, the SEC announced a settlement with Koppers Holdings Inc. for improper use of non-GAAP measures, including failing to disclose material information about two non-GAAP financial measures the company highlighted regarding its debt reduction efforts.<sup>1</sup>

---

## **HIGHLIGHTS FROM THE REVISED GUIDANCE**

The revised guidance provides examples of (i) non-GAAP financial measures that the SEC staff views as potentially misleading, (ii) recognition and measurement principles inconsistent with GAAP and (iii) improper prominence of non-GAAP financial measures, as well as further clarity on improper non-GAAP income statements. At the recent annual AICPA & CIMA Conference on Current SEC and PCAOB Developments, Lindsey McCord, Chief Accountant in the SEC’s Division of Corporation Finance, noted that the revised guidance reflects views the Staff has previously communicated, not new guidance.

### **Misleading Adjustments**

The revised guidance includes additional factors for registrants to consider in evaluating whether the presentation of a non-GAAP financial measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant’s business may be misleading. The SEC views “an operating expense that occurs repeatedly or occasionally, including at irregular intervals, as recurring” and notes that, in assessing whether an operating expense is “normal,” it would consider “the nature and effect of the non-GAAP adjustment and how it relates to the company’s operations, revenue generating activities, business strategy, industry and regulatory environment.” However, the determination of whether an adjustment results in a misleading non-GAAP measure “depends on a company’s individual facts and circumstances.” A company should bear in mind that the SEC’s view of what constitutes a proper adjustment for a non-GAAP measure may be narrower than what is permitted under the corresponding definition of such non-

## SULLIVAN & CROMWELL LLP

GAAP measure in the company's credit agreements or other agreements, which may permit the company to exclude, among other things, "irregular" recurring expenses. In accordance with C&DI 102.09, if certain conditions are met, the non-GAAP measure in the company's credit agreement may be disclosed in an MD&A section as a material item affecting liquidity, but would not be permitted to be included in other disclosures as a performance measure.

### Recognition and Measurement Principles

The revised guidance provides additional examples of non-GAAP adjustments the SEC considers misleading because they have the effect of changing the recognition and measurement principles required to be applied in accordance with GAAP and are considered "individually tailored." The guidance notes that the following may all be considered misleading: (i) changing the pattern of revenue recognition, (ii) presenting a non-GAAP measure of revenue that deducts transaction costs as if the company is an agent in the transaction when gross presentation as a principal is required under GAAP (or the inverse), and (iii) changing the basis for calculating revenue for expense in a non-GAAP performance measure from an accrual basis, in accordance with GAAP, to a cash basis.

### Inadequate Labeling and Description of Non-GAAP Financial Measures

The revised guidance adds two questions relating to labeling and disclosure of adjustments. The first new question provides several examples that would violate Regulation G because they do not have an appropriate label and clear description:

- Failure to identify and describe a measure as non-GAAP.
- Presenting a non-GAAP measure with a label that does not reflect the nature of the non-GAAP measure, such as:
  - A contribution margin that is calculated as GAAP revenue less certain expenses, labeled "net revenue";
  - A non-GAAP measure labeled the same as a GAAP line item or subtotal even though it is calculated differently than the similarly labeled GAAP measure, such as "Gross Profit" or "Sales"; and
  - A non-GAAP measure labeled "pro forma" that is not calculated in a manner consistent with the pro forma requirements in Article 11 of Regulation S-X.

The second new question notes that some non-GAAP measures could mislead investors to such a degree that these measures would be considered materially misleading even with "extensive, detailed disclosure about the nature and effect of each adjustment."

### Prominence of Non-GAAP Financial Measures

The revised guidance provides further discussion of the "equal or greater prominence" requirement applicable to SEC filings and any earnings release furnished as an exhibit to a Current Report on Form 8-K, noting the requirement applies to the presentation, and any related discussion and analysis, of a non-GAAP

measure. The guidance provides the following new examples of presentations that do not comply with the “equal or greater prominence” requirement:

- Presenting a ratio where a non-GAAP financial measure is the numerator and/or denominator without also presenting the ratio calculated using the most directly comparable GAAP measure(s) with 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.

With respect to the Staff’s continuing view that presentation of a non-GAAP income statement (including in a reconciliation) is misleading, under the revised guidance, the SEC notes it considers a non-GAAP income statement to be one that is “comprised of non-GAAP measures and includes all or most of the line items and subtotals found in a GAAP income statement.”

---

## IMPLICATIONS

The new and revised C&DIs reflect the SEC’s evolving views on non-GAAP financial measures, which were last updated in 2016. Given the SEC’s continued scrutiny of public companies’ use of non-GAAP financial measures, registrants should review their disclosures (including in earnings releases) and consult with their legal and accounting advisers in light of the revised guidance.

\* \* \*

## ENDNOTES

- 
- <sup>1</sup> See SEC Charges Koppers Holdings Inc. for Materially Misleading Statements Regarding Non-GAAP Financial Measures (Nov. 1, 2022), *available at* <https://www.sec.gov/enforce/33-11129-s>.

## SULLIVAN & CROMWELL LLP

### ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 900 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

### CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to [SCPublications@sullcrom.com](mailto:SCPublications@sullcrom.com).