

April 19, 2017

Non-GAAP Financial Measures

SEC Staff Comments Focus on Compliance With 2016 Guidance, Particularly the Undue Prominence of Non-GAAP Measures

In May 2016, the SEC's Division of Corporation Finance issued new guidance in the form of Compliance and Disclosure Interpretations, or C&DIs, identifying a number of potentially problematic uses of non-GAAP financial measures.¹ This 2016 guidance evidenced a more restrictive stance by the SEC staff, particularly as compared to SEC staff guidance issued in 2010 that was widely viewed as permitting greater flexibility.² The 2016 guidance was also accompanied by public statements by SEC staff members as to their intent to increase scrutiny of non-GAAP measures used in SEC filings.

To date, the SEC staff has publicly released close to 300 comment letters (containing over 500 comments) to nearly 250 companies challenging the calculation and presentation of non-GAAP financial measures in filings made subsequent to the issuance of this guidance. Based on our analysis of these comment letters, we have identified a number of areas of SEC staff focus during this period, in descending order of frequency:

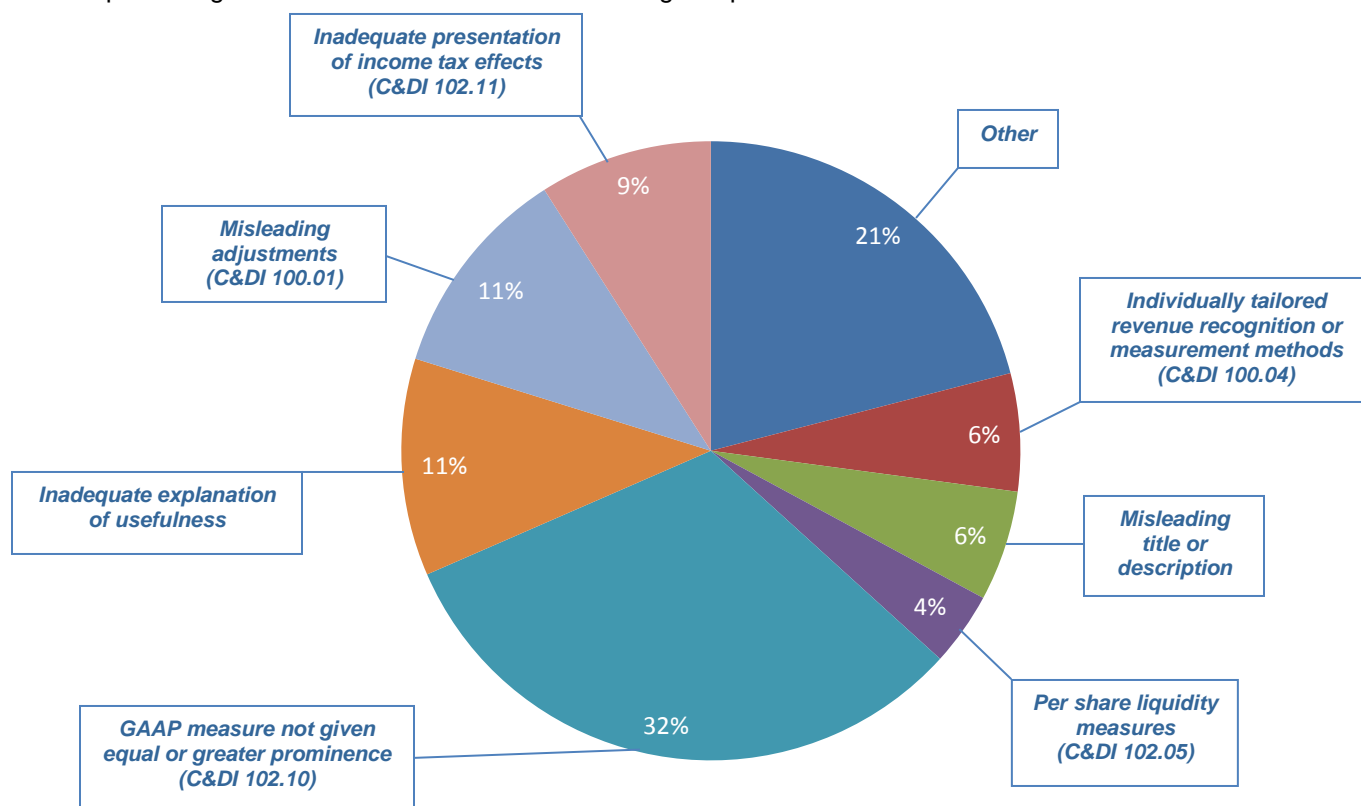
- Failure to present GAAP measure with equal or greater prominence (C&DI 102.10)
- Inadequate explanation of usefulness of non-GAAP measure
- Misleading adjustments, such as exclusion of normal, recurring cash expenses (C&DI 100.01)
- Inadequate presentation of income tax effects of non-GAAP measure (C&DI 102.11)
- Individually tailored revenue recognition or measurement methods (C&DI 100.04)
- Misleading title or description of non-GAAP measure
- Use of per share liquidity measures (C&DI 102.05)

As indicated above, five of these areas relate specifically to concerns addressed by the May 2016 guidance (with the comments usually citing the relevant C&DI), while the other two reflect continued focus

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on issues (explanation of usefulness and misleading titles) that have long been the subject of staff comment. This analysis suggests that the staff's efforts to monitor and enforce compliance with its May 2016 guidance is expanding, rather than replacing, its traditional areas of focus regarding non-GAAP measures.³

The following chart shows the frequency with which each of these areas was raised in staff comments, as a percentage of total non-GAAP comments during this period:⁴



The nature of the comments received in each area is discussed in further detail below. In preparing disclosure, companies should be mindful of these areas of staff focus. The staff's scrutiny of non-GAAP financial measures—in particular the “equal or greater prominence” requirement—is expected to continue.

GAAP measure not given equal or greater prominence

The SEC staff has shown great interest in policing compliance with its strict interpretation of the “equal or greater prominence” requirement applicable to SEC filings and earnings releases furnished on Form 8-K.⁵ This area, including the strict interpretation set out in C&DI 102.10, represents by far the largest proportion (approximately a third) of the non-GAAP comments on filings since May 2016. Comments in this area fall into three main subcategories:

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- **Comparable GAAP Measure Omitted or Given Second.** A number of the comments have focused on issuers' failure to present the most comparable GAAP measure prior to the non-GAAP measure (or, in some cases, at all) when discussing a non-GAAP measure in narrative or tabular format. The comments make clear that in all discussions or presentations (including tabular reconciliations) of non-GAAP measures, the comparable GAAP measure must be presented first. In addition, some comments identified an unequal emphasis in the presentation of non-GAAP measures as compared to the corresponding GAAP measures (such as having three bullet points and one chart for the non-GAAP measures but only one bullet point and no chart for the comparable GAAP measures).
- **Full Non-GAAP Income Statement.** In C&DI 102.10, the SEC staff clarified that “[p]resenting 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” would be an example of giving undue prominence to non-GAAP measures. A number of comments have reminded issuers of this position and the need to revise their reconciliation so as not to provide what appears to be a full non-GAAP income statement.
- **Excluding a Quantitative Forward-Looking Reconciliation.** In accordance with Regulation G, and Item 10(e)(1)(i)(B), when presenting a forward-looking non-GAAP financial measure, issuers must include, “to the extent available without unreasonable efforts,” a reconciliation of the measure to the most directly comparable GAAP measure. C&DI 102.10 and the staff’s numerous comments on this point have made clear that if an issuer excludes a quantitative forward-looking reconciliation, more specific disclosure is required as to an issuer’s reliance on the “unreasonable efforts” exception, along with identification of the information that is unavailable.

The SEC scrutiny in this area has extended, in some cases, to enforcement investigations or action. For example, in January 2017, the SEC announced a settlement with MDC Partners Inc. for, among other things, improper use of non-GAAP measures, including failing to give GAAP measures equal or greater prominence, despite having committed to do so in response to earlier SEC staff comments.⁶

Inadequate Explanation of Usefulness of Non-GAAP Financial Measures

Although the SEC staff did not issue new guidance as to Item 10(e)(1)(i)(C) of Regulation S-K, the SEC staff has continued to focus on issuers' disclosure of how their non-GAAP financial measures provide useful information to investors. In particular, the SEC staff has asked issuers to provide a more substantive discussion of how *each* non-GAAP measure provides useful information to investors regarding the issuer's financial condition and results of operation, and, in certain circumstances, to include the associated limitations the non-GAAP measure may have for investors when assessing results of operations.

Potentially Misleading Adjustments

The non-GAAP rules do not prohibit the exclusion of recurring items from non-GAAP measures, but merely prohibit the *identification* of an excluded recurring item as “non-recurring, infrequent or unusual.”⁷ C&DI 100.01, however, imposes an additional restraint, providing that “[c]ertain adjustments may violate Rule 100(b) of Regulation G because they cause the presentation of the non-GAAP measure to be misleading,” including “presenting a performance measure that excludes normal, recurring, cash operating expenses.” The SEC staff has issued a number of comments questioning issuers' adjustments and requesting explanations as to why certain adjustments are not “normal, recurring, cash operating

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expenses.” Particular areas of focus include litigation expenses, lease/rent expense, restructuring charges and acquisition and integration costs. SEC staff attention tends to be magnified where an issuer has included such charges over a number of years.

Inadequate Presentation of Income Tax Effects

C&DI 102.11 provides that an issuer “*should provide income tax effects on its non-GAAP measures depending on the nature of the measures*” and that “*income taxes should be shown as a separate adjustment and clearly explained.*” Most of the comments based on this C&DI asked issuers to avoid presenting the adjustments to arrive at a non-GAAP measure “net of tax,” but instead to present the income tax effects as a separate adjustment and to clearly explain how the income tax effect was calculated.

Use of Individually Tailored Revenue Recognition or Measurement Methods

C&DI 100.04 provides that a non-GAAP measure that individually tailors revenue recognition or measurement methods could be misleading in violation of Rule 100(b) of Regulation G. SEC staff objections to individually tailored recognition or measurement methods have further clarified that use of individually tailored accounting principles (such as deferring revenue and costs, adjusting weighted-average common shares and adjusting assets for proportionate economic ownership) and individually tailored expense recognition methods (such as removing only portions of depreciation expense) may, in the SEC staff’s view, also be misleading.

Use of a Per Share Non-GAAP Financial Measure as a Liquidity Measure

A number of the comments have reiterated the SEC’s opposition to per share presentations of liquidity measures. Although such presentations have long been prohibited, C&DI 102.05 and the related comments make clear that the SEC staff looks at the *substance* of the non-GAAP measure in making its determination of the acceptability of a per share measure, rather than how it is characterized. In particular, such per share data is prohibited if the measure *can be used* as a liquidity measure, even if management characterizes it as a performance measure.⁸ The SEC staff has been willing to engage with issuers on this topic and has engaged in a dialogue with a number of issuers as to whether and how certain measures comply with C&DI 102.05. In fact, this is an area where guidance is likely to continue to evolve given the staff’s statement in a January 2017 letter to Allergan plc stating that the staff would, in light of the discussion about the matter, “*evaluate the industry practices . . . and consider whether additional comprehensive non-GAAP staff guidance is appropriate.*”⁹

Misleading Titles or Descriptions

Item 10(e)(1)(ii)(E) of Regulation S-K has been, and continues to be, a focus of SEC staff comments. Item 10(e)(1)(ii)(E) provides that issuers cannot “[u]se titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.” A number of the SEC staff comments relating to this requirement ask issuers to revise the title of a non-

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GAAP cash flow measure (such as “cash flow from core operations” or free cash flow that has been adjusted) to prevent confusion with GAAP cash flow. Additionally, the SEC staff has objected to the use of certain titles that it deems confusingly similar to GAAP titles, such as “operating,” “comparable,” “underlying” and “core,” when referring to non-GAAP measures.

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ENDNOTES

- ¹ The SEC staff’s C&DIs, including those on non-GAAP measures, are available on the SEC’s website at <https://www.sec.gov/divisions/corpfin/cfguidance.shtml>.

For a discussion of the staff’s May 2016 guidance, see our publication, dated May 24, 2016, entitled “[Non-GAAP Financial Measures: SEC Staff Updates Guidance and Indicates Plans to Increase Scrutiny of Non-GAAP Financial Measures.](#)”

For a comprehensive discussion of the SEC’s non-GAAP rules, as well as public company governance, compensation and disclosure more generally, see the Public Company Deskbook: Complying with Federal Governance and Disclosure Requirements (Practising Law Institute) by our partners Bob Buckholz, Marc Treviño and Glen Schleyer, available at 1-800-260-4754 (1-212-824-5700 outside the United States) or <http://www.pli.edu>.
- ² For a discussion of the staff’s 2010 guidance, see our publication, dated January 19, 2010, entitled “[Non-GAAP Financial Measures: SEC Staff Updates Guidance on Use of Non-GAAP Financial Measures.](#)”
- ³ It is noteworthy that comments on the traditional issues (explanations of usefulness and misleading titles) were raised just as frequently in comment letters issued after the May 2016 guidance, but related to filings made *before* the guidance, as they were for post-C&DI filings. In contrast, the comments for post-C&DI filings were almost twice as likely to cite one of the new C&DIs.
- ⁴ The comment letters we analyzed are those for filings made after May 17, 2016, the date of issuance of the guidance, and include comments made public through April 14, 2017.
- ⁵ The non-GAAP rules for SEC filings and earnings releases furnished on Form 8-K are included in Item 10(e) of Regulation S-K. Regulation G contains non-GAAP rules applicable to all public disclosures. The rule sets are largely similar, with one key difference being that Regulation G does not require the GAAP measure to be given “equal or greater prominence” to the non-GAAP measure.
- ⁶ See SEC Press Release, *Company Settles Charges Over Undisclosed Perks and Improper Use of Non-GAAP Measures* (Jan. 18, 2017), *available at* <https://www.sec.gov/news/pressrelease/2017-21.html>.
- ⁷ See Item 10(e)(1)(ii)(B) of Regulation S-K.
- ⁸ It is important to note that EBIT and EBITDA cannot be presented on a per share basis, even if such measures are presented as performance measures. See C&DI 103.02.
- ⁹ SEC Comment Letter to Allergan plc Re: Form 8-K Filed August 8, 2016 (Jan. 11, 2017), *available at* <https://www.sec.gov/Archives/edgar/data/1578845/00000000017001061/filename1.pdf>.

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