

October 4, 2016

## Non-GAAP Financial Measures

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### Update on the SEC's Increased Scrutiny of Non-GAAP Disclosure

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The SEC continues to focus on the use of non-GAAP financial measures. As widely reported, on May 17, 2016, the SEC's Division of Corporation Finance issued new and revised Compliance and Disclosure Interpretations ("C&DIs")<sup>1</sup> regarding the use of non-GAAP financial measures in public disclosures and SEC filings amidst growing criticism that the use of these metrics may be misleading to investors. In the months following the release of the C&DIs, the SEC staff has intensified its monitoring of reporting companies' use of non-GAAP financial measures and has indicated its willingness to act through enforcement, if necessary. In light of this increased scrutiny, we encourage reporting companies to review their use of non-GAAP financial measures in upcoming earnings releases, future SEC filings and other public disclosures.

#### High Volume of SEC Comment Letters Focusing on Use of Non-GAAP Financial Measures

In recent months, the SEC staff has issued a significant number of comments relating to non-GAAP disclosures made in SEC filings that are potentially noncompliant with Regulation G and/or Item 10(e) of Regulation S-K and/or inconsistent with the C&DIs. In particular, the SEC staff has identified non-GAAP disclosure practices in SEC filings and earnings releases pre-dating the C&DIs that it viewed as inconsistent with the C&DIs, and required these companies to take corrective action in future filings. SEC staff comments in this area frequently relate to:

- **Prominence of Non-GAAP Financial Measures:** The SEC staff has shown significant interest in compliance with its interpretation of the "equal or greater prominence" requirement applicable to SEC filings and earnings releases included on Form 8-K. The SEC staff has issued numerous comments calling out disclosure practices that present non-GAAP financial measures more prominently than the corresponding GAAP financial measures (particularly in the highlights section of an earnings release) and that do not present reconciliations to the equivalent GAAP financial measure for historic and/or forward-looking non-GAAP financial measures. In many

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instances, the SEC staff's comments effectively require that the corresponding GAAP measure receives greater prominence.

- **Usefulness and Purpose of Non-GAAP Financial Measures:** The SEC staff has continued its focus on the disclosure of the usefulness and purpose of non-GAAP financial measures as required by Items 10(e)(i)(C) and (D) of Regulation S-K, making numerous requests that reporting companies provide additional detail regarding why management believes investors will find each non-GAAP financial measure to be useful and how management uses each non-GAAP financial measure in managing the business.

### Increased Risk of SEC Enforcement Actions

In a speech in June 2016, SEC Chair Mary Jo White reiterated the SEC staff's concern about misleading non-GAAP financial measures and the use of such measures by reporting companies that extends "too far and beyond what is intended and allowed by [SEC] rules."<sup>2</sup> She indicated that the SEC staff remains focused on the misuse of non-GAAP financial measures and is prepared to initiate enforcement actions if necessary. More recently, various sources have reported that the SEC's Division of Enforcement has sent inquiries to some reporting companies regarding potential violations of Item 10(e) of Regulation S-K in earnings releases that predate the issuance of the C&DIs. The inquiries also request information and documents relating to earnings release materials prepared in prior fiscal periods.

### Implications

The SEC staff continues to strongly encourage reporting companies to revisit their use of non-GAAP financial measures in light of the C&DIs and Chair White has indicated that audit committees should oversee these practices. In preparing upcoming earnings releases, future SEC filings and other public disclosures, reporting companies should pay particular attention to the expansive positions reflected in the C&DIs and the SEC staff's comments. Although many reporting companies have modified their non-GAAP disclosures during the last quarter in response to the C&DIs, the SEC staff's heightened scrutiny of non-GAAP financial measures is expected to continue and may involve comments or inquiries regarding disclosures that predate the C&DIs.

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### ENDNOTES

<sup>1</sup> U.S. Securities and Exchange Commission, *Non-GAAP Financial Measures, Compliance & Disclosure Interpretations* (May 17, 2016), available at: <https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm>. These C&DIs are discussed in our memo to clients entitled *Non-GAAP Financial Measures: SEC Staff Updates Guidance and Indicates Plans to Increase Scrutiny of Non-GAAP Financial Measures* (May 24, 2016), <https://www.sullcrom.com/non-gaap-financial-measures-sec-staff-updates-guidance-and-indicates-plans-to-increase-scrutiny-of-non-gaap-financial-measures>.

<sup>2</sup> SEC Chair Mary Jo White, *Keynote Address, International Corporate Governance Network Annual Conference: Focusing the Lens of Disclosure to Set the Path Forward on Board Diversity, Non-GAAP, and Sustainability* (June 27, 2016), available at: <https://www.sec.gov/news/speech/chair-white-icgn-speech.html>.

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