SULLIVAN & CROMWELL LLP

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Non-GAAP Financial Measures

SEC Staff Updates Guidance and Indicates Plans to Increase Scrutiny of Non-GAAP Financial Measures

SUMMARY

The SEC's Division of Corporation Finance has 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 filings. The new C&DIs note several uses of non-GAAP financial measures that the staff views as potentially misleading; interpret very expansively the "equal or greater prominence" requirement applicable to SEC filings and earnings releases included in a Form 8-K Report; and provide restrictive new guidance on the use of certain per share measures. The guidance comes against a backdrop of growing criticism in the financial press and in recent public statements by senior SEC officials of companies' use of non-GAAP financial measures. In public comments since the release of the new guidance, the staff has indicated that it intends to increase its scrutiny of non-GAAP financial measures and the number of comments it issues relating to use of these measures by reporting companies.

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 Reg. 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.

Reg. 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 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 in a Form 8-K), the filing must present the most directly comparable GAAP measure with equal or greater prominence, and must include a numerical reconciliation of the kind required by Reg. 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.

In recent months, a number of senior SEC officials have expressed concern about misleading non-GAAP financial measures, non-GAAP financial measures that are presented in an unduly prominent manner and the increasing reliance and reporting on non-GAAP measures by analysts and the financial press. For example, in March, the SEC's chief accountant, James V. Schnurr, noted that the SEC staff had observed "a significant and, in some respects, troubling increase over the past few years in the use of, and nature of adjustments within, non-GAAP measures by companies as well [as the] prominence that the analysts and media have accorded such measures when reporting on the results of the companies they cover."[1]

HIGHLIGHTS FROM THE REVISED GUIDANCE

The revised guidance provides examples of non-GAAP financial measures that the staff views as potentially misleading, an expansive interpretation of the "equal or greater prominence" requirement, and examples of per share measures that the staff considers objectionable.

Misleading Non-GAAP Financial Measures

The revised guidance states that a non-GAAP measure could be misleading if it excludes non-recurring charges but does not exclude non-recurring gains that occurred in the same period. The guidance also notes that a non-GAAP "performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business could be misleading." The guidance only addresses cash operating expenses, and does not address measures excluding stock-based compensation expense and other non-cash recurring expenses, although such measures have also been criticized in the financial press.

Another new interpretation proscribes non-GAAP performance measures that accelerate revenue, relative to when it is permitted to be recognized under GAAP, and notes that measures that use "individually tailored recognition and measurement methods" to adjust other GAAP financial statement line items would raise a similar concern.

[1] James V. Schnurr, Remarks before the 12th Annual Life Sciences Accounting and Reporting Congress (March 22, 2016), *available at* https://www.sec.gov/news/speech/schnurr-remarks-12th-life-sciences-accounting-congress.html.

The guidance notes that a non-GAAP measure could be misleading if it is presented inconsistently between periods – for example, if a company adjusts for a charge or gain in one period, but then does not adjust that measure for a similar charge or gain in a subsequent period – unless the change is disclosed and the reasons for it are explained. However, "depending on the significance of the change, it may be necessary to recast prior measures to conform the current presentation and place the disclosure in the appropriate context." The requirement for consistency between periods may also lead to staff comments where a company discontinues using a non-GAAP measure, suggesting that companies may wish to proactively explain in their filings the rationale for such changes.

Prominence of Non-GAAP Financial Measures

The guidance provides a new and very expansive reading of the "equal or greater prominence" requirement applicable to SEC filings and earnings releases included in a Form 8-K. Although it acknowledges that determining "whether a non-GAAP measure is more prominent than the comparable GAAP measure generally depends on the facts and circumstances in which the disclosure is made," the guidance then gives eight examples of presentations the staff finds unacceptable, several of which effectively require that the corresponding GAAP measure receive greater prominence:

- 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;
- Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures;
- 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;
- A non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption);
- 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;
- 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;
- 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; 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.

Per Share Measures

The new guidance confirms the longstanding staff position that non-GAAP liquidity measures (other than the traditional "funds from operations" metric commonly reported by real estate investment trusts) may not be presented on a per share basis in SEC filings. The guidance goes on to state that even when management presents a metric solely as a performance measure, "the staff will focus on the substance of the non-GAAP measure and not management's characterization" of it, and as an application of that approach, states the EBIT and EBITDA may never be presented on a per share basis.

IMPLICATIONS

Historically, earnings releases have attracted relatively few SEC staff comments, despite their being submitted to the SEC under Item 2.02 of Form 8-K. We would expect an increased volume of staff comments relating to the use of non-GAAP measures in these earnings releases, and in other SEC filings, going forward. Companies should therefore be reviewing their disclosures in light of the new guidance.

Implications for Foreign Private Issuers

The application of these developments to "foreign private issuers" is somewhat complex. Earnings releases of dual-listed foreign private issuers are generally not subject to the Reg. G and Item 10(e) requirements, even when submitted to the SEC on Form 6-K. However, these requirements do apply to any earnings release submitted on Form 8-K (including by a foreign private issuer using that form), and to any materials included or incorporated by reference into an Annual Report on Form 20-F (though not an Annual Report on Form 40-F, under the MJDS system) or a registration statement under the Securities Act of 1933. Foreign private issuers may also wish to consider the extent to which these requirements might be seen to represent "best practice", at least in some quarters.

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CONTACTS

New York

Ari B. Blaut	+1-212-558-1656	blauta@sullcrom.com
Robert E. Buckholz	+1-212-558-3876	buckholzr@sullcrom.com
Catherine M. Clarkin	+1-212-558-4175	clarkinc@sullcrom.com
Jay Clayton	+1-212-558-3445	claytonwj@sullcrom.com
Donald R. Crawshaw	+1-212-558-4016	crawshawd@sullcrom.com
Robert W. Downes	+1 212-558-4312	downesr@sullcrom.com
John E. Estes	+1 212-558-4349	estesj@sullcrom.com
William G. Farrar	+1-212-558-4940	farrarw@sullcrom.com
David B. Harms	+1-212-558-3882	harmsd@sullcrom.com
Scott D. Miller	+1 212-558-3109	millersc@sullcrom.com
Robert W. Reeder III	+1-212-558-3755	reederr@sullcrom.com
Glen T. Schleyer	+1-212-558-7284	schleyerg@sullcrom.com
Rebecca J. Simmons	+1-212-558-3175	simmonsr@sullcrom.com

Washington, D.C.

Eric J. Kadel, Jr.	+1-202-956-7640	kadelej@sullcrom.com
Robert S. Risoleo	+1-202-956-7510	risoleor@sullcrom.com

Los Angeles

Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
Rita-Anne O'Neill	+1-310-712-6698	oneillr@sullcrom.com
Alison S. Ressler	+1-310-712-6630	resslera@sullcrom.com

Palo Alto		
Sarah P. Payne	+1-650-461-5669	paynesa@sullcrom.com
John L. Savva	+1-650-461-5610	savvaj@sullcrom.com
London		
Nikolaos G. Andronikos	+44-20-7959-8470	andronikosn@sullcrom.com
Chris Beatty	+44-20-7959-8505	beattyc@sullcrom.com
Kathryn A. Campbell	+44-20-7959-8580	campbellk@sullcrom.com
Richard C. Morrissey	+44-20-7959-8520	morrisseyr@sullcrom.com
John O'Connor	+44-20-7959-8515	oconnorj@sullcrom.com
David B. Rockwell	+44-20-7959-8575	rockwelld@sullcrom.com
George H. White III	+44-20-7959-8570	whiteg@sullcrom.com
Frankfurt		
Krystian Czerniecki	+49-69-4272-5525	czernieckik@sullcrom.com
Paris		
William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
Melbourne		
Robert Chu	+61-3-9635-1506	chur@sullcrom.com
Sydney		
Waldo D. Jones, Jr.	+61-2-8227-6702	jonesw@sullcrom.com
Tokyo		
Izumi Akai	+81-3-3213-6145	akaii@sullcrom.com
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com
Hong Kong		
Garth W. Bray	+852-2826-8691	brayg@sullcrom.com
Michael G. DeSombre	+852-2826-8696	desombrem@sullcrom.com
Chun Wei	+852-2826-8666	weic@sullcrom.com