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SEC Updates Guidance on Use of Non-GAAP Financial Measures

The staff of the SEC’s Division of Corporation Finance (the “Staff”) has issued new and revised Compliance and Disclosure Interpretations (“C&DIs”) addressing the use of non-GAAP financial measures. These C&DIs address both communications subject to Regulation G, which applies to all public disclosures by public companies that contain non-GAAP measures, and to filings subject to Item 10(e) of Regulation S-K, which applies to certain reports filed with the SEC, including earnings releases furnished pursuant to Item 2.02 of Form 8-K. These new and revised C&DIs are intended to address the SEC’s concerns regarding the perceived increased use of potentially misleading non-GAAP financial measures and represent a significant change in the Staff’s approach to non-GAAP financial measures.

Background

The SEC’s original rules regarding non-GAAP financial measures were adopted in 2003. Seven years later, in 2010, the Staff observed that while those rules had achieved substantial progress towards reducing the inappropriate use of non-GAAP measures, certain Staff interpretive guidance had resulted in some unintended consequences. For example, certain measures that some argued would be useful to investors and the market were effectively prohibited. In light of this, the Staff issued a number of new C&DIs in 2010 indicating an increased flexibility in its interpretation of the rules regarding non-GAAP measures.

Subsequent to the 2010 C&DI revisions, the Staff has continued to issue comments concerning non-GAAP measures in the context of its review of registrants’ public filings and, in some cases, objected to certain measures. These comments often focus on registrants’ disclosures as to why their non-GAAP measures are deemed useful by management, apparent “cherry picking” of adjustments within a non-GAAP measure, and adjustments to remove normal, cash operating expenses. In the past year, the volume of Staff comments on the use of non-GAAP measures has increased.

In recent months, the SEC has cautioned that it has increased its focus on the use by registrants of financial measures based on non-GAAP measures rather than in accordance with generally accepted accounting principles. At a March 2016 meeting with an audience of industry professionals at the U.S. Chamber of Commerce, SEC Chairman Mary Jo White expressed concern with the increased use of non-GAAP financial measures that could be confusing to investors. Similarly, at the recent Life Sciences Accounting and Reporting Congress in March 2016, SEC Chief Accountant James Schnurr indicated that the SEC staff had observed “a significant and, in some respects, troubling increase . . . in the use of, and nature of adjustments within, non-GAAP measures” as well as their prominence. And in a May 2016
speech before the Baruch College Financial Reporting Conference, SEC Deputy Chief Accountant Wesley Bricker noted that recent examples of non-GAAP measures had caused concern, including the use of individually-tailored accounting principles to calculate non-GAAP earnings, providing per share data for non-GAAP performance measures that look like liquidity measures, and non-GAAP tax expense.

**New and Revised C&DI*s**

In response to these concerns regarding the use of certain non-GAAP financial measures, the Staff has issued several new C&DI*s, and revised others, addressing:

- Potentially misleading non-GAAP financial measures;
- The presentation of GAAP measures with equal or greater prominence;
- The disclosure of non-GAAP financial information on a per-share basis, and
- The presentation of non-GAAP financial information calculated net of taxes.

While Staff pronouncements often formalize positions that have been applied on an informal basis, for example as part of the Staff comment process, we note that some of the positions reflected in the new and revised C&DI*s in fact are new.

**Potentially Misleading Non-GAAP Financial Measures**

Rule 100(b) of Regulation G prohibits the use of a non-GAAP financial measure that is misleading when viewed in context with the information accompanying that measure and any other accompanying discussion of that measure. New C&DI*s 100.01 through 100.04 set forth the Staff’s view that:

- Certain adjustments, although not explicitly prohibited, can result in a non-GAAP measure that is misleading (for example, presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant’s business could be misleading).

- A non-GAAP measure can be misleading if it is presented inconsistently between periods. For example, a non-GAAP measure that adjusts a particular charge or gain in the current period and for which other, similar charges or gains were not also adjusted in prior periods could violate Rule 100(b) unless the change between periods is disclosed and the reasons for it are explained. In addition, depending on the significance of the change, it may be necessary to recast prior measures to conform to the current presentation and place the disclosure in the appropriate context.
A non-GAAP measure can be misleading if the measure excludes charges, but does not exclude any gains. For example, a non-GAAP measure that is adjusted only for non-recurring charges when there were non-recurring gains that occurred during the same period could violate Rule 100(b).

A registrant that presents a non-GAAP performance measure that is adjusted to accelerate revenue recognized ratably over time in accordance with GAAP as though it earned revenue when customers are billed cannot present this measure in documents filed or furnished with the SEC or provided elsewhere, such as on company websites.

Non-GAAP measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could violate Rule 100(b). Other measures that use individually tailored recognition and measurement methods for financial statement line items other than revenue may also violate Rule 100(b).

**Presentation of GAAP Measures with Equal or Greater Prominence**

Item 10(e) of Regulation S-K requires that when a registrant presents a non-GAAP financial measure, it must include a presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with GAAP. This requirement applies to non-GAAP measures presented in documents filed with the SEC and also earnings releases furnished under Item 2.02 of Form 8-K. In a significantly revised C&DI 102.10, the Staff has adopted a much more prescriptive approach by providing several examples of disclosures that would cause a non-GAAP measure to be considered more prominent than the most directly comparable GAAP measure:

- 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;
- Using 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.

The Staff confirmed that if a registrant presents EBIT or EBITDA as a performance measure, such measures should be reconciled to net income as presented in the statement of operations under GAAP. Operating income would not be considered the most directly comparable GAAP financial measure because EBIT and EBITDA make adjustments for items that are not included in operating income.

**Disclosure of Non-GAAP Financial Information on a Per Share Basis**

The SEC has revised its guidance in several C&DIIs regarding the presentation of non-GAAP financial measures on a per-share basis. Namely:

- Consistent with the Staff’s prior guidance, only non-GAAP performance measures, not liquidity measures, may be presented on a per-share basis. The revised CD&I clarifies that the Staff will focus on the substance of the non-GAAP measure in determining whether it is effectively a liquidity measure or a performance measure, rather than simply defer to management’s characterization (C&DI 102.05);

- Although the use of the non-GAAP measure “free cash flow” is not prohibited under Item 10(e), this is a liquidity measure that cannot be presented on a per-share basis (C&DI 102.07);

- Neither EBIT nor EBITDA may be presented on a per-share basis (C&DI 103.02);

- Real estate investment trusts may continue to present “funds from operations” (FFO), as defined by the National Association of Real Estate Investment Trusts (NAREIT) in effect as of May 17, 2016, as a performance measure on a per-share basis (C&DI 102.01); and

- Companies presenting FFO on a basis other than as defined by NAREIT are cautioned that any adjustments made to FFO must comply with the requirements of Item 10(e) for either a performance measure or a liquidity measure, depending on the nature of the adjustments, some of which
adjustments may trigger the prohibition on presenting this measure on a per-share basis (C&DI 102.02).

**Presentation of Non-GAAP Financial Information Calculated Net of Taxes**

C&DI 102.11, as revised, addresses how income tax effects related to adjustments to arrive at a non-GAAP measure should be calculated and presented. According to the Staff, a registrant should address the income tax effects on its non-GAAP measures depending on the nature of the measures. If a measure is a liquidity measure that includes income taxes, it might be acceptable to adjust GAAP taxes to show taxes paid in cash. If a measure is a performance measure, the registrant should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. In addition, adjustments to arrive at a non-GAAP measure should not be presented “net of tax.” Rather, income taxes should be shown as a separate adjustment and clearly explained.

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In light of this significantly updated guidance, registrants that disclose non-GAAP financial measures in their public communications should review these CD&Is, as well as prior guidance, and evaluate the guidance in preparing future disclosures that include non-GAAP financial measures. In addition, in light of the SEC’s recent increased focus on gatekeepers and the shift in enforcement to financial reporting violations, including actions regarding failures to properly implement, maintain, and evaluate internal controls over financial reporting (“ICFR”), registrants should expect more enforcement in this area. As noted by SEC Chair Mary Jo White at the 2015 AICPA National Conference, “Audit committees of every company must be entirely committed to their oversight of financial reporting. They must, for example, be able to adequately review how management is designing and implementing ICFR and how it is using non-GAAP measures.” Audit committees and disclosure committees, as well as financial reporting teams, should be mindful of the connection between effective ICFR and the preparation and presentation of non-GAAP financial measures.


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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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