SHEARMAN & STERLING LLP

CLIENT PUBLICATION

CAPITAL MARKETS | OCTOBER 19, 2016

Updated Non-GAAP Guidance: The First 150 Comment Letters

In May of this year, the staff of the SEC's Division of Corporation Finance updated its C&DIs regarding the use of non-GAAP financial measures. We summarized the May 2016 update in an earlier client publication. Since the update, the staff has issued over 150 comment letters on non-GAAP measures that have become publicly available. We have reviewed the comment letters and company responses and summarize the most frequent and interesting issues.

SEC Comments and Enforcement

The SEC staff comment letters were often issued in conjunction with a review of the company's 10-K and 10-Qs, and included comments on earnings releases and slide presentations. Most of the disclosures that the staff commented on predated the May 2016 update, so companies had not been able to take the update into account in preparing them. Consistent with expectations, the staff did not ask companies to amend their past filings, but was satisfied with company undertakings to modify their disclosures going forward.

In addition to the comment letters from the staff of the SEC's Division of Corporation Finance, which reviews companies' filings in the ordinary course, we understand that the SEC's Division of Enforcement has sent letters to some companies, asking about their past compliance with the non-GAAP rules. The SEC also recently brought an enforcement action where it alleged truly fraudulent manipulation of a non-GAAP measure. While those enforcement letters so far do not seem to have spread more widely and the facts in the recent enforcement action were particularly egregious, together they are a timely, and perhaps not entirely coincidental, reminder of the importance that the SEC attaches to this topic.

This client publication highlights some of the areas of concern that the staff of the SEC's Division of Corporation Finance focused on in its comment letters since the May 2016 update. Some comments were more sector-specific, such as those regarding Cash Available for Distributions or similar metrics by non-MLP companies in the oil and gas sector. We have limited ourselves to comments that were fairly common, or that could be relevant for companies in a wide range of industries.

SEC Staff May Be Listening to Your Earnings Call

In several of the letters, the SEC staff commented not just on non-GAAP measures used in SEC filings and earnings releases, but also on those referred to on earnings calls. For example, one comment letter asked why the company had not provided a reconciliation of some non-GAAP measures that management discussed on the call, but which were not included in the earnings release and therefore not reconciled there.

Equal or Greater Prominence

By far the most common comment, appearing in roughly 40% of the letters, asked for compliance with the requirement to include a presentation of the most directly comparable GAAP financial measure "with equal or greater prominence." This applies whenever a non-GAAP measure is included in a document filed with the SEC or, for US domestic issuers, in an earnings release furnished to the SEC under Item 2.02 of Form 8-K (but not to earnings call transcripts or slides not required to be furnished under Item 2.02). The May 2016 update specifically characterized it as non-compliant with the equal or greater prominence requirement to have a non-GAAP measure precede the most directly comparable GAAP measure—something that was previously not explicit.

- ***Headlines, Bullets, Tables***. In many instances, the comment was triggered by headlines, bullets or tables that either mentioned only non-GAAP measures, or mentioned them first, before providing the corresponding GAAP numbers. The May 2016 update had expressly highlighted this as inconsistent with the requirement.
- ***CEO Quotes***. A brief comment from the CEO is a standard feature of many earnings releases that gives management an opportunity to share its perspective. Understandably, management would like to avoid cluttering this with references to GAAP measures that are disclosed elsewhere and may interrupt the flow. In a few letters, the SEC staff highlighted CEO quotes that only mentioned non-GAAP performance, but usually in the context of earnings releases that also gave non-GAAP measures greater prominence in other ways.
- ***Narrative***. The May 2016 update stated that it was impermissible to provide discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location of equal or greater prominence. Several comment letters raised this point when a narrative discussion of a company's performance in MD&A or an earnings release was framed primarily or exclusively around non-GAAP measures. What the staff apparently considered permissible, however, is a combined discussion of factors that affected both GAAP and non-GAAP performance to avoid unnecessary repetition.
- ***Derivative Non-GAAP Measures***. The staff often treated non-GAAP margins, ratios and per-share metrics as separate financial measures. In the staff's view, these measures may require not only separate reconciliation, but also a presentation of the comparable GAAP measure in a location of equal or greater prominence. For example, the staff found a presentation of Adjusted EBITDA as a percentage of sales to require a presentation of net income as a percentage of sales that preceded it.

Reasons

Close to 30% of the comment letters asked companies to provide more detail and specificity when explaining why the company believes its non-GAAP measures provide useful information to investors regarding the company's financial condition and results of operations. This statement of reasons is required when non-GAAP measures are included in SEC filings or in earnings releases of US domestic issuers that are furnished on Form 8-K.

- ***Specific to the Company's Circumstances***. The comments in this area emphasized the need for adequately detailed information specific to the company's circumstances. Boilerplate statements that management believes that the company's non-GAAP measures provide investors with helpful supplemental information, or that analysts find them useful, may not suffice.

- ***For Each Non-GAAP Measure***. The staff asked some companies for expanded disclosures regarding the usefulness of each of their non-GAAP measures. Sometimes, the staff focused on particular adjustments and queried how they were consistent with the measure's intended purpose, as further discussed below.

Labeling

About a quarter of the comment letters included comments about the proper labeling of non-GAAP measures. Once again, the SEC staff relied on the broad principle of preventing misleading disclosure, rather than on specific rules about labeling that apply only to SEC filings.

- ***Using GAAP Names for Non-GAAP Measures***. Several comments asked companies to clearly and consistently identify non-GAAP measures as such. Companies would sometimes introduce a non-GAAP measure, but then use the GAAP name for the same measure elsewhere in the document without clearly identifying it as non-GAAP every time. Similarly, and consistent with prior practice, the staff asked companies not to use labels like "EBITDA" or "Free Cash Flow" for measures that included adjustments beyond those customarily made for measures with these names, unless the label includes terms such as "as adjusted."
- ***Using "Pro Forma" for Non-S-X Compliant Pro Forma Information***. Companies that have announced or consummated a significant acquisition frequently want to present their financial metrics on a basis that illustrates the effect of the acquisition. These metrics are often referred to as "pro forma" to distinguish them from the acquiror's historical standalone financial information. In a number of comment letters, the SEC staff took the view that the term "pro forma" should be reserved for financial measures that have been prepared in accordance with the SEC's rules for pro forma financial statements in Regulation S-X.
- ***Core vs. Non-Core***. Some companies use the term "core" to refer to earnings or costs that they report on a non-GAAP basis, designating revenues or costs that they eliminate through adjustments as "non-core." The SEC staff commented on this terminology in several letters, asking companies to clarify how they define "core" for this purpose, or questioning whether use of the term was appropriate when the relevant adjustments seemed inherent to the company's core business operations and kept reoccurring over several years. Some companies were able to provide satisfactory explanations, others decided to change the terminology. A similar comment related to calling certain non-GAAP adjustment items included in operating income "non-operating."

Potentially Impermissible Adjustments

Prior to the May 2016 update, non-GAAP adjustments were generally viewed as permitted if they were sufficiently transparent so as not to mislead investors, subject to a handful of specific prohibitions for SEC filings. Under the new interpretations, some non-GAAP adjustments are presumed to be misleading, and therefore impermissible. Below are some of the adjustments that the SEC staff raised most often as problematic. Overall, it appears that the staff will apply the updated C&DIs rigorously, but more as rebuttable presumptions than as absolute prohibitions. Where companies can make a strong case for why a particular non-GAAP measure is useful to investors, they may be able to persuade the staff that it remains permissible, even if the relevant adjustments fall into these categories.

- ***Normal, Recurring Cash Operating Expenses***. The staff had highlighted this category in the updated C&DIs. Examples in the recent comment letters include store closing costs, store opening costs and rent expense for retailers; harbor fees paid by an oil storage provider; cost of land purchases in cost of sales for an engineering and construction services company; facility deactivation costs for an energy company; litigation settlements; and acquisition-related expenses (discussed below). Some of these comments resulted in additional disclosure, others led to the elimination of the adjustment in subsequent periods.

- ***Acquisition-Related Expenses***. Adjustments for acquisition-related expenses are a standard feature of many non-GAAP measures. Companies often add back transaction expenses or costs of integrating the acquired business and realizing expected synergies. While not specifically highlighted in the May 2016 update, the SEC staff challenged these adjustments in several comment letters, particularly when it viewed acquisitions not as one-time events, but as part of the company's growth strategy. For example, the staff pointed out that one company had made more than ten acquisitions in the past six years, four alone in the past two years, with two new acquisitions already pending. Most companies that received this comment successfully responded with detailed explanations and expanded disclosures, but some stopped using the relevant measure or adjustment.
- ***Tailored Recognition and Measurement Methods***. The May 2016 update specifically highlighted accelerated revenue recognition, but also mentioned other non-GAAP recognition and measurement methods as potentially misleading. Examples from the comment letters include adjustments to neutralize the net effect from the deferral of revenues and the related cost of sales; including principal collections on finance leases in revenues of equipment leasing companies; and adjustments for purchase accounting (discussed below). While the May 2016 update suggests that non-GAAP revenue recognition methods are inherently suspect, the staff may consider arguments as to why a particular method may be appropriate in special circumstances. It helps when the company can demonstrate that its treatment of non-cash revenue reflects widespread industry practice. As a rule, adjustments that eliminate deferral and effectively turn "revenues" into "billings" are not permitted. However, the staff has confirmed that companies can supplement revenue numbers with properly characterized disclosures of billings or bookings, which are not considered non-GAAP measures.
- ***Purchase Accounting Adjustments***. Several letters included comments on non-GAAP adjustments seeking to reverse the impact of purchase accounting in connection with acquisitions. Purchase accounting can increase costs through higher depreciation and amortization charges from asset write-ups to fair value. It can also reduce revenues recognized post acquisition from target companies as their deferred revenue balances are written down to fair value. Again, the staff queried the appropriateness of non-GAAP adjustments that neutralize these effects, especially with respect to revenue recognition, but seemed receptive to arguments about the usefulness of the measures if accompanied by expanded disclosure.
- ***Cash-Based Adjustments for Performance Measures***. The staff queried whether it was appropriate to adjust performance measures for items that never run through the income statement, even though they represent cash received, such as principal repayments collected on a long-term receivable. Conversely, where non-GAAP adjustments are defined or explained on the basis that they are non-cash, the staff may challenge whether the relevant non-GAAP measure is in fact a performance measure rather than a liquidity measure. One of the reasons the distinction can be significant is because liquidity measures may not be presented on a per share basis. In the May 2016 update the staff specifically said that it would focus on the substance of the non-GAAP measure and not management's characterization of it.

- ***Definitions, Explanations and Disclaimers***. As discussed above, the staff has been very focused on how companies define their non-GAAP measures and explain the reasons why they believe the measures are useful to investors. The staff will often scrutinize individual adjustments against these definitions and explanations and point out inconsistencies. For example, if the company's stated rationale for the non-GAAP measure is that it enhances comparability across periods, the staff may question adjustments that appear in multiple periods, even when they are not labeled "non-recurring." The staff may also challenge adjustments based on a perceived inconsistency with protective disclaimer language. Where a company explained non-GAAP adjustments as items not representative of its ongoing operating performance, the staff asked it to reconcile this with a warning elsewhere that similar charges would occur in the future.

Reconciliation

Many letters also commented on the content or format of the reconciliation of non-GAAP measures to the comparable GAAP measures. Some of these simply asked companies to provide additional detail and explanation for certain adjustments, particularly when they carried generic names like "Other." Areas of particular focus with respect to reconciliations included the following:

- ***Tax Effects***. The May 2016 update included guidance on how to present the income tax effects of non-GAAP adjustments, and this came up in many comment letters. Most of the comments asked companies not to show adjustments "net of tax," but instead to present the relevant item before tax, and show the tax effect in a separate reconciliation line, with appropriate explanatory disclosure consistent with the applicable C&DI.
- ***Separate Reconciliation for Each Non-GAAP Measure***. In a few letters, the staff asked companies to separately reconcile each non-GAAP measure, even if it could be derived from other non-GAAP measures for which a reconciliation was provided. For example, companies were required to reconcile non-GAAP EPS to GAAP EPS even if the company already reconciled non-GAAP net income to GAAP net income.
- ***Constant Currency***. While the C&DIs regarding constant currency presentation did not change in the May 2016 update, many of the staff's recent comment letters addressed this topic. A reconciliation of constant currency revenues to GAAP revenues is required even when the presentation only discusses the year-over-year change on a constant currency basis. The company also must clearly explain its method of calculation.
- ***Full Non-GAAP Income Statement***. Several letters reminded companies of the staff's position that a reconciliation that includes a full non-GAAP income statement violates the mandated equal or greater prominence for GAAP measures. Similarly, the staff asked companies to start reconciliation tables with the relevant GAAP measure at the top.

Financial Guidance

Companies often have a practice of reporting management's expectations for future performance, referred to as "financial guidance," "earnings guidance" or "outlook," on a non-GAAP basis. The SEC's non-GAAP rules have always required that such forward-looking non-GAAP measures be accompanied by a quantitative reconciliation to the comparable GAAP measures "to the extent available without unreasonable efforts." Many companies that provide financial guidance do not include reconciliations to GAAP guidance in reliance on this exemption.

The SEC's 2003 adopting release for its non-GAAP rules contemplated that if the GAAP financial measure is not accessible on a forward-looking basis, the registrant must disclose that fact and provide reconciling information that is available without an unreasonable effort. Furthermore, the registrant must identify information that is unavailable and disclose its probable significance. The May 2016 update combined these requirements with the rule of equal or greater prominence, suggesting that the disclosure about the unavailability of forward-looking GAAP information and its probable significance itself needed to appear in a location of equal or greater prominence.

Many recent comment letters reminded companies that omitted a reconciliation of their non-GAAP financial guidance of the need to make these disclosures. However, most of the letters did not repeat the statement from the new C&DIs that these disclosures had to appear in a location of equal or greater prominence. Some companies responded to the comment by committing to reconcile their forward-looking non-GAAP measures to the comparable GAAP measures in subsequent filings or earnings releases. Others expanded their disclosures, typically by adding a statement after the financial guidance statement in the earnings release that highlighted the unavailability of financial guidance on a GAAP basis and referred readers to a later part of the document for more detail. Some of the latter companies included in their disclosures certain quantitative information about omitted non-GAAP adjustments that could already be quantified, such as those for announced or completed acquisitions.

Conclusion

The SEC staff remains focused on the use of non-GAAP measures. This first round of comment letters illustrates how the SEC staff intends to apply the May 2016 update in practice and should prove useful for companies in anticipating potential comments. While most of the disclosures that the staff commented on in this round were issued prior to the May 2016 update, companies have since gone through at least one full cycle of quarterly earnings with an opportunity to reflect the update in their SEC filings and earnings releases. It remains to be seen what types of comments the staff will have on these more recent disclosures.

SHEARMAN & STERLING LLP

AUTHOR

Harald Halbhuber
New York
+1.212.848.7150
harald.halbhuber@shearman.com

CONTACTS

Richard B. Alsop
New York
+1.212.848.7333
richard.alsop@shearman.com

Jonathan M. DeSantis
New York
+1.212.848.5085
jonathan.desantis@shearman.com

Robert Ellison
São Paulo
+55.11.3702.2220
robert.ellison@shearman.com

Robert Evans III
New York
+1.212.848.8830
revans@shearman.com

Stuart K. Fleischmann
New York
+1.212.848.7527
sfleischmann@shearman.com

Lisa L. Jacobs
New York
+1.212.848.7678
ljacobs@shearman.com

Merritt S. Johnson
New York
+1.212.848.7522
merritt.johnson@shearman.com

Jason R. Lehner
Toronto
+1.416.360.2974
jlehner@shearman.com

Ilir Mujalovic
New York
+1.212.848.5313
ilir.mujalovic@shearman.com

Manuel A. Orillac
New York
+1.212.848.5351
morillac@shearman.com

Alan Seem
Menlo Park
+1.650.838.3753
alan.seem@shearman.com

Antonia E. Stolper
New York
+1.212.848.5009
astolper@shearman.com

Robert C. Treuhold
New York
+1.212.848.7895
rtreuhold@shearman.com

Harald Halbhuber
New York
+1.212.848.7150
harald.halbhuber@shearman.com

Apostolos Gkoutzinis
London
+44.20.7655.5532
apostolos.gkoutzinis@shearman.com

David Dixter
London
+44.20.7655.5633
david.dixter@shearman.com

Richard J.B. Price
London
+44.20.7655.5097
rprice@shearman.com

Jacques B. McChesney
London
+44.20.7655.5791
jacques.mcchesney@shearman.com

Trevor Ingram
London
+44.20.7655.5630
trevor.ingram@shearman.com

Marwa M. Elborai
London
+44.20.7655.5524
marwa.elborai@shearman.com

Pawel J. Szaja
London
+44.20.7655.5013
pawel.szaja@shearman.com

Mehran Massih
London
+44.20.7655.5603
mmassih@shearman.com

Jonathan Handyside
London
+44.20.7655.5021
johnathan.handyside@shearman.com

Andreas Löhdefink
Frankfurt
+49.69.9711.1622
andreas.loehdefink@shearman.com

Domenico Fanuele
Rome
+39.06.697.679.210
dfanuele@shearman.com

Tobia Croff
Milan
+39.02.0064.1509
tobia.croff@shearman.com

Emanuele Trucco
Milan
+39.02.0064.1527
emanuele.trucco@shearman.com

Tommaso Tosi
Milan
+39.02.0064.1520
tommaso.tosi@shearman.com

Sami L. Toutounji
Paris
+33.1.53.89.70.62
stoutounji@shearman.com

Hervé Letréguilly
Paris
+33.1.53.89.71.30
hletreguilly@shearman.com

Colin Law
Hong Kong
+852.2978.8090
colin.law@shearman.com

Kyungwon (Won) Lee
New York
+1.212.848.8078
kyungwon.lee@shearman.com

Andrew R. Schleider
Singapore
+65.6230.3882
aschieider@shearman.com

Masahisa Ikeda
Tokyo
+03.5251.1601
mikeda@shearman.com

Peter Chen
Hong Kong
+852.2978.8012
peter.chen@shearman.com

Matthew Bersani
Hong Kong
+852.2978.8096
matthew.bersani@shearman.com

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069