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SEC Updates Guidance on Use of Non-GAAP Financial Measures

On May 17, 2016, the Securities and Exchange Commission released updated guidance regarding the disclosure of non-GAAP financial information by public companies.[1] This updated guidance comes in the wake of several public statements during the first half of 2016 by SEC Chair Mary Jo White, SEC Commissioner Kara M. Stein, SEC Chief Accountant James Schnurr and SEC Deputy Chief Accountant Wesley R. Bricker, each expressing concern over existing market practices surrounding the use and disclosure of non-GAAP financial information by public companies and suggesting that the SEC will increase its scrutiny in this area.

We believe the updated guidance will impact routine earnings press releases, investors presentations and SEC filings for a significant number of public companies. Many companies will need to revisit the basic structure of their earnings press releases, including how metrics are presented in headlines, captions and tables, the text of legends addressing non-GAAP financial measures, and the presentation of forward-looking guidance for metrics like adjusted net income, adjusted EBITDA and other non-GAAP financial measures. Some companies will also need to consider whether any adjustments to their historic non-GAAP financial measures could be considered misleading under the SEC's updated guidance. The bottom line is that public companies should take a fresh look at their disclosures in preparation for their next reporting cycle.

Display GAAP Information with Equal or Greater Prominence

Regulation S-K requires any document filed with the SEC containing a non-GAAP financial measure to also present the most directly comparable GAAP financial measure with "equal or greater prominence" as the non-GAAP financial measure.[2] This equal or greater prominence requirement is also applicable to financial information furnished to the SEC pursuant to Item 2.02 of Form 8-K, so that quarterly earnings press releases are covered for most public companies.[3]

Although determining the prominence of any non-GAAP financial measure disclosed is necessarily dependent on the facts and circumstances of the particular disclosure, the SEC's updated guidance provides several concrete examples in which the SEC *would* consider the non-GAAP financial measure to be impermissibly displayed with greater prominence than the most directly comparable GAAP financial measure. These examples include the following:

- Omitting comparable GAAP financial measures from an earnings release headline or caption containing non-GAAP financial measures.

- Disclosing a non-GAAP financial measure before its most directly comparable GAAP financial measure (including in an earnings release headline or caption).

- Describing a non-GAAP financial measure using superlatives (*e.g.*, "record performance" or "exceptional") without at least an equally prominent descriptive characterization of the most directly comparable GAAP financial measure.

- Providing discussion and analysis of a non-GAAP financial measure (*e.g.*, trend analysis or period-over-period comparisons) without a similar discussion and analysis of the most directly comparable GAAP financial measure in a location with equal or greater prominence.

- Presenting a full, non-GAAP income statement, including when reconciling non-GAAP financial measures to their most directly comparable GAAP financial measures.

- Presenting a non-GAAP financial measure in a style that emphasizes the non-GAAP financial measure over its most directly comparable GAAP financial measure (*e.g.*, bold, larger font).

- Providing tabular disclosure of non-GAAP financial measures without preceding them with an equally prominent tabular disclosure of the most directly comparable GAAP financial measures or including the most directly comparable GAAP financial measures in the same table as the non-GAAP financial measures.

- Excluding a quantitative reconciliation of a forward-looking non-GAAP financial measure without disclosing that such a reconciliation cannot be provided without unreasonable efforts and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence.

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

The SEC also revised its prior guidance concerning the ability of public companies to disclose non-GAAP financial measures on a per share basis. Although the SEC has long prohibited the disclosure of non-GAAP liquidity measures on a per share basis, the SEC's updated guidance clarifies that the determination of whether a non-GAAP financial measure is a performance measure (in which case presentation on a per share basis is permissible) or a liquidity measure (in which case such a presentation is not permissible) will be made based on whether the measure "can be used as a liquidity measure, even if [the company] presents it solely as a performance measure."[4] In particular, the SEC indicated that it will focus on the substance of any non-GAAP financial measure in determining whether it is a liquidity or performance measure rather than its characterization by the company, effectively establishing an objective standard for making this determination. This objective standard is further reflected in the SEC's other changes to its prior guidance specifying that *free cash flow*, *EBIT* and *EBITDA* are all liquidity measures that may not be presented on a per share basis.[5]

Non-GAAP Financial Information Calculated Net of Taxes

The SEC's updated guidance also addressed adjustments used to reflect the impact of taxes when computing non-GAAP financial measures. Most notably, the SEC indicated that any adjustments as a result of taxes should be shown and explained as a separate adjustment in calculating a non-GAAP financial measure rather than using adjustments which themselves are net of the relevant effect of taxes.[6]

Instances When Disclosure of Non-GAAP Financial Information May Be Misleading

In addition to the updates discussed above, the SEC also issued new guidance concerning instances when the disclosure of non-GAAP financial information may be considered misleading. The SEC's guidance highlights that certain adjustments used in calculating non-GAAP financial measures, though not explicitly prohibited by SEC rule, may still result in misleading disclosure in violation of Rule 100(b), which prohibits untrue and misleading statements and omissions.[7] In particular, the SEC cited the following as examples of non-GAAP financial measures that *could* be misleading in violation of Rule 100(b):[8]

- A non-GAAP performance measure that excludes normal, recurring, cash operating expenses necessary to operate the company's business.

- A non-GAAP financial measure that is presented inconsistently between periods, such as a non-GAAP financial measure that adjusts for a particular charge or gain in the current period, but which (without explanation) does not adjust for other, similar charges or gains in prior periods.[9]

- A non-GAAP financial measure that is adjusted only for non-recurring charges when non-recurring gains also occurred during the same period.

The SEC's new guidance also addresses non-GAAP financial measures that adjust GAAP's ordinary revenue recognition rules. Specifically, the SEC stated that a registrant may not present a non-GAAP performance measure that adjusts to accelerate revenue recognized ratably over time under GAAP as though it were earned when a customer was billed, and stated that non-GAAP financial measures that adjust to "substitute individually tailored revenue recognition and measure methods for those of GAAP" *could* be misleading in violation of Rule 100(b).[10]

Possibility for Future SEC Action Concerning Non-GAAP Financial Information

The numerous public statements by SEC leadership suggest that the SEC's scrutiny of non-GAAP financial information may not stop with its most recent guidance. In addition to foreshadowing many of the changes in disclosure of non-GAAP financial information contained in the SEC's updated guidance, SEC Deputy Chief Accountant Bricker also recently reiterated several additional points which have been previously highlighted by SEC Chair White and others in recent public statements which could form the basis for future SEC scrutiny over the process undertaken by public companies in calculating and disclosing non-GAAP financial information, including:

- Preparers of financial disclosure should consider how their disclosure controls and procedures apply to the disclosure of non-GAAP financial measures.

- Audit committees should pay close attention to the non-GAAP financial measures that a company presents, including the related disclosures and the processes that the company follows to consider both the appropriateness and reliability of those measures, a comment previously made by SEC Chair White in December 2015.

Given this updated guidance and the potential for additional future SEC scrutiny in this area, each public company should carefully evaluate its disclosure of non-GAAP financial information going forward to ensure it complies with all facets of the SEC's rules, including this updated guidance, and appropriately assists investors to understand the company's business and financial results.

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[1] *See* SEC Division of Corporation Finance, Non-GAAP Financial Measures Compliance and Disclosure Interpretations ("CD&I") (May 17, 2016), *available at* https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[2] *See* 17 C.F.R. § 229.10(e)(1)(i)(A).

[3] *See* Instruction 2 to Item 2.02 to Form 8-K.

[4] CD&I, Question 102.05.

[5] *See* CD&I, Questions 102.07 and 103.02.

[6] CD&I, Question 102.11.

[7] CD&I, Question 100.01.

[8] *See* CD&I, Questions 100.01-100.03.

[9] The SEC also indicated that, depending on the significance of the change involved, it may be necessary to recast prior measures to conform to the current presentation and place the disclosure in the appropriate context. *See* CD&I, Question 100.02.

[10] *See* CD&I, Question 100.04.