

Publications

Securities Alert: SEC Updates Guidance on Non-GAAP Financial Measures

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On May 17, 2016, the SEC updated its Compliance & Disclosure Interpretations (C&DIs) concerning the use of non-GAAP financial measures. The new guidance focuses on the calculation and presentation of non-GAAP financial measures in SEC filings and earnings releases subject to Regulation G and/or Item 10(e) of Regulation S-K.

General

The new C&DIs set forth in Questions 100.01 to 100.04 provide that presenting the following types of non-GAAP financial measures may be misleading and violate Rule 100(b) of Regulation G:

- Performance measures that exclude normal, recurring, cash operating expenses necessary to operate a company's business;
- Non-GAAP financial measures that are presented inconsistently between periods, such as a 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;
- Non-GAAP financial measures that exclude charges, but do not exclude any gains, such as a measure that is adjusted only for non-recurring charges when non-recurring gains also occurred during the same period; and
- Non-GAAP financial measures that substitute individually tailored revenue (and other financial statement line items) recognition and measurement methods for those of GAAP.

Non-GAAP Per Share Performance Measures

C&DI Question 102.05 confirms that non-GAAP earnings per share measures may be included in documents filed with or furnished to the SEC and should be reconciled to GAAP earnings per share. However, non-GAAP liquidity measures that measure cash generated may not be presented on a per share basis. Companies may not include a non-GAAP per share measure in documents filed with or furnished to the

SEC that can be used as a liquidity measure (including free cash flow, EBIT and EBITDA), even if management presents it solely as a performance measure. The SEC will evaluate whether a company's use of non-GAAP per share data is permitted based on the substance of the non-GAAP measure and not on management's characterization of the measure.

Equal or Greater Prominence

Item 10(e)(1)(i)(A) of Regulation S-K requires that when a company presents a non-GAAP measure it must present the most directly comparable GAAP measure with equal or greater prominence. C&DI Question 102.10 sets forth the following examples of disclosures that would cause a non-GAAP financial measure to be more prominent than a GAAP financial measure and violate Item 10(e)(1)(i)(A) of Regulation S-K:

- 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.

Income Tax Effects

C&DI Question 102.11 provides that the calculation and presentation of income tax effects related to adjustments to arrive at a non-GAAP measure depends on the nature of the measure. For a liquidity measure that includes income taxes, it may be acceptable to adjust GAAP taxes to show taxes paid in cash. For a performance measure, the company should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. Adjustments to arrive at a non-GAAP measure should not be presented "net of tax," but should instead be shown as a separate adjustment and clearly explained.

Free Cash Flow

C&DI Question 102.07 reminds companies that present a measure of free cash flow to clearly describe how they calculate the measure and provide a required reconciliation. Companies should not imply that free cash flow represents the residual cash flow available to the company for discretionary expenditures since many companies have mandatory debt service requirements or other non-discretionary expenditures that are not deducted from the measure. C&DI Question 103.02 further provides that free cash flow may not be presented on a per share basis.

EBIT and EBITDA

C&DI Question 103.02 clarifies that if EBIT or EBITDA is presented as a performance measure, the measure should be reconciled to net income as presented in the statement of operations under GAAP. The SEC does not consider operating income to be the most directly comparable GAAP financial measure because EBIT and EBITDA make adjustments for items that are not included in operating income. C&DI Question 103.02 further provides that EBIT and EBITDA may not be presented on a per share basis.

Going Forward

In light of these revised and updated C&DIs, the SEC has made clear that it will continue to focus on proper presentation and calculation of non-GAAP financial measures and companies will need to carefully review and update their disclosure of non-GAAP financial measures to ensure compliance with SEC rules, regulations and guidance.