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ALERT MEMORANDUM

Non-GAAP Financial Measures: The SEC's Evolving Views

June 13, 2016

For months now, the Securities and Exchange Commission (the "SEC") has been warning – in speeches by commissioners and senior staff, at conferences, and in comment letters to companies – about growing misuse of non-GAAP financial measures ("NGFMs"). On May 17, 2016, the SEC's Division of Corporation Finance released new and updated Compliance and Disclosure Interpretations ("C&DIs") on the use of NGFMs that demonstrate the SEC's tightening policy. The C&DIs challenge practices that were previously considered permissible and indicate various types of practices that will likely prompt SEC scrutiny.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or any of our partners and counsel listed under Capital Markets or Corporate Governance in the "Our Practice" section of our website.

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This memorandum discusses the SEC's views, as reflected in the new C&DIs, and recommends that companies review their approach to using NGFMs to take those views into account.

NGFMs Potentially Considered Inherently Misleading

Four new C&DIs exemplify the SEC staff's focus on whether certain types of NGFMs could be inherently misleading and thus prohibited under Rule 100(b) of Regulation G. Under the 2003 rules on NGFMs, specific prohibitions are limited to those in Item 10(e)(1)(ii) of Regulation S-K, which applies only to documents filed with the SEC and does not apply to earnings releases. The approach described in the C&DIs extends the idea that some types of measures or practices may be prohibited to the full range of a company's public communications, including earnings releases, corporate websites and publicly available presentation slides. Specifically, new C&DIs caution against the following practices as potentially misleading:

- Presenting a non-GAAP performance measure that excludes "normal, recurring, cash operating expenses necessary to conduct the company's business."
    - Under the previous guidance and Item 10(e), excluding recurring items from a NGFM was generally allowed as long as they were not described as non-recurring, infrequent or unusual (which is explicitly prohibited under Item 10(e)(1)(ii)(B) if the excluded item is reasonably likely to recur within two years or has occurred within prior two years).
    - Excluding recurring items from a NGFM is still allowed, as long as they are appropriately described, but the new C&DI indicates that the SEC staff may challenge recurring items excluded from a performance measure if the staff concludes they constitute normal cash operating expenses. The new C&DI, however, is silent on the exclusion of normal, recurring *non-cash* operating expenses (such as equity-based compensation expense, which many companies exclude from non-GAAP performance measures).
    - This approach has appeared in staff comments from time to time. For example, the staff has objected, as potentially misleading, to the exclusion of marketing expense from a non-GAAP performance measure where it was a normal, recurring operating cash expenditure of the company, and to the exclusion of acquisition-related expenses where acquisitions were a critical component of the company's strategy.
- Changing the definition of NGFMs from period to period, unless the company discloses the change and the reasons for it. If the change is significant, the company may need to recast the prior period measures using the new definition to ensure comparability with the current presentation.
- Excluding charges, but not gains, if the justification for exclusion applies to both ("cherry picking"). For example, if a NGFM excludes non-recurring charges, it should also exclude non-recurring gains during the same period.
- Presenting a non-GAAP revenue measure that backs out the effect of GAAP revenue recognition and measurement principles applicable to a company's business.
    - A new C&DI indicates that Regulation G prohibits a NGFM that adds back revenue that would have been deferred and recognized ratably under GAAP, and notes that similar non-GAAP adjustments to other line items may also be misleading. The SEC staff has indicated that this language should be read broadly: any adjusted revenue measure will be subject to close scrutiny.[1]
    - This kind of non-GAAP revenue adjustment, if appropriately presented and explained, was previously thought to be acceptable. Many companies, including those with subscription-based businesses or those delivering multiple elements or using percentage-of-completion accounting, have employed non-GAAP adjusted revenue measures to illustrate the amount of new business in

[1] SEC Deputy Chief Accountant Wesley Bricker warned in a recent speech that any adjusted revenue NGFM will likely receive a comment from the SEC staff, and any justification for the adjustment provided in response will be scrutinized "closely, and skeptically." Remarks before the 2016 Baruch College Financial Reporting Conference (May 5, 2016), *available at* https://www.sec.gov/news/speech/speech-bricker-05-05-16.html.

a given period (effectively, "billings"), where the related revenue (and cost) will be recognized in a later period under GAAP.

- Although this is the only one of these new C&DIs that identifies a NGFM practice as *actually* misleading (rather than *potentially* misleading) in the staff's view, the staff's approach to adjusted revenue measures seems to be evolving, and presentation of a "billings" concept may be acceptable. Anticipating the adoption of the new revenue recognition standard under U.S. GAAP and IFRS starting (for most companies) with 2018 may also be relevant to a company's presentation of an adjusted revenue measure.

Equal or Greater Prominence

One new C&DI that is likely to have a significant practical impact provides a detailed list of disclosure practices the SEC staff believes improperly make NGFMs more prominent than the most directly comparable GAAP measure. Under Item 10(e) of Regulation S-K, whenever a NGFM is used in an SEC filing or an earnings release, the most directly comparable GAAP measure must be presented with "equal or greater prominence." While the list of examples provided in this C&DI is fairly consistent with the SEC staff's views expressed in the past through comment letters, the examples suggest some bright line tests for "equal or greater prominence" in situations that left room for interpretation in the past. Companies should consider the implications of this new guidance for their earnings releases in particular, which are subject to this requirement under Item 10(e).

- When a NGFM is used in a headline or caption, the most directly comparable GAAP measure must be presented in the same headline or caption. For example, in an earnings release that includes a NGFM in a headline or bullet points at the top, the comparable GAAP measure should be included as well as the NGFM.

- The most directly comparable GAAP measure must be presented first, including when it is used in a headline or caption.

- If a tabular disclosure of NGFMs is included, the most directly comparable GAAP measures must be either (1) presented in an equally prominent tabular disclosure that precedes the NGFM table or (2) included in the same table (presumably earlier).

- If a company uses a different font or style (*e.g.*, larger font, bold or italics) to emphasize a NGFM, the most directly comparable GAAP measure must also be presented with similar emphasis.

- Similarly, if a NGFM is emphasized by using a descriptive characterization (the examples given in the C&DI are "record performance" and "exceptional"), the company must also describe the most directly comparable GAAP measure with "an equally prominent descriptive characterization." This may present a challenge where the period-over-period change in the comparable GAAP measure is less significant than the NGFM or in the opposite direction. It could also be challenging to comply in disclosures that are meant to be concise and punchy, like management quotations in an earnings release.

- If a company includes discussion and analysis of a NGFM, it must also include discussion and analysis of the most directly comparable GAAP measure that is equal or greater in its scope and location. In particular, this may necessitate a discussion of net income in the earnings release and MD&A, which many companies omit as repetitive of the individual income statement line item discussion.

- Companies may not present a full income statement of NGFMs or, when reconciling a NGFM to the most directly comparable GAAP measure, a full non-GAAP income statement.

Forward-Looking NGFMs

In the case of forward-looking NGFMs, both Regulation G and Item 10(e) of Regulation S-K provide an exception to the requirement to reconcile a NGFM to the most directly comparable GAAP measure when the reconciliation requires "unreasonable efforts." In the original adopting release,[2] the SEC indicated that if a company makes use of this exception, it must (1) state that reconciliation of the forward-looking NGFM is not available without unreasonable efforts, (2) provide any reconciling items that are available without unreasonable efforts and (3) identify information that is unavailable and its probable significance.

A new C&DI re-affirms that these disclosures are required and also states that they are subject to the requirement of equal or greater prominence under Item 10(e) of Regulation S-K. This will have significant consequences for issuers that present guidance using NGFMs without reconciliation to GAAP measures, because they will need to identify the missing GAAP measures and explain their probable significance, and do so without letting the NGFMs be more prominent. Including the required disclosure in a footnote will probably not be sufficient.

Per Share Presentation and Liquidity vs. Performance Measures

Several updated CD&Is concern the SEC's long-standing prohibition against presenting non-GAAP liquidity measures on a per share basis (such as "free cash flow per share") in documents filed with or furnished to the SEC. Although the staff generally takes the view that per share presentation of non-GAAP performance measures may be meaningful to investors and is permitted if appropriately presented and reconciled, one updated C&DI disallows per share presentation of EBIT or EBITDA, regardless of whether management presents it as a performance or liquidity measure.

Another updated C&DI on this topic notes that, in determining whether a NGFM is used as a performance measure or a liquidity measure, the SEC staff will focus on the substance of the measure instead of relying on management's characterization of it. Chief Accountant Mark Kronforst of the SEC Division of Corporation Finance recently stated that in the past, the SEC staff showed some deference to management on the labeling of NGFMs as performance or liquidity measures, but going forward, the staff will start challenging management's characterizations.[3]

Despite this stricter guidance, per share presentation of other non-GAAP performance measures should continue to be permitted, unless the measure could also be viewed as a liquidity measure. In particular, in another updated C&DI, the staff confirmed that it accepts as a performance measure "funds from operations" ("FFO"), a measure

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[2] SEC, Final Rule: Conditions for Use of Non-GAAP Financial Measures (Release No. 33-8176; 34-47226), Section II.A.3.b. (for Regulation G) and Section II.B.2. (for Item 10(e) of Regulation S-K), *available at* https://www.sec.gov/rules/final/33-8176.htm .

[3] Public Company Accounting Oversight Board, Standing Advisory Group Meeting (May 18-19, 2006), webcast and audio available at https://pcaobus.org/News/Events/Pages/SAG-meeting-May-2016.aspx.

typically presented by REITs, under the National Association of Real Estate Investment Trusts definition in effect as of May 17, 2016, and that REITs can continue to present FFO on a per share basis.

Tax-Related Effects in NGFMs

Income tax effects on a NGFM seems to have drawn the SEC staff's particular attention. In recent remarks, Mssrs. Kronforst and Bricker both singled out "non-GAAP tax expense" as one of the practices that is causing concern at the SEC. A new C&DI reflects this focus. It indicates that a company's calculation and presentation of the income tax effects related to the adjustments for a NGFM should be appropriately calculated to reflect the nature of the NGFM. Two examples are provided by the new C&DI:

- For a non-GAAP liquidity measure, it may be acceptable to adjust GAAP taxes to show only taxes paid in cash.
- For a non-GAAP performance measure, current and deferred income tax expense should be included commensurate with the non-GAAP measure of profitability. For example, the SEC staff has indicated in comment letters that where a company's income tax rate was lower due to certain expenses that are excluded from a NGFM, the tax rate used in calculating the NGFM should also be adjusted to reflect the exclusion of those expenses.

The C&DI also provides new guidance on presenting the tax effects of adjustments applied to a NGFM in the required reconciliation. Until now, companies have often presented a non-GAAP adjustment "net of tax," so long as the tax effect for each reconciling item was disclosed parenthetically or in a footnote to the reconciliation table. Under the new guidance, a non-GAAP adjustment should not be presented "net of tax," but instead, the tax effect should be presented as a separate adjustment and clearly explained.

Foreign Private Issuers

Regulation G applies to foreign private issuers ("FPIs"), but there is an exemption that applies to most published disclosures by an FPI that is listed outside the United States and that uses IFRS or another body of non-U.S. accounting principles.[4] FPI earnings releases are also treated differently under the SEC's rules: Item 2.02 of Form 8-K makes domestic issuer earnings releases subject to some requirements of Regulation S-K Item 10(e), notably the prominence requirement, but FPI earnings releases are not subject to any comparable requirement.

Item 10(e) of Regulation S-K does apply to documents that FPIs file with the SEC, including the annual report on Form 20-F and any other document that is incorporated by reference into a registration statement under the Securities Act.[5] For this purpose, reports on Form 6-K are furnished rather than filed, and thus not subject to Item 10(e) unless specifically incorporated into a registration statement. FPIs often elect not to incorporate their earnings release 6-Ks into their registration statements, among other reasons because they do not comply with the requirements of Item 10(e).

[4] *See* Rule 100(c) of Regulation G. The exemption is unavailable to an FPI that is listed only in the United States, and it is not available for NGFMs that relate to financial statements prepared under U.S. GAAP. It only applies to a disclosure that is made outside the United States, or included in a written communication released outside the United States (even if it is concurrently released in the United States).

[5] NGFMs included in Annual Reports on Form 40-F filed by Canadian companies under the multijurisdictional disclosure system (MJDS) are not subject to Regulation G or Item 10(e) of Regulation S-K.

As a matter of best practice, however, many reporting FPIs do generally seek to comply to varying degrees with the SEC's rules on NGFMs in their earnings releases and other investor materials outside their registration statements and annual reports. These issuers should review their practices in light of the changes in SEC views reflected in the new C&DIs.

For SEC filings made by FPIs, Item 10(e) of Regulation S-K provides a narrow exemption for a NGFM that is "expressly permitted" under the accounting principles used in the issuer's primary financial statements. Reliance on this exception is rare and may become more so as views of NGFMs converge among regulators internationally. For example, in June 2016, the Board of the International Organization of Securities Commission (IOSCO) published a Statement on Non-GAAP Financial Measures that presents guidelines that are largely consistent with Regulation G, Item 10(e) of Regulation S-K and the C&DIs.

What Should a Company Do?

- Re-examine the company's use of NGFMs in earnings releases, SEC filings and other public disclosures, particularly in light of the SEC staff's focus on potentially misleading measures, and evaluate the number of NGFMs it uses, the complexity of those NGFMs and whether it has a substantive justification for using them. A senior SEC official recently commented that the staff expects issuers to address the SEC's views on NGFMs in reporting second-quarter earnings. [6]

- Review the presentation of NGFMs in earnings releases and SEC filings, to ensure that GAAP measures are always presented with equal or greater prominence, consistent with the guidance provided in the C&DIs. Pay particular attention to the order of appearance (GAAP measures must precede NGFMs) and style of presentation (if a NGFM is emphasized, the most directly comparable GAAP measure must be equally emphasized).

- Review guidance practices to be sure that NGFM guidance addresses the concern under the new C&DIs by either reconciling to GAAP guidance or giving appropriate prominence to the absence of such a reconciliation, the reasons it is impractical and the probable significance of unavailable reconciling items.

- Be careful when excluding recurring expenses that could be viewed as essential to the company's business or strategy. Of particular concern are any exclusions of normal, recurring cash operating expenses.

- Focus on any per-share presentation of a NGFM that is or could be viewed as a liquidity measure, particularly in light of the new staff bar on presenting EBIT or EBITDA on a per share basis in SEC filings and earnings releases.

- Ensure that income tax effects on NGFMs are calculated to reflect the adjustments made to the NGFMs appropriately.

[6] At the PCAOB meeting discussed above, Mr. Kronforst suggested that the second quarter of 2016 would be a good opportunity for companies to "self correct," and for companies that fail to do so, there will be an uptick in the number of comments on NGFMs.

- Consider reviewing the approach to NGFMs with the audit committee in advance of the next earnings release.

Link to C&DIs

http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm

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