SEC Releases Guidance on Non-GAAP Financial Measures

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On May 17, the staff of the SEC's Division of Corporation Finance released new and revised **Compliance and Disclosure Interpretations** (C&DIs) on the use of non-GAAP financial measures. Coming after months of concern voiced by SEC officials and some financial columnists that companies are deploying non-GAAP financial measures in misleading or confusing ways, the new guidance clarifies – and in some cases changes – the rules for using non-GAAP financial measures under Regulation G, which applies to all public disclosures by SEC registrants (with limited exceptions for foreign private issuers), and Item 10(e) of Regulation S-K, which applies to SEC filings and earnings releases.

The new guidance is not officially a rule change, though some of it expands on the text of Regulation G and may lead to changes in common practice. We believe non-GAAP financial measures are widely used by companies, investors and analysts to monitor performance, incentivize management and facilitate intercompany and interperiod comparisons and that, so long as a reconciliation to GAAP is provided, presenting these measures is generally appropriate. While the guidance may herald a formal move by the SEC towards adopting a different view, we do not believe it is time for companies to stop using non-GAAP financial measures.

Certain Presentations Are Prohibited

The guidance indicates that –

- the use of non-GAAP revenue recognition and measurement methods could violate Regulation G – and this may also be the case for line items other than revenue;
- some adjustments that are not specifically prohibited can cause a non-GAAP financial measure to be misleading, for example when an adjustment excludes normal, recurring, cash operating expenses necessary to operate the business;
- a non-GAAP financial measure can be misleading if presented inconsistently between periods, and, if a change in presentation is significant, it may be necessary to recast prior periods;
- non-GAAP financial measures adjusting for non-recurring charges, but not non-recurring gains, could be misleading; and
- income-tax effects related to adjustments must be shown as a separate adjustment, and adjustments may not be shown "net of tax."

It is not clear why the staff is so troubled by adjusted revenue measures, or what limiting principle mandates an apparent prohibition on adjustments to revenue but still permits adjustments to other line items, such as operating or net income or cash flow from operations. Some companies may find the guidance difficult to deal with when GAAP rules on revenue recognition change, as it could create obstacles to showing results in different periods on a comparable basis.

Equal Prominence

Regulation G does not require equal prominence of GAAP and non-GAAP financial measures, but Item 10(e) does require such prominence in SEC filings and earnings releases. In line with recent speeches criticizing the prominence of non-GAAP presentations, the guidance provides examples where the staff believes non-GAAP presentations have greater prominence, including –

- using a non-GAAP financial measure before a GAAP measure in a heading or caption, or including only a non-GAAP financial measure;
- emphasizing a non-GAAP financial measure by using a bold or larger font than used for the comparable GAAP measure;
- presenting a full income statement of non-GAAP financial measures or presenting a full non-GAAP income statement when providing a GAAP reconciliation;
- describing a non-GAAP financial measure without equally prominently characterizing a GAAP measure; and
- providing tabular disclosure of a non-GAAP financial measure without preceding it by, or including in the table, the comparable GAAP measure.

While some of these statements are consistent with prior practice, others are new, including the prohibition on placing non-GAAP financial measures first. These changes will still permit the use of non-GAAP financial measures in earnings releases but will likely require many companies to change their presentations.

Forward-Looking Measures

Regulation G and Item 10(e) require companies to provide a quantitative reconciliation of forward-looking non-GAAP financial measures to the extent available without "unreasonable efforts," recognizing that at the time of disclosure of a forward-looking non-GAAP financial measure, a company may not be able to quantify all of the amounts that would impact the comparable GAAP financial measure. The adopting release for Regulation G issued in 2003 states that if a comparable GAAP financial measure is not available on a forward-looking basis, a company must disclose that fact, provide the reconciling information that is available, and identify the unavailable information and disclose its probable significance. This requirement has not attracted notice, and the new guidance reiterates the 2003 adopting release and states that a presentation of a forward-looking non-GAAP financial measure that omits a quantitative reconciliation will be considered to have greater prominence if the presentation does not also identify the information that is not available and disclose its probable significance in a location of equal or greater prominence. This will represent a significant change for many companies, as few companies identify the unavailable information and even fewer identify its probable significance.

Per-Share Measures

As in recent comment letters, the guidance focuses on presenting non-GAAP liquidity measures on a per-share basis. The staff has long believed that only non-GAAP performance measures should be presented on a per-share basis. The guidance states that the staff will analyze whether a particular non-GAAP financial measure is effectively a liquidity measure or a performance measure, rather than simply defer to management's characterization. The guidance also states that neither free cash flow nor EBIT or EBITDA may be presented on a per-share basis. Per-share funds from operations (FFO), however, will continue to be permitted for REITs.

Practical Implications

The guidance comes at the end of the first quarter reporting season, giving companies some breathing room to adjust before releasing second quarter results. All companies that use non-GAAP financial measures will need to take a fresh look at their presentations, including earnings releases, investor decks and SEC filings.

In particular, companies should –

- ensure that non-GAAP financial measures are not given greater prominence than (or used as a substitute for) GAAP measures, in particular in headlines, captions and tables;
- confirm that per-share measures are presented only for performance metrics and not liquidity metrics, in particular free cash flow and EBIT or EBITDA measures;
- ensure that non-GAAP presentations are calculated consistently across periods;
- clarify the names of any non-GAAP financial measures so that they are not confusingly similar to the names of GAAP measures; and
- confirm strict adherence to Regulation G and Item 10(e), especially in providing clear reconciliations, explanations and justifications.

We expect the staff to continue focusing on non-GAAP disclosures and actively challenge companies through comment letters when the staff believes non-GAAP presentations are misleading or are supplanting GAAP presentations. Although SEC officials have stated that they are considering additional rulemaking and even enforcement actions, in the near term we expect the staff to assess whether the new guidance and recent attention will successfully lead to self-correction.

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