

Client Alert

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SEC Staff Release New Guidance on Use of Non-GAAP Measures

Following a series of recent speeches by the Chair and Staff of the Securities and Exchange Commission (“SEC”) on potential misuses of non-GAAP financial measures by public companies, on May 18, 2016, the SEC Staff released 12 new or updated Compliance and Disclosure Interpretations (“C&DIs”) on the subject.¹ Collectively, the C&DIs and speeches suggest that the SEC is taking a narrower view of non-GAAP measures and will require many companies to reconsider the manner in which they present these metrics. We summarize key developments in the new or amended C&DIs below.

General Matters

The C&DIs² begin with four new questions that apply generally and concern misleading non-GAAP measures that could violate Rule 100(b) of Regulation G.³

- Question 100.01 clarifies that certain adjustments, although not explicitly prohibited, can still result in a non-GAAP measure that is misleading. By way of example, the Staff notes that presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a company’s business could be misleading.
- Question 100.02 indicates that a non-GAAP measure can also be misleading if it is presented inconsistently between periods. For example, the Staff observes that a non-GAAP 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 could violate Rule 100(b) of Regulation G unless the change between periods is disclosed and the reasons for it explained. In addition, depending on the significance of the change, it may be necessary to recast prior measures to conform to the current presentation and place the disclosure in the appropriate context.
- Question 100.03 provides that a non-GAAP measure can be misleading if the measure excludes charges but does not exclude any gains. For example, the Staff notes that a non-GAAP measure

¹ The SEC’s rules on the disclosure of non-GAAP financial information are found in Regulation G and Item 10(e) of Regulation S-K.

² The full text of the C&DIs is available at: <https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm>.

³ Rule 100(b) provides:

A registrant, or a person acting on its behalf, shall not make public a non-GAAP financial measure that, taken together with the information accompanying that measure and any other accompanying discussion of that measure, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading.

that is adjusted only for non-recurring charges when there were non-recurring gains that occurred during the same period could violate Rule 100(b) of Regulation G.

- Question 100.04 begins with the hypothetical situation in which a company presents a non-GAAP performance measure that is adjusted to accelerate revenue recognized ratably over time in accordance with GAAP as though it earned revenue when customers are billed. It then asks whether this measure can be presented in documents filed or furnished with the SEC or provided elsewhere, such as on company websites. In response, the Staff indicates that it may not. The Staff clarifies that non-GAAP measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could violate Rule 100(b) of Regulation G. Other measures that use individually tailored recognition and measurement methods for financial statement line items other than revenue may also violate Rule 100(b).

Funds from Operations

“Funds from Operations” (“FFO”) is a non-GAAP measure that real estate investment trusts regularly report.

- Question 102.01 confirms that the definition of FFO as adopted by the National Association of Real Estate Investment Trusts (“NAREIT”) and in effect on May 17, 2016, is an acceptable performance measure. The Staff also indicated that it does not object to presentation of FFO on a per share basis.
- Question 102.02 confirms that a company can present FFO on a basis other than that as defined by NAREIT so long as any adjustments to FFO comply with Item 10(e) of Regulation S-K⁴ and the measure does not violate Rule 100(b) of Regulation G.

Smoothing

Question 102.03 (which discusses the Item 10(e) prohibition against adjusting a non-GAAP financial performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual) is updated to include a cross-reference to new Question 100.01.

Per Share Measures

- Question 102.05 clarifies that non-GAAP liquidity measures that measure cash generated must not be presented on a per share basis in documents filed or furnished with the SEC. According to the Staff, whether per share data is prohibited depends on whether the non-GAAP measure can be used as a liquidity measure, even if management presents it solely as a performance measure. When analyzing these questions, the Staff indicates it will focus on the substance of the non-GAAP measure and not management’s characterization of the measure.
- Question 102.07 clarifies that free cash flow is a liquidity measure that must not be presented on a per share basis.

⁴ Item 10(e) governs all filings with the SEC under the Securities Act of 1933 and the Securities Exchange Act of 1934. It prohibits the presentation of non-GAAP financial measures on the face of a company’s financial statements or in the accompanying notes, as well as on the face of any pro forma financial information required to be disclosed pursuant to Regulation S-X. Item 10(e) applies to the Summary Financial Information, Selected Historical Financial Information, Management’s Discussion and Analysis under Item 303. It also applies to other sections of prospectuses and periodic reports that contain non-GAAP financial measures.

- Question 103.02 clarifies that EBIT and EBITDA (and similar measures) must not be presented on a per share basis.

Prominence

Question 102.10 provides several examples of situations in which a non-GAAP measure is presented impermissibly in a fashion more prominent than the corresponding GAAP measurement. Thus, a company is prohibited from:

- 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 or 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;⁵ 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

Question 102.11 clarifies that a company should provide income tax effects on its non-GAAP measures depending on the nature of the measures. If a measure is a liquidity measure that includes income taxes, the Staff believes it might be acceptable to adjust GAAP taxes to show taxes paid in cash. If a measure is a performance measure, the company should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. In addition, the Staff cautions that

⁵ The same “unreasonable efforts” exception is found in Rule 100(a) of Regulation G. Note that the requirement to disclose the fact that the company cannot provide the required reconciliation without unreasonable efforts and identify the information that is unavailable and its probable significance is not new. The SEC’s 2003 adopting release (Release No. 33-8176 (“Conditions for Use of Non-GAAP Financial Measures”)) provides, “[i]f 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.” In our experience, however, few companies that use the “unreasonable efforts” exception provide this additional disclosure.

adjustments to arrive at a non-GAAP measure should not be presented “net of tax.” Rather, income taxes should be shown as a separate adjustment and clearly explained.

Takeaways

When the SEC first adopted Regulation G and Item 10(e) of Regulation S-K in 2003, the Staff closely monitored corporate disclosure and narrowly construed the regulations. Over time, the Staff adopted a more flexible attitude and began to permit a broader array of non-GAAP measures and related disclosure practices.⁶

The Chair and Staff’s recent speeches, coupled with the revised C&DIs, make clear that the pendulum has begun to swing back in the other direction. We have already begun to see an uptick in Staff comment letters on the use of non-GAAP measures, and expect that companies will continue to see more of them in the coming months. Now is the calm before the storm, and it is a good time for companies to review their past practices on the disclosure of non-GAAP measures with an eye toward adjusting them in light of the new guidance.

While rulemaking activities at the SEC are beginning to slow down in the run up to the presidential election, the SEC’s enforcement apparatus remains in overdrive. To date, the SEC has not brought many enforcement cases premised on the violation of Regulation G.⁷ Nevertheless, companies that do not adjust to the SEC’s new guidance may well find themselves in the crosshairs of the SEC Enforcement Division.

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⁶ See e.g., the SEC Staff’s January 15, 2010 C&DIs on the subject.

⁷ See Litigation Release No. 21290 (Nov. 12, 2009).