

A New Chapter for Non-GAAP Financial Measures

June 28, 2016

Securities

The SEC's Division of Corporation Finance (the "Division") recently issued updated interpretive guidance on the use of non-GAAP financial measures. This guidance reflects an increasingly assertive position taken by the SEC in recent months regarding public companies' use of numerical measures of performance, financial position or cash flows that are not calculated in accordance with generally accepted accounting principles ("GAAP"). This renewed focus follows years of use of non-GAAP financial measures by many issuers and recent analyst research and press reports that have raised questions about the discrepancies between such measures and financial performance metrics calculated in accordance with GAAP.¹ In response to the perceived misuse of non-GAAP financial measures, SEC Chair Mary Jo White stated in December 2015 that:

[T]he use of non-GAAP financial measures ... deserves close attention, both to make sure that our current rules are being followed and to ask whether they are sufficiently robust in light of current market practices. Non-GAAP measures are allowed in order to convey information to investors that the issuer believes is relevant and useful in understanding its performance. By some indications, such as analyst coverage and press commentary, non-GAAP measures are used extensively and, in some instances, may be a source of confusion.²

In addition, in March 2016, the SEC's Chief Accountant, James V. Schnurr, noted that the SEC had observed "a significant and, in some respects, troubling increase over the past few years in the use of, and nature of adjustments within, non-GAAP measures by companies as well [as]

¹ See, e.g., Tatyana Shumsky and Theo Francis, "Accounting Choices Blur Profit Picture," *The Wall Street Journal* (June 28, 2016); Justin Lahart, "S&P 500 Earnings: Far Worse than Advertised," *The Wall Street Journal* (Feb. 24, 2016); Michael Rapoport, "Tailored Accounting at IPOs Raises Flags," *The Wall Street Journal* (Jan. 7, 2015).

² Mary Jo White, [Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility"](#) (Dec. 9, 2015). Chair White's comments also hold the possibility of further rulemaking to address specific areas of concern surrounding the use of non-GAAP financial measures. More recently, another SEC Commissioner has raised similar concerns regarding the use of Non-GAAP Measures. See Kara M. Stein, [Statement on the Commission's Consideration of the Public Company Accounting Oversight Board's Proposed 2016 Budget and Accounting Support Fee](#) (Mar. 14, 2016).

prominence that the analysts and media have accorded such measures when reporting on the results of the companies they cover.”³

In light of these developments, this is a good time for public companies to review their use of non-GAAP financial measures and related disclosures to ensure that presentations of non-GAAP financial measures are compliant with applicable disclosure requirements. This advisory reviews the regulatory framework governing the use of non-GAAP financial measures and the Division’s recently released guidance and notes certain areas for particular consideration by public companies and their advisors.

Regulation of Non-GAAP Financial Measures

Background

The decade prior to the passage of the Sarbanes-Oxley Act of 2002 witnessed a rising tide of financial measures derived using methods that differed from GAAP.⁴ These measures provided technology startups and other companies reporting low revenues and high costs with an alternative means to explain their businesses to investors without relying exclusively on traditional GAAP metrics. However, market participants and commentators soon expressed concern regarding the use of non-GAAP financial information due to the lack of a uniform definition of such measures and the risk that such measures could, as a consequence, mislead investors.⁵ Congress responded to these concerns by instructing the SEC, in Section 401(b) of the Sarbanes-Oxley Act, to adopt rules regulating the use of “pro forma” financial information.

In January 2003, the SEC adopted rules in response to this mandate in two main areas.⁶ First, the SEC added an accounting disclosure regulation, Regulation G, which prohibits the use of non-GAAP financial measures outside of SEC filings without complementary disclosure of the most directly comparable GAAP financial measure and a reconciliation of the two measures.⁷ Second, the SEC adopted Item 10(e) of Regulation S-K, which requires additional disclosures and imposes certain restrictions regarding the use of non-GAAP financial measures in SEC filings. The SEC also amended Form 8-K to require that earnings releases be furnished to the SEC under Item 2.02 of Form 8-K and that non-GAAP financial measures included in such releases comply with the requirements of Item 10(e) of Regulation S-K.

In the early years following the adoption of these rules, the SEC engaged in active oversight of the use of non-GAAP financial measures, primarily through comment letters issued by the Division in its review of public company filings. However, in later years, the number of comments issued by the Division regarding non-GAAP financial measures has decreased from

³ James V. Schnurr, [Remarks Before the 12th Annual Life Sciences Accounting and Reporting Congress](#) (Mar. 22, 2016).

⁴ Commonly used non-GAAP financial measures have included (a) earnings before interest and taxes (“EBIT”), (b) earnings before interest, taxes, depreciation and amortization (“EBITDA”), (c) adjusted EBITDA, (d) adjusted revenues; (e) adjusted earnings, (f) adjusted earnings per share, (g) free cash flow, (h) core earnings, and (i) funds from operations (“FFO”).

⁵ See *Cautionary Advice Regarding the Use of “Pro Forma” Financial Information in Earnings Releases*, Release No. 33-8039 (Dec. 4, 2001).

⁶ *Conditions for Use of Non-GAAP Financial Measures*, Release No. 34-47226 (Jan. 16, 2003).

⁷ 17 C.F.R. § 244.100 *et seq.*

a high of over 1,400 comments in 2006 to fewer than 400 comments per year since 2012.⁸ This decrease in Division comments, coupled with Division guidance in 2010 that provided more flexibility to the use of non-GAAP measures,⁹ contributed to what many now see as more widespread use of non-GAAP financial measures in recent years.¹⁰ Thus, companies have continued to supplement their GAAP financial reporting with non-GAAP information that is intended to provide additional insight into the business and convey changes to the business that are organic and separate from those that may be considered unusual, infrequent or unrepresentative of underlying trends. The SEC's recent emphasis on policing the use of non-GAAP financial measures comes against this backdrop.

Regulation G: Non-GAAP Financial Measures in Public Statements

Regulation G covers the use of non-GAAP financial measures in any public disclosure, such as press releases, investor calls, CEO letters included in annual reports and other corporate announcements, in two ways.¹¹ First, it sets forth a general anti-fraud rule that a registrant may not make public a non-GAAP financial measure that, in light of any accompanying information and discussion, includes a false statement of material fact or omits a statement or fact needed to render the use of the non-GAAP financial measure not misleading.¹²

Second, Regulation G requires a specific disclosure framework whenever a registrant publicly discloses material information that includes a non-GAAP financial measure. Under that framework, the registrant must also include:

- a presentation of the “most directly comparable” financial measure according to GAAP; and
- a reconciliation of the differences between the two measures.¹³

In general, the reconciliation must be quantitative for both the historical information and any forward-looking information presented. In recognition of the potential difficulty in reconciling forward-looking information, however, Regulation G only requires quantitative reconciliation of such information “to the extent available without unreasonable efforts.” Separately, the registrant must identify what information is not available and disclose its probable significance.¹⁴

Regulation G defines a non-GAAP financial measure as a “numerical measure of a registrant’s historical or future financial performance, financial position or cash flow” that either excludes

⁸ See, [Appendix A](#).

⁹ The interpretative guidance issued by the Division in 2010 gave companies increased latitude to use non-GAAP financial measures by, for example making clear that it was permissible to present non-GAAP measures that excluded the impact of recurring items and permitting the use of measures not otherwise used by management, as long as such measures adhered to Regulation G and Item 10(e) of Regulation S-K.

¹⁰ According to an article in *The Wall Street Journal* citing research firm Audit Analytics, only 29 companies in the S&P 500 index used exclusively GAAP measures in 2015. Tatyana Shumsky and Theo Francis, “Accounting Choices Blur Profit Picture,” *The Wall Street Journal* (June 28, 2016).

¹¹ The rule, however, does not cover disclosure of non-GAAP financial measures if the disclosure is part of certain communications regarding business combination transactions.

¹² Rule 100(b) of Regulation G.

¹³ Rule 100(a) of Regulation G.

¹⁴ *Id.*

amounts that the “most directly comparable GAAP measure” would have included or, alternatively, includes amounts that the comparable GAAP measure would have excluded. The definition thus includes all measures that in effect portray (a) a measure of performance that is different from that presented in the financial statements as calculated under GAAP or (b) a measure of liquidity that differs from cash flow or cash flow from operations as calculated under GAAP.¹⁵

The definition of a non-GAAP financial measure expressly excludes financial and statistical measures calculated using exclusively one or both of (a) financial measures calculated in accordance with GAAP and (b) operating or other measures that are not GAAP financial measures. The definition also excludes financial measures that must be disclosed to satisfy “GAAP, [SEC] rules, or a system of regulation of a government or governmental authority or self-regulatory organization that is applicable to the registrant.”¹⁶

Regulation G applies to any entity required to file reports under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, except for registered investment companies.¹⁷

Item 10(e) of Regulation S-K: Non-GAAP Financial Measures in SEC Filings

Item 10(e) of Regulation S-K governs the use of non-GAAP financial measures in SEC filings.¹⁸ Item 10(e), which applies to all registrants that make filings with the SEC, except registered investment companies, uses the same definition of non-GAAP financial measure as in Regulation G, but at the same time imposes requirements and prohibitions that are more extensive than those in Regulation G. As with Regulation G, Item 10(e) of Regulation S-K does not cover disclosure of non-GAAP financial measures if the disclosure is part of certain communications regarding business combination transactions.

Item 10(e) requires the same complementary and reconciling presentation as is required under Regulation G. Item 10(e) further provides, however, that the presentation of the most directly comparable GAAP measure must be of equal or greater prominence than the corresponding non-GAAP financial measure. In addition, Item 10(e) provides that a registrant must include a statement detailing why its management believes each non-GAAP financial measure is useful to

¹⁵ Rule 101(a) of Regulation G.

¹⁶ *Id.*

¹⁷ Foreign private issuers are generally subject to Regulation G, unless they qualify for an exemption by satisfying the following three conditions: (a) the securities of the foreign private issuer are listed on an exchange (or quoted on an inter-dealer quotation system) outside the United States, (b) the non-GAAP financial measure is not based on a measure calculated and presented according to U.S. GAAP, and (c) the disclosure is made (or released in a written communication) by or on behalf of the foreign private issuer outside the United States. When Regulation G, or Item 10(e) of Regulation S-K, as described in footnote 18 below, applies to a foreign private issuer whose primary financial statements are prepared in accordance with an accounting standard other than U.S. GAAP (i.e., foreign private issuers that utilize International Financial Reporting Standards), Regulation G requires a presentation of, and reconciliation to, the most comparable measure under the applicable accounting standard.

¹⁸ Foreign private issuers are generally subject to these requirements, however, a foreign private issuer may use an otherwise-prohibited financial measure in a Form 20-F if that measure is (a) required or expressly permitted by the standard-setter that sets forth the accounting principles employed in that issuer's primary financial statements and (b) included in the foreign private issuer's annual report or financial statements employed in the issuer's home country or market.

investors, as well as a second statement about the additional purposes for which management uses each measure.¹⁹

Furthermore, Item 10(e) prohibits companies from disclosing non-GAAP financial measures that:

- exclude charges or liabilities requiring cash settlement (or that would have required such settlement without an alternative means of settlement) from non-GAAP liquidity measures, except for EBIT and EBITDA;²⁰
- adjust non-GAAP performance measures to remove or smooth items described as infrequent or non-recurring if either (a) the type of charge or gain is reasonably likely to recur within two years or (b) a similar charge or gain occurred within the previous two years;²¹
- present non-GAAP financial measures on the face of the registrant's GAAP financial statements or corresponding notes;
- present non-GAAP financial measures on the face of any pro forma financial information that must be disclosed to satisfy Article 11 of Regulation S-X; and
- use titles or descriptions of non-GAAP financial measures that are identical or confusingly similar to those used for GAAP financial measures.

SEC Guidance: New and Revised Compliance and Disclosure Interpretations

On May 17, 2016, the SEC's Division of Corporation Finance issued new and revised compliance and disclosure interpretations regarding the use of non-GAAP financial measures. The discussion that follows summarizes a number of key topics addressed by the updated Non-GAAP C&DIs.

Use of Potentially Misleading Non-GAAP Financial Measures

Section 100 of the Non-GAAP C&DIs covers several potentially misleading uses of non-GAAP financial measures. The guidance in this section is reflective of the Division's renewed focus on preventing the use of potentially misleading non-GAAP financial measures. Between January 1, 2015 and May 31, 2016, we estimate that approximately 15 percent of comments issued by the

¹⁹ Guidance from the Division has clarified that it is not a requirement for a registrant to use a non-GAAP financial measure in managing its business (or for other purposes) simply because it discloses it. [Compliance and Disclosure Interpretation regarding Non-GAAP Financial Measures](#) ("Non-GAAP C&DI") No. 102.04 (Jan. 11, 2010).

²⁰ Regulation S-K, Item 10(e)(1)(ii)(A).

²¹ This prohibition will be dependent on the description of the charge or gain that is being adjusted. For instance, it would be inappropriate to state that a charge or gain is infrequent if a similar charge had been taken in a recent period. However, subject to compliance with Regulation G and the other requirements of Item 10(e) of Regulation S-K, a company may disclose a non-GAAP measure that excludes a recurring charge as long as the measure is not inaccurately described as non-recurring, infrequent or unusual. Non-GAAP C&DI No. 102.03 (May 17, 2016).

Division regarding non-GAAP financial measures addressed the use of potentially misleading non-GAAP financial measures.

Problematic or Misleading Disclosures

The guidance states that certain adjustments, although not explicitly prohibited, may result in non-GAAP financial measures that are misleading. For example, in an interpretation that essentially follows Item 10(e) of Regulation S-K, the Division emphasizes that presenting a performance measure that excludes normal, recurring cash operating expenses necessary to operate a registrant's business could be considered misleading.²² Similarly, a non-GAAP financial measure that is adjusted only for non-recurring charges when there were also non-recurring gains that occurred during the same period may violate Rule 100(b) of Regulation G.²³ Although the guidance in this section of the Non-GAAP C&DIs only addresses cash operating expenses, and does not address adjustments made to exclude stock-based compensation expenses and other recurring non-cash expenses, we see no reason why such measures would not be subject to increased scrutiny by the Division in the future.

Inconsistency Between Periods

In addition, a non-GAAP financial measure could be considered misleading if it is presented inconsistently between periods—for example, if a company adjusts a particular charge or gain in one period, but does not adjust similar charges or gains in a prior (or subsequent) period, unless the change is disclosed and the reasons for it are explained.²⁴ Furthermore, “depending on the significance of the change, it may be necessary to recast prior measures to conform to the current presentation and place the current period disclosure in the appropriate context.”²⁵ Companies should keep this in mind when discontinuing the use of non-GAAP financial measure and may wish proactively to include disclosure in their filings related to the rationale for such discontinuation.

Individually Tailored Revenue Recognition

The guidance also emphasizes that a registrant may not present 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 were billed.²⁶ The Division goes on to state that any substitution of “individually tailored revenue recognition and measurement methods” may raise concerns that such an adjustment would be misleading.²⁷ Based on this new guidance, if a company presents a non-GAAP revenue measure that backs out the effect of GAAP revenue recognition principles applicable to its business, such measure could be considered per se misleading and, therefore, impermissible. In fact, the interpretation explicitly states that adding back revenue that would be deferred and recognized ratably over time under GAAP is not permitted.²⁸ SEC Deputy Chief Accountant Wesley Bricker has stated that if a company utilizes a non-GAAP financial measure that adjusts revenue, it will likely receive a

²² Non-GAAP C&DI No. 100.01 (May 17, 2016).

²³ Non-GAAP C&DI No. 100.02 (May 17, 2016).

²⁴ *Id.*

²⁵ *Id.*

²⁶ Non-GAAP C&DI No. 100.04 (May 17, 2016).

²⁷ *Id.*

²⁸ *Id.*

comment from the Division. He went on to state that any justification for such adjustment that a company provides in response will be scrutinized “closely, and skeptically.”²⁹

This new interpretation is particularly important for companies to consider because this kind of non-GAAP financial adjustment was previously thought to be acceptable if a company provided appropriate disclosure and explanation. It will be interesting to see if the Division gets push-back on this point, especially in light of the ongoing evolution of GAAP revenue recognition principles.

While these are just examples of disclosures that *could* be misleading, by highlighting these examples, we believe the Division has raised the bar in terms of the quality of disclosures that must accompany non-GAAP financial measures of a similar nature. Thus, going forward, companies should focus on explaining clearly how non-GAAP financial measures are calculated and the rationale for the chosen adjustments. However, in some cases, no level of accompanying disclosure may suffice to prevent a measure from being considered misleading by the Division.

Prominence of Comparable GAAP Financial Measures

Under Item 10(e) of Regulation S-K, when a registrant presents a non-GAAP financial measure, it must present the most directly comparable GAAP financial measure with “equal or greater prominence.” Between January 1, 2015 and May 31, 2016, we see that approximately 25 percent of comments issued by the Division regarding non-GAAP financial measures addressed this requirement. The revised guidance provides an expansive and largely formulaic reading of “equal or greater prominence.” Although conceding that “whether a non-GAAP measure is more prominent than the comparable GAAP measure generally depends on the facts and circumstances in which the disclosure is made,” in the Non-GAAP C&DIs the Division provides eight examples of presentations that would not comply with the “equal or greater prominence rule.”³⁰ Many of these examples effectively require that the corresponding GAAP financial measure be given greater prominence than the non-GAAP financial measure, rather than just equal prominence. The Division considers the following examples to be non-compliant:

- 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, caption or quotation);
- 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;

²⁹ Wesley R. Bricker, [Remarks Before the 2016 Baruch College Financial Reporting Conference](#) (May 5, 2016).

³⁰ Non-GAAP C&DI No. 102.10 (May 17, 2016).

- providing tabular disclosure of non-GAAP financial measures without preceding that 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.

While bordering on a “form over substance” litany of disclosure peeves, this explication of the “greater or equal prominence” requirement of Item 10(e) is an indication of a growing impatience by the Division with practices, largely in earnings releases, investor presentations and proxy statements, which have skirted the disclosure principles of Item 10(e).³¹ This will likely be a focus of the Division in its review of filings and related materials going forward, and some of the examples provided in the guidance may cause companies to depart from past practices in order to avoid the receipt of comments addressing the prominence of non-GAAP financial measures in their earnings releases and/or other SEC filings.

EBIT and EBITDA

EBIT and EBITDA are non-GAAP financial measures that can be used both to indicate a company’s liquidity as well as its operating performance.³² As noted above, Item 10(e) of Regulation S-K prohibits registrants from excluding charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP *liquidity* measures, other than EBIT and EBITDA.³³ Measures that are calculated differently from EBIT and EBITDA do not fall under the exception provided for in Item 10(e) and are generally impermissible when used as a liquidity measure. In certain cases, however, disclosure of such measures may nonetheless be appropriate.³⁴ Such measures should not be characterized as EBIT or EBITDA, but rather should have titles that distinguish them from EBIT or EBITDA (for example, “Adjusted EBITDA”).³⁵

³¹ Disclosure furnished under Item 2.02 of Item 8-K, such as earnings releases, is also subject to the “greater or equal prominence” requirement of Item 10(e). For more information related to disclosure of target levels in proxy statements, see footnote 45.

³² The Division has clarified that, as discussed in the adopting release, for purposes of EBIT and EBITDA, “earnings” refers to net income as presented in the statement of operations under GAAP. Non-GAAP C&DI No. 103.01 (Jan. 11, 2010); see also Release No. 34-47226 (Jan. 16, 2003).

³³ Regulation S-K, Item 10(e)(1)(ii)(A).

³⁴ Item 303 of Regulation S-K, for example, requires disclosure of material items affecting a company’s liquidity. If a company entered into a credit agreement that contains a material covenant tied to “Adjusted EBITDA” and management believes that the credit agreement is a material agreement, that the covenant is a material term of the agreement and that information about the covenant is material to an investor’s understanding of the company’s financial condition and/or liquidity, then the company may be required to disclose “Adjusted EBITDA” as part of its MD&A. Non-GAAP C&DI No. 102.09 (Jan 11, 2010).

³⁵ Non-GAAP C&DI No. 103.01 (Jan. 11, 2010).

A common area for Division comments on non-GAAP financial measures involves the reconciliation of those non-GAAP measures to the comparable GAAP measure, including incorrect EBIT or EBITDA reconciliation.³⁶ Companies should continue to carefully review their processes for reconciliation of non-GAAP financial measures to the most directly comparable GAAP measure, particularly when reconciling EBIT or EBITDA. If EBIT or EBITDA is presented as a performance measure, such measure should be reconciled to net income as presented in the statement of operations under GAAP. In this case, the Division has clarified that reconciling to operating income is inappropriate because EBIT and EBITDA make adjustments for items that are not included in operating income.³⁷

Per Share Presentation of Non-GAAP Financial Measures

The use of per share non-GAAP financial measures is not specifically prohibited under Item 10(e)(1)(ii) of Regulation S-K, and, in the revised guidance the Division clarifies that certain uses of non-GAAP earnings per share numbers are acceptable because certain non-GAAP per share performance measures may be meaningful from an operating standpoint.³⁸ On the other hand, the revised guidance goes on to confirm the Division's long-established position that liquidity measures may generally not be presented on a per share basis in SEC filings.³⁹

In general, non-GAAP financial measures that report on cash or funds generated from operations (such as free cash flow) or that are capable of doing so (such as EBIT and EBITDA) are considered liquidity measures for purposes of the prohibition on presenting liquidity measures on a per share basis.⁴⁰ Non-GAAP performance measures that are presented on a per share basis are still considered acceptable by the Division and should be presented with, and reconciled to, net income, or income from continuing operations, taken from the statement of operations. When determining whether per share data constitutes a liquidity measure or a performance measure, the Division indicated that it will focus on the substance of the non-GAAP measure rather than management's characterization thereof.⁴¹

³⁶ For example, when the Division determines that EBITDA is being used as a liquidity measure, it may request an explanation as to why such non-GAAP liquidity measure was not reconciled to operating cash flow as the most directly comparable GAAP measure (rather than net income).

³⁷ Non-GAAP C&DI No. 103.02 (May 17, 2016). As noted above, EBIT and EBITDA should not be presented on a per share basis.

³⁸ Non-GAAP C&DI No. 102.05 (May 17, 2016).

³⁹ *Id.*

⁴⁰ Release No. 34-47226 (Jan. 16, 2003); see also Non-GAAP C&DI Nos. 102.07 and 103.02 (May 17, 2016). Non-GAAP liquidity measures should be presented with, and reconciled to, comparable amounts from the statement of cash flows (i.e., cash flows from operating, investing and financing). The Division views funds from operations ("FFO") as defined by the National Association of Real Estate Investment Trusts ("NAREIT") as an acceptable non-GAAP performance measure and does not object to its presentation on a per share basis. The most recent definition of "funds from operations" was adopted by NAREIT effective as of May 17, 2016. Non-GAAP C&DI No. 102.01 (May 17, 2016).

⁴¹ Non-GAAP C&DI No. 102.05 (May 17, 2016). Notwithstanding the substantive analysis regarding whether per share data constitutes a liquidity measure or a performance measure, the Division amended Non-GAAP C&DI No. 103.02 to confirm that EBIT and EBITDA may not be presented on a per share basis, even when presented as performance measures.

Tax Effects on Non-GAAP Financial Measures

The guidance states that a registrant may need to provide information regarding income tax effects on its non-GAAP financial measures depending on the nature of the measures used.⁴² If the registrant is using a non-GAAP liquidity measure that includes income taxes, it may be appropriate to adjust GAAP taxes to show taxes paid in cash. In the case of a performance measure, the registrant should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. In addition, the Division's guidance makes it clear that adjustments made to arrive at a non-GAAP measure should not be presented as "net of tax"; rather they should be shown as a separate adjustment and clearly explained.

Takeaways

The SEC has made it clear that there will be an increase in the number of SEC comments related to non-GAAP financial measures, at least in the near term, and the Division is already issuing comments based on the new guidance. In particular, it appears that the SEC will focus its efforts to address the use of potentially misleading non-GAAP financial measures, the prominence of non-GAAP financial measures as compared to GAAP measures, and the use of certain unacceptable per share measures. In addition, it is certainly possible that there could be more activity by the SEC's Division of Enforcement in connection with possible improper use of non-GAAP financial measures, likely focusing on measures that are misleading.⁴³

What Should Companies Do?

In light of increased scrutiny regarding the use of non-GAAP financial measures, companies should:

- consider why each non-GAAP financial measure is being used and how it provides investors with useful information;
- review the disclosures associated with non-GAAP financial measures to ensure that the nature and importance of the non-GAAP measures are being explained to investors;
- ensure that non-GAAP financial measures are not given greater prominence than the most comparable GAAP measures;
- confirm that adjustments reflected in the reconciliation of non-GAAP financial measures are sufficiently detailed;
- review all adjustments used to calculate non-GAAP financial measures and consider whether charges and gains are treated consistently within a single fiscal period and whether potential inconsistencies with prior periods may require prior periods to be recast;

⁴² Non-GAAP C&DI No. 102.11 (May 17, 2011).

⁴³ When the Division of Enforcement's Financial Reporting and Audit Group was created in 2013, the use of non-GAAP financial measures was highlighted as a possible area of scrutiny. See Michael Rapoport, "[SEC Task Force Probes Use of Non-GAAP Metrics](#)," *The Wall Street Journal* (Dec. 10, 2013).

- harmonize the use of non-GAAP financial measures across all communications (e.g., press releases, investor presentations and filings, including periodic and current reports and proxy statements);
- ensure that all non-GAAP financial measures are defined, contrasted with and reconciled to the most comparable GAAP measures;
- ensure that non-GAAP financial measures included in proxy statements are drafted in accordance with Regulation G, Item 10(e) and applicable Division guidance;⁴⁴
- consider how disclosure controls and procedures cover the calculation of non-GAAP financial measures;
- ensure that audit committees pay close attention to the use of non-GAAP financial measures, including the required related disclosures, and the processes being followed to consider both the appropriateness and reliability of the measures; and
- review with the company's independent auditor the scope of its audit and review procedures, including management representation letters, with respect to non-GAAP financial measures to ensure smooth coordination, particularly with respect to earnings releases.

We expect the Division to continue to heighten its focus on non-GAAP financial measure disclosures, which will surely increase the number of Division comments in this area. However, the hope is that the Division will allow companies to self-correct, at least initially, and not challenge companies on some of these issues without giving companies time to think about their non-GAAP financial disclosures and reflect the necessary changes in future filings, earnings releases and presentations.

⁴⁴ Instruction 5 to Item 402(b) of Regulation S-K provides that disclosure of target levels in the Compensation Discussion and Analysis ("CD&A") that are non-GAAP financial measures are not subject to the requirements of Regulation G and Item 10(e). However, this instruction does not extend to other uses of non-GAAP financial information (for example, to explain the relationship between pay and performance), which must comply with the requirements of Item 10(e). In these pay-related circumstances only, the Division will not object if a registrant includes the required GAAP reconciliation and other information in an annex to the proxy statement, provided the registrant includes a prominent cross-reference to such annex. Alternatively, if the non-GAAP financial measures are the same as those included in a company's previously filed Form 10-K that incorporates by reference the proxy statement's Item 402 disclosure, the Division will not object if the registrant complies with Regulation G and Item 10(e) by providing a prominent cross-reference to the pages in the Form 10-K containing the required GAAP reconciliation and other information. Non-GAAP C&DI No. 108.01 (July 8, 2011).

Securities

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Securities practice group:

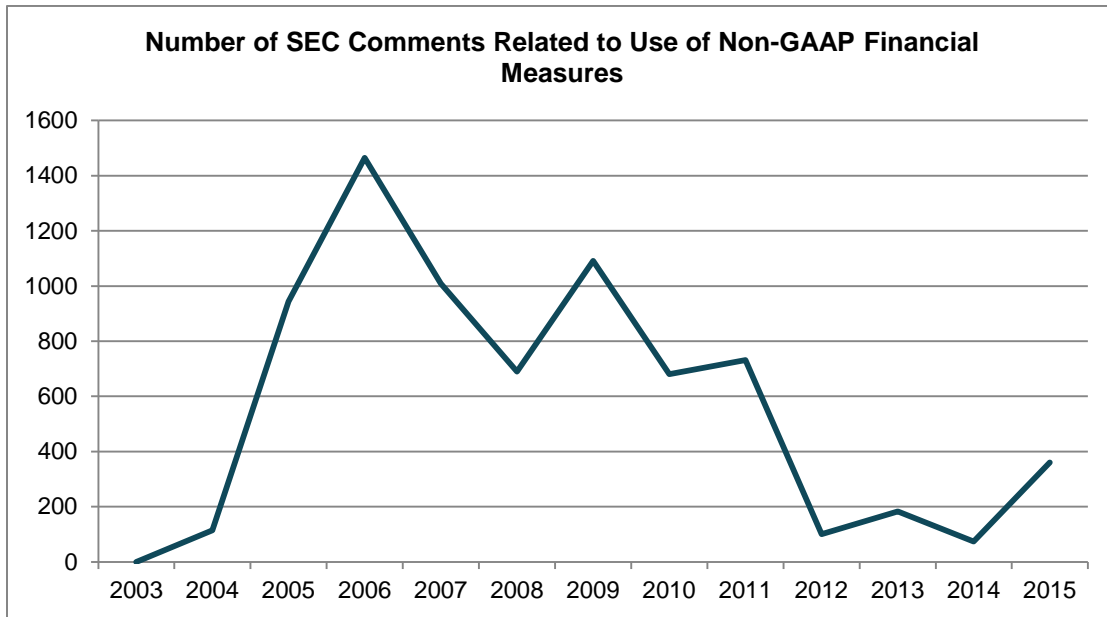
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Appendix A



*Average number of comments per year determined based on a review of materials available on Intelligize.com.