

LEGAL UPDATES

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STEVEN R. BARRETT
CHATTANOOGA:
423.757.5905
STEVE.BARRETT@
HUSCHBLACKWELL.COM

SEC Publishes Stricter Interpretations on the Use of Non-GAAP Measures

Last month, the Division of Corporation Finance (the Division) of the Securities and Exchange Commission (SEC) released several new and revised compliance and disclosure interpretations (CDIs) on the use of non-GAAP financial measures in public disclosures and SEC filings under Item 10(e) of Regulation S-K and Regulation G. The changes and revisions could impact how companies prepare their disclosures and filings for the upcoming financial quarter.

Interpretations Reflect Greater Scrutiny

The relevant provisions of Item 10(e) of Regulation S-K apply to non-GAAP measures in materials filed with or, in the case of quarterly earnings disclosures under Item 2.02 of Form 8-K, furnished to the SEC. Regulation G covers any public disclosure of non-GAAP measures, including oral statements by certain company executives, information posted on a company's website or transmission of material information to anyone who may trade on the basis of said information.

The Division's stance in these CDIs reflects a heightened scrutiny of companies' use of non-GAAP measures in public disclosures and SEC filings. The analysis below summarizes important shifts in the Division's application of SEC rules to non-GAAP measures that should be considered as you prepare your upcoming disclosures and filings.

Disclosure of Non-GAAP Measures on a Per Share Basis

Non-GAAP liquidity measures that calculate cash generated may be presented on an aggregate basis with appropriate context, but cannot be presented on a per share basis under Item 10(e) of Regulation S-K. Frequently used non-GAAP liquidity measures that can no longer be presented

on a per share basis include free cash flow and earnings before interest and taxes (EBIT), as well as earnings before interest, taxes, depreciation and amortization (EBITDA), even if used by management as a performance measure. These measures may still be presented at the enterprise level, subject to an appropriately clear description of their significance to shareholders, as well as their calculation and any applicable use by management. The determination of whether a measure is a liquidity measure depends on the nature of the adjustments made in deriving the measure from GAAP numbers and whether, in the SEC staff's view, such measurement can be used as a liquidity measure, even if the company considers it a performance measure (Questions 102.05, 102.07 and 103.02).

Non-GAAP per share performance measures are still permitted and should be reconciled with net income in the statement of operations under GAAP. Nonetheless, EBIT and EBITDA are not permitted on a per share basis, even as performance measures, pursuant to Item 10(e)(1)(ii)(A) of Regulation S-K (Questions 103.01 and 103.02).

Misleading Non-GAAP Measures May Violate Rule 100(b)

Non-GAAP adjustments, not expressly prohibited, may still be in violation of Rule 100(b) of Regulation G. According to the Division, an adjustment may be misleading and thus violate Rule 100(b) if the adjustments to create the non-GAAP measure are misleading (Question 100.01).

Presenting a performance measure that excludes normal, recurring cash operating expenses necessary to operate a registrant's business could be misleading even though it is not expressly prohibited (Question 100.01).

Inconsistent, period-to-period presentations of non-GAAP measures may violate Regulation G. A company that presents a non-GAAP measure that makes adjustments for charges or gains in its current disclosure in a manner that is inconsistent with the treatment of similar items in presenting the same non-GAAP metric in prior periods could be in violation of the rule. If a company does decide to change the manner in which a non-GAAP measure is calculated and presented, it should be transparent about the change and explain why the change was made. Additionally, if the adjustments are material, the Division suggests that companies make retroactive adjustments to their previous disclosures of the same non-GAAP metric to ensure conformity and avoid misleading investors (Question 100.02).

Non-GAAP measures that exclude one-time charges, but do not exclude one-time gains, may be misleading. A non-GAAP measure that excludes non-recurring charges but not non-recurring gains in the same period could be considered misleading and a violation of Regulation G (Question 100.03).

Non-GAAP performance measures that substitute individually tailored revenue recognition and measurement methods for GAAP measures could violate Regulation G. This CDI indicates that any

non-GAAP measure that substitutes individually tailored revenue recognition and measurement methods for GAAP measurements—such as an adjustment that would accelerate revenue recognized ratably over time under GAAP as if it were all earned upfront when customers are billed—may violate Regulation G (Question 100.04).

New Requirements for Giving GAAP Measures Equal or Greater Prominence

GAAP measures should be presented with the same or greater prominence than non-GAAP measures under Item 10(e) of Regulation S-K. When an issuer uses a non-GAAP measure in its earnings releases and other SEC filings, the GAAP measure should be of equal or greater prominence than the non-GAAP measure. The Division's stance on the prominence of a GAAP versus non-GAAP measure is determined by the facts and circumstances surrounding presentation of the measures (Question 102.10).

Notwithstanding this general “facts and circumstances” standard, the CDIs also articulated some very prescriptive standards in offering the following examples of disclosure in which the Division would consider non-GAAP measures to be presented on a basis that was impermissibly more prominent than the comparable GAAP measure:

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 “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) of Regulation S-K without disclosing that fact and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence.

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.

Note, however, that these “equal or greater prominence” requirements from Item 10(e)(1)(i)(A) of Regulation S-K do not apply to disclosure that is “furnished” for purposes of Regulation FD compliance under Item 7.01 of Form 8-K (as opposed to earnings releases disclosed under Item 2.02 or other “filed” disclosures).

Disclosure of Tax Effects Relating to Non-GAAP Measures Under Item 10(e) of Regulation S-K

Depending on the nature of the measures, entities should disclose the income tax effects on non-GAAP measures in filings that are subject to Item 10(e) of Regulation S-K. It may be acceptable to adjust GAAP taxes to show taxes paid in cash in deriving a non-GAAP liquidity measure. On the other hand, if a non-GAAP measure is used as a performance measure, an entity should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability (Question 102.11).

Non-GAAP adjustments should not be presented as “net of tax.” Rather, income taxes should be shown as a separate adjustment and clearly explained (Question 102.11).

Clarification on REIT Use of Funds From Operations

SEC permits the use of funds from operations (FFO) as a performance measure. The Division confirmed that real estate investment trusts (REITs) may present the non-GAAP measure FFO using the definition of FFO released by the National Association of Real Estate Investment Trusts (NAREIT) on January 1, 2000, and, since the Division regards NAREIT FFO as a performance metric, it may be presented on a per share basis (Question 102.03)

The presentation of FFO as adjusted on a basis other than as defined by NAREIT is also allowed, provided the presentation complies with Item 10(e) and Regulation G. However, depending on their nature, adjustments to NAREIT FFO may result in a liquidity measure. Companies should carefully review any adjustments they make to FFO as defined by NAREIT, because if the resulting adjusted number may be viewed as a liquidity measure, even if management describes it as a performance measure, it cannot be presented on a per share basis (Question 102.02 and 102.5).

Considerations for Future Disclosures and Filings

A day after these CDIs were released, Mark Kronforst, the Chief Accountant for the SEC's Division of Corporation Finance, spoke at the Public Company Accounting Oversight Board's Standing Advisory Group concerning, among other things, the SEC's recent emphasis on the use of non-GAAP measures. Kronforst stated, "This next quarter will be a great opportunity for companies to self-correct." It would be prudent for companies to heed this suggestion and tailor their upcoming disclosures and filings to conform to the Division's latest guidance concerning non-GAAP measures.

Additionally, for each non-GAAP measure that a company uses in a public disclosure or SEC filing, it should be able to clearly and succinctly present how the measure is calculated, why it communicates meaningful information to the company's shareholders and, to the extent material, how management uses the measure in evaluating the company's performance.

What This Means to You

Now more than ever, it's crucial for companies to closely monitor the types of financial measures they employ in their public disclosures and filings. Companies subject to SEC Regulations G and S-K should ensure, prior to their next quarterly earnings release, that their CEO, CFO, General Counsel, investor relations professionals and others (including Board committees) actively involved in such disclosures are apprised of the impact of these new CDIs on that process and on subsequent SEC filings (including future proxy statements that include non-GAAP financial information). These companies also should regularly check for the SEC's most recent comment letters and CDIs to ensure that their public disclosures and filings are in compliance with the applicable securities regulations.

Contact Us

For more information on the implications of these new CDIs, contact Jeff Haughey, Steve Barrett, Rebecca Taylor, Noble Freeman or any other member of Husch Blackwell's Securities & Corporate Governance team.