

Practice Update

SEC Updates Guidance on Non-GAAP Financial Reporting

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On May 17, 2016, the Securities and Exchange Commission (SEC) released updated Compliance and Disclosure Interpretations (C&DIs) related to the use of non-GAAP (Generally Accepted Accounting Principles) financial measures in documents filed with or furnished to the SEC. The C&DIs are the Commission's latest attempt to address its concerns with potentially misleading disclosure practices related to non-GAAP financial metrics. The C&DIs can be found [here](#).

We expect these C&DIs will have a considerable impact on financial disclosures, particularly earnings releases. This Practice Update discusses some of this new SEC guidance in four categories as follows.

(I) Presenting GAAP Measures With Equal or Greater Prominence

Under Item 10 of Regulation S-K, a registrant that presents a non-GAAP measure must present the “most directly comparable” GAAP measure with “equal or greater prominence.” The relative prominence of the measures generally depends on the facts and circumstances in which the disclosure

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is made. However, the SEC considers the following examples of disclosure of non-GAAP measures as more prominent and conflicting with Item 10 (C&DI 102.10):

- Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures
- Failing to precede a tabular disclosure of non-GAAP financial measures with an equally prominent tabular disclosure of the comparable GAAP measures
- 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
- 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
- Presenting a non-GAAP measure without preceding it with its 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

(II) Potentially Misleading Non-GAAP Financial Metrics and Adjustments

Per Regulation G, a registrant may not use or present a non-GAAP measure in a manner that is misleading. The C&DIs outline some uses of non-GAAP measures that can render them misleading: (a) presenting a non-GAAP measure inconsistently between periods (C&DI 100.02); (b) excluding charges while failing to exclude gains (C&DI 100.03);

and (c) substituting individually tailored revenue recognition and measurement methods (*e.g.*, accelerating revenue by recognizing revenue when customers are billed) for GAAP methods (C&DI 100.04). Also, certain adjustments, although not explicitly prohibited, can result in a non-GAAP measure that is misleading (C&DI 100.1).

(III) Presenting Non-GAAP Measures on a Per Share Basis

Non-GAAP earnings per share numbers are permitted in documents filed or furnished with the SEC. Item 10(e) of Regulation S-K recognizes that certain non-GAAP per share performance measures may be meaningful from an operating standpoint. Still, non-GAAP per share performance measures should be reconciled with GAAP earnings per share (C&DI 102.05).

Non-GAAP liquidity metrics that measure cash generated must not be presented on a per share basis (C&DI 102.05). This guidance is based on the Commission's 1973 Accounting Series Release No. 142, where it sought to avoid possible investor confusion arising from the use of non-GAAP financial measures. The SEC noted that "[i]f accounting net income computed in conformity with generally accepted accounting principles is not an accurate reflection of economic performance for a company or an industry, it is not an appropriate solution to have each company independently decide what the best measure of its performance should be and present that figure to its shareholders as Truth" (SEC Proposed Rule: Conditions for Use of Non-GAAP Financial Measures, Release No. 33-8145).

Whether per share data is permitted depends on whether the non-GAAP measure can be used as a liquidity metric, even if management presents it solely as a performance measure. In determining whether the measure is a performance or liquidity measure, the SEC will focus on the substance of the

non-GAAP measure and not management's characterization of the measure (C&DI 102.05).

(IV) EBIT, EBITDA, and Other Non-GAAP Measures

If EBIT and EBITDA is presented as a performance measure it must be reconciled to net income as presented in the statement of operations under GAAP. Also, these "measures must not be presented on a per share basis" (C&DI 103.02).

Item 10(e)(1)(ii) does not prohibit using the free cash flow (FCF) measure, which is typically calculated as cash flows from operating activities less capital expenditures, in documents filed with the SEC. However, (1) a clear description of how FCF is calculated, as well as the necessary reconciliation, should accompany the measure where it is used; (2) companies should avoid misleading implications regarding the FCF metric's usefulness (*e.g.*, FCF should not be used in a manner that implies it represents the residual cash flow available for discretionary expenditures); and (3) the metric must not be presented on a per share basis because it is considered a liquidity measure (C&DI 102.05; 102.07).

The SEC accepts the National Association of Real Estate Investment Trusts' (NAREIT's) definition of "funds from operations" (FFO) in effect as of May 17, 2016 as a performance measure and does not object to its presentation on a per share basis (C&DI 102.1). A registrant may present FFO on a basis other than as defined by NAREIT, provided that any adjustments made to FFO comply with Item 10(e) of Regulation S-K and the measure does not violate Rule 100(b) of Regulation G. Adjustments to FFO must comply with requirements for performance or liquidity measures, depending on the nature of the adjustments, some of which may trigger the prohibition on presenting FFO on a per share basis (C&DI 102.02).

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