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SEC Reins in Use of Non-GAAP Financial Measures with New Guidance

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On May 17, 2016, the Securities and Exchange Commission issued six new Compliance & Disclosure Interpretations (C&DIs) and modified other existing C&DIs to provide additional guidance on the use of non-GAAP financial measures under Regulation G. The new guidance reflects concerns recently voiced by the SEC about the proliferation of the use of non-GAAP financial measures, including the types of adjustments taken, the prominence of such adjustments and the focus given to these non-GAAP financial measures by the financial news media who often report the non-GAAP measure without reference to the related GAAP measure.

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On May 17, 2016, the Securities and Exchange Commission issued six new Compliance & Disclosure Interpretations (C&DIs) and modified other existing C&DIs to provide additional guidance on the use of non-GAAP financial measures under Regulation G. Since 2003, the SEC has required companies that disclose or release non-GAAP financial measures to include in that disclosure or release a presentation of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure. The new guidance reflects concerns recently voiced by the SEC about the proliferation of the use of non-GAAP financial measures, including the types of adjustments taken, the prominence of such adjustments and the focus given to these non-GAAP financial measures by the financial news media who often report the non-GAAP measure without reference to the related GAAP measure.

Highlights of the new guidance include the following:

- Adjustments to a GAAP financial measure may violate Regulation G because they are misleading even though they are not expressly prohibited by Regulation G.
- Adjustments to GAAP measures that are inconsistently applied between financial reporting periods may be misleading. An adjustment for a particular charge or gain that creates a non-GAAP financial measure in a current period could be misleading unless adjustments for similar charges and gains are made in past periods. Changes in adjustments between periods that are not significant may be permitted if the change between periods and the reasons for the change are disclosed.
- A non-GAAP financial measure adjusting for non-recurring charges could be misleading if it does not also adjust for non-recurring gains that occur in the same period.
- A non-GAAP financial measure may not be presented with greater prominence than the comparable GAAP measure. Examples of non-GAAP presentations that are more prominent and may violate Item 10(e) of Regulation S-K, include:
    - Presenting a full income statement of non-GAAP financial measures, even if the presentation is used to reconcile these non-GAAP measures to the most directly comparable GAAP measures;
    - An earnings release headline or caption that includes non-GAAP financial measures but not

comparable GAAP measures;

- Emphasizing a non-GAAP measure with the style of presentation (*e.g.*, bold or larger font) compared to the GAAP measure;
- A non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline, caption or table);
- Describing a non-GAAP measure as “record performance” or “exceptional” without at least an equally prominent description of the comparable GAAP measure;
- 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; and
- Providing a 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.
- Non-GAAP financial measures that substitute individually tailored recognition and measurement methods for financial statement line items may violate Rule 100(b) of Regulation G. For example, non-GAAP financial measures that make adjustments to revenue recognition so that earned revenue is recognized when a customer is billed, rather than ratably over time in accordance with GAAP, is not permitted under Regulation G.
- A per share non-GAAP financial measure that can be used as a liquidity measure violates Item 10(e) of Regulation S-K, even if presented by management as a performance measure. When reviewing the use of a per share non-GAAP financial measure, the SEC will focus on the substance of a non-GAAP financial measure rather than management’s characterization of a non-GAAP financial measure.
- Free cash flow, EBIT and EBITDA may never be presented on a per share basis.
- Income tax effects related to adjustments that create a non-GAAP measure should be provided depending on the nature of the non-GAAP measure. For a liquidity non-GAAP measure that includes income taxes, it may be acceptable to adjust GAAP taxes to show taxes paid in cash. For a performance measure, current and deferred income tax expense commensurate with the non-GAAP measure of profitability should be included. No adjustments that create a non-GAAP financial measure should be shown “net of tax”; instead, income taxes should be shown as a separate adjustment and clearly explained.

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