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Falling out of the GAAP: Recent SEC Staff Comments on Energy Companies' Non-GAAP Financial Measures Disclosures

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In May 2016, the Division of Corporation Finance of the Securities and Exchange Commission ("SEC") added new Compliance & Disclosure Interpretations ("C&DIs") to the existing catalog of C&DIs that addresses disclosures of "non-GAAP financial measures."¹

Non-GAAP financial measures are numerical metrics of a registrant's historical or future financial performance, financial position or cash flows that in various degrees adjust amounts calculated and presented in accordance with U.S. generally accepted accounting principles ("GAAP"). They are used by companies to provide additional insights into their businesses, and are often driven by expectations of investors and analysts to have a metric with which to compare companies within the same industry. For example, many exploration and production companies present non-GAAP financial measures such as earnings before interest, taxes, depreciation, amortization and exploration expenses (EBITDAX), and adjusted versions of EBITDAX. For yield-generating midstream master limited partnerships ("MLPs"), distributable cash flow tends to be an important non-GAAP financial measure.

The SEC's Regulation G and Item 10(e) of Regulation S-K ("Item 10(e)") govern the presentation of companies' non-GAAP financial measures in their SEC filings, earnings releases and investor presentations, and on companies' websites. These regulations essentially require that each non-GAAP financial measure be a relevant, meaningful and useful measure that does not mislead investors.

The new C&DIs were issued amidst rising concerns voiced by SEC officials and staff about the increasing use of non-GAAP financial measures that did not meet the guidelines in the current rules. In 2016, numerous energy companies received SEC staff comments addressing their compliance with the non-GAAP financial measures guidance, including the new C&DIs.² Most of these comments addressed non-GAAP measures appearing in companies' quarterly earnings announcements filed (or furnished) as exhibits to Current Reports on Form 8-K, further demonstrating the staff's increasing focus on companies' disclosures in their press releases and on their websites, in addition to their periodic reports and registration statement filings.

In this article, where a discussion of a registrant's response to a comment is not followed by a discussion of any subsequent staff objections to the registrant's response, we are assuming that the registrant's response did not warrant further comment by the staff.

Upstream

The most prominent feature of Regulation G and Item 10(e) is the requirement for companies using a non-GAAP measure in their filings or communications to include as well (i) a presentation of the most directly comparable GAAP financial measure, with that presentation having equal or greater prominence than the disclosed non-GAAP measure, and (ii) a reconciliation showing the differences between the non-GAAP measure and the most directly comparable financial measure calculated in accordance with GAAP.

¹ The issuance of these new C&DIs was the subject of a previous Haynes and Boone, LLP *Client Alert*, to which reference is made for more detail regarding non-GAAP financial measures and these new interpretations. See Matthew L. Fry, Lucy Liu, *Client Alert: "SEC Issues Additional Guidance Regarding the Use of Non-GAAP Financial Measures"* (June 7, 2016).

² In this article, the term "non-GAAP financial measure" is sometimes condensed to read: "non-GAAP measure."

Numerous upstream companies received comments about their failure to comply with these requirements (see, e.g., *Clayton Williams Energy, Inc. — response to oral comments given on Mar. 21, 2016* (Mar. 24, 2016); *EP Energy Corp.* (May 16, 2016); *Kosmos Energy Ltd.* (June 23, 2016); *Vanguard Natural Resources LLC* (June 27, 2016); *Chesapeake Energy Corp.* (Apr. 7, 2016); *SM Energy Co.* (July 19, 2016)). In *Occidental Petroleum Corp.* (June 23, 2016), the staff's comment letter noted that the company's earnings release containing a presentation of its "core earnings," a non-GAAP measure, had failed to include the most comparable GAAP measure.

Some staff comments focused on the definition of "non-GAAP financial measure." In *Lucas Energy Inc.* (May 10, 2016), the staff commented that the term "PV-10," defined in a proxy statement as "estimated discounted future cash flow before tax expense," was a non-GAAP measure and that the company should include a reconciliation to its nearest GAAP-basis measure – the standardized measure of discounted future net cash flows.³ The staff questioned another company's use of an annualized revenue amount without also disclosing additional details, including how the measure was calculated, its material underlying assumptions and whether the annualized revenue amount represented the company's expectations for the full fiscal year.

Chesapeake Energy Corporation's first quarter 2016 earnings release included a presentation of adjusted net earnings (loss) per fully diluted share, a non-GAAP measure. The company had recorded GAAP net losses for fiscal 2015 and the first quarter of 2016. In calculating its adjusted net loss per diluted share for those periods, the staff noted that the company had included in its weighted average shares denominator, diluted potential common shares issuable (e.g., unvested restricted stock and shares underlying convertible securities outstanding). GAAP requires companies to include diluted potential shares in its total weighted average shares denominator when computing *earnings* per share; however, companies incurring losses are not permitted under GAAP to include dilutive potential shares in their total weighted average shares when calculating net *losses* per share (see FASB ASC paragraphs 260-10-45-18 and 45-19).⁴

The staff observed that including potential shares for loss per share calculation purposes, even in a non-GAAP measure, had not only gone beyond the scope of the definition of non-GAAP measure in Item 10(e)(2), but it was also inconsistent with a fundamental aspect of the calculation of GAAP earnings per share (*Chesapeake Energy Corp.* (July 1, 2016)). The staff cited newly added C&DI Question 100.01, which provides that certain adjustments may violate Regulation G because they cause the presentation of the non-GAAP measure to be misleading.

Another topic drawing comments was Item 10(e)(1)(i)(C)'s requirement that companies disclose the reasons why company management believes the presentation of the non-GAAP measure provides useful information to investors about the company's financial condition and results of operations (see, *Kosmos Energy Ltd.* (June 23, 2016)). Apache Corporation's earnings release for its second quarter 2016 results drew the comment that its explanation of usefulness to investors should be "more substantive and concise" (*Apache Corp.* (Sept. 22, 2016)).

The C&DIs and the staff differentiate between non-GAAP performance measures and non-GAAP liquidity measures. For example, in *EQT Corp.* (July 9, 2015), the staff asked how an adjusted net operating revenues non-GAAP measure provided useful information to investors about the company's operating results. The measure had excluded the revenue impact of changes in the fair value of derivative instruments prior to settlement, and was net of transportation and processing costs. The company responded that the measure was used by its management to evaluate comparisons of period-to-period earnings and "cash flow trends." The staff

³ See Financial Accounting Standards Board Accounting Series Codification ("FASB ASC") paragraphs 932-235-50-29 and 50-30.

⁴ In calculating loss per share under GAAP, the effect of adding dilutive potential common shares in the weighted average shares calculation would reduce the amount of net loss per share.

asked whether the non-GAAP measure was considered by management to be a performance measure or a liquidity measure. The company replied that it was a performance measure, and agreed to remove all references to the term “cash flow trends” in its related disclosures (*EQT Corp. — response* (August 13, 2015)).

Vanguard Natural Resources, LLC, an upstream MLP entity, employed a non-GAAP measure in its earnings releases – “Adjusted Net Income Attributable to Common and Class B Unitholders” – that drew comments. The non-GAAP measure reflected adjustments that had excluded the impact of, among other items, (i) changes in fair value of the company’s commodity derivative contracts; (ii) net gains and losses on acquisitions of oil and gas properties; and (iii) other non-cash items, such as impairment charges and gains on debt extinguishment. The staff asked about the stated purpose of this non-GAAP measure (*Vanguard Natural Resources, LLC* (July 25, 2016)). The company replied by clarifying its explanation of the purpose of the measure and providing sample disclosures that elaborated on the components of the particular line items used in its calculation (*Vanguard Natural Resources, LLC— response* (July 28, 2016)).

In *EP Energy Corp.* (July 11, 2016), the staff focused on the company’s first quarter 2016 earnings release. The staff asked whether the company’s “Adjusted EPS” figure had been presented “net of tax” — a presentation frowned upon in C&DI Question 102.11. Secondly, the staff commented on the company’s “discretionary cash flow” and “discretionary cash flow per share” presentations. The company contended that these non-GAAP measures were important because they provided information for analyzing the company’s ability to generate funds for its operations and acquisition/divestiture activities. The staff countered with its opinion that these measures were non-GAAP liquidity measures and that the presentation of a per-share non-GAAP liquidity measure was inconsistent with C&DI Question 102.05.⁵ Finally, the company’s reconciliation of adjusted cash operating costs to total operating expenses had excluded transportation costs, exploration charges and hydrocarbon purchases. The staff’s view was that these items were normal, recurring and necessary operating expenses, rendering the non-GAAP measure potentially misleading and inconsistent with C&DI Question 100.01.

Midstream

Given the concentration of yield-generating MLPs in the midstream industry, it is not surprising that several comments focused on non-GAAP measures to quantify midstream companies’ cash generation, such as distributable cash flow, adjusted EBITDA and adjusted net cash flows. A common theme of many of these comments related to identifying the items that had been included or excluded for purposes of calculating the non-GAAP measure.

A significant component of some distributable cash flow calculations was “maintenance capital expenditures,” an adjustment typically reducing companies’ EBITDA. Because there was no standard accounting definition for the term, the staff asked midstream companies to disclose how their maintenance capital expenditures were calculated and clarify specifically what the expenditures were maintaining (*Enlink Midstream Partners, L.P.* (June 10, 2015)). In response to such a question, TC Pipelines LP said that it defined its maintenance capital expenditures as cash costs and expenses made to maintain, over the long term, the company’s operating capacity, system integrity and reliability, including expenditures for constructing and developing new capital assets to replace or improve existing ones. Examples included expenditures to replace pipelines, fund the acquisition of certain equipment, maintain equipment safety and address environmental regulations (*TC Pipelines LP — response* (Aug. 14, 2016)).

⁵ The staff confirmed in this comment letter that whenever a non-GAAP liquidity measure is used, cash flows from operating, investing and financing activities is the preferred most-comparable GAAP measure that should be presented and to which the non-GAAP measure is to be reconciled.

Companies in true corporate form also made their case for presenting their distributable cash flows as a useful and relevant non-GAAP measure. The staff had noted that non-GAAP measures focusing on cash generated were typically presented for yield-generating MLPs, not corporations, and asked one company (which had previously converted from a partnership to a corporation) why this metric remained meaningful (*Kinder Morgan, Inc.* (June 28, 2016)). The company responded that its Distributable Cash Flow measure now quantified its adjusted earnings available to create value to its common stockholders. This value could come in the form of dividends, share repurchases, debt retirement, acquisitions or expansion capital projects (*Kinder Morgan, Inc. – response* (July 12, 2016)).

As noted above, non-GAAP measures used to gauge the generation of cash are typically considered non-GAAP liquidity measures. Under Item 10(e)(1)(ii)(A), companies may not exclude from their non-GAAP liquidity measures charges that require or will require cash settlement (or would have required cash settlement absent an ability to settle in another manner), other than EBITDA and similar measures. Midstream companies argued that their distributable cash flow and cash available for dividends were non-GAAP performance measures, not liquidity measures – and some did so successfully (contending that its distributable cash flow was an accurate measure of profitability of its operating assets). See, *Kinder Morgan – response* (Aug. 10, 2016); but see, *SemGroup Corp. – response* (Aug. 22, 2016).

A partnership's Adjusted EBITDA featured exclusions for "Merger and transition related expenses" (relating to a 2015 merger), "Constitution Pipeline project development costs" (relating to a certification denial by a state official) and "Expenses associated with strategic alternatives" (concerning a terminated merger with Energy Transfer Equity, L.P.). The staff asked the partnership whether these adjustments were in reality normal, recurring, cash operating expenses, and therefore inappropriate adjustments that were contrary to Question 100.01 of the C&DIs (*Williams Partners, L.P.* (Sept. 30, 2016)). The partnership responded that those items were not normal, recurring, cash operating expenses necessary for it to operate its business, and that their use was neither misleading nor inappropriate (*Williams Partners, L.P. – response* (Oct. 14, 2016)).

The staff observed that a pipeline company's adjustments to its total gross operating margin, a non-GAAP measure, for "shipper make-up rights," had the effect of accelerating the recognition of revenues that would otherwise be deferred – a treatment inconsistent with Question 100.04 of the CD&Is. Question 100.04 disapproves of presenting non-GAAP performance measures adjusted to accelerate revenue that must be recognized ratably over time by GAAP (*Enterprise Products Partners LP* (June 22, 2016)).⁶ See also, *Enable Midstream Partners, LP* (Sept. 23, 2016), dealing with whether subtracting the partnership's costs of its natural gas and natural gas liquids from the total of its product sales and service revenues was a meaningful measure.

The staff noted that a company's earnings release had not contained a reconciliation showing the nature of the individual adjustments made to calculate its non-GAAP measure of "Modified EBITDA." It also noted that the Modified EBITDA sum had been further adjusted to arrive at another non-GAAP measure, "Adjusted EBITDA," but that in that case, a reconciliation had been included. The company responded that it would clarify in future filings where its adjustments could be found (*The Williams Companies, Inc.* (Sept. 30, 2016)).

⁶ Under tariffs or contractual arrangements, shippers may be required to ship and pay for a minimum volume over an agreed-upon period, with make-up rights. Note 3 to Enterprise Products Partners, LP's consolidated financial statements as of and for the year ended December 31, 2015, stated that under GAAP, company revenues attributable to shipper make-up rights are initially deferred and then subsequently recognized at the earlier of when the deficiency volume is shipped, when the shipper's ability to meet the minimum volume commitment expires or when the pipeline is otherwise released from its transportation service performance obligations. The company told the staff that its management, in assessing the company's financial performance, had typically adjusted its gross operating margin measure for current periods by including deferred transportation revenues relating to the make-up rights.

Disclosures of a partnership's Adjusted EBITDA throughout its fiscal 2015 earnings release did not include a presentation of the most directly comparable GAAP measure. Question 102.10 of the C&DIs provides in part that the omission of comparable GAAP measures from an earnings release headline or caption that included non-GAAP measures would not be considered compliant under the rules (*Tallgrass Energy Partners, LP* (July 1, 2016); see also, *Summit Midstream Partners, LP* (Oct. 26, 2016); *SemGroup Corp.* (Aug. 4, 2016)); *DCP Midstream Partners, LP* (June 28, 2016)).

In its fiscal 2015 Form 10-K, a company's Adjusted EBITDA calculation included adjustments for selected items (e.g., certain severance costs, costs related to its predecessor's bankruptcy and defense costs), which the company believed had impacted the comparability of its financial results from period to period. Many of these adjustments related to items that had occurred in multiple periods. The staff cited Item 10(e)(1)(ii)(B), which prohibits companies from adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years, or there was a similar charge or gain within the prior two years (*SemGroup Corp.* (Aug. 4, 2016)).

Other Industry Segments

Oilfield Services and Equipment Suppliers.

Staff comments issued to oilfield services and oilfield equipment ("OFS") companies on their non-GAAP measures were similar in many respects to the comments received by upstream and midstream filers, as well as by registrants in more traditional industries, such as manufacturing.

The staff issued comments to OFS companies that had failed to:

- Include a reconciliation of their non-GAAP measures to their most directly comparable GAAP measures (*Cameron International Corp.* (Aug. 13, 2015));
- Present the most comparable GAAP measures in such a way that they were given equal or greater prominence to the non-GAAP measures presented (*USA Compression Partners, LP* (Apr. 21, 2016); *Mammoth Energy Services, Inc.* (Aug. 11, 2016); *L.B. Foster Company* (June 21, 2016); *ION Geophysical Corp.* (Oct. 20, 2016)); and
- Explain in sufficient detail why their non-GAAP measures were useful for investors (*Core Laboratories N.V.* (Mar. 14, 2016)).

A presentation in an earnings release of Adjusted EBITDA had characterized the adjustments as "non-routine" in nature. The staff noted that many of the adjustments had in fact recurred in multiple periods for which the non-GAAP measure had been presented (*Parker Drilling Co.* (Dec. 29, 2015)). Another OFS company had presented its Adjusted EBITDA with adjustments that had excluded "other non-operating income or expense, net." The staff requested clarification and disclosure of exactly what items were included within these excluding adjustments (*Mammoth Energy Services, Inc.* (Aug. 11, 2016)).

A company website disclosure of certain financial data presented a number of per-share measures, including cash flow per share. The staff asked the company how it had considered the guidance in Regulation G, since non-GAAP liquidity measures (such as cash flow) should not be presented on a per share basis (*Parker Drilling Co.* (Dec. 29, 2015)); see C&DI Question 102.05.

Other comments were directed at OFS companies that had disclosed gross profits for each of their business segments. The staff noted that these measures were non-GAAP measures because they did not comply with FASB ASC Topic 280, *Segment Reporting*, and as such, were subject to all of the provisions of Regulation G

and Item 10(e) (*L.B. Foster Company* (June 21, 2016); *Mammoth Energy Services, Inc.* (Aug. 11, 2016)); see also, C&DI Question 104.03.⁷

Downstream

Similar to other energy industry sectors, many of the comments to companies in the downstream sector tended to involve measures such as Adjusted EBITDA and segment performance metrics. The staff noted that a refining, logistics and marketing company had disclosed “gross margin” individually for each of its segments, each of which represented a distinct non-GAAP measure, and directed the company to provide separate reconciliations for each segment and on a consolidated basis (*Par Pacific Holdings, Inc.* (July 14, 2016)). Other comments criticized presentations of non-GAAP measures in companies’ filings and earnings releases that had greater prominence than their most comparable GAAP measures. See, *Delek US Holdings, Inc.* (Aug. 2, 2016); *PBF Energy, Inc.* (July 5, 2016).

VTTI Energy Partners LP, a terminal company providing storage services for refined products and crude oil, presented its Adjusted EBITDA in its Management’s Discussion and Analysis section of its fiscal 2015 Form 20-F. Adjusted EBITDA had been adjusted to exclude foreign currency derivative gains and include cash receipts related to previously-earned harbor fees at its Rotterdam terminal. The staff asked the company how those adjustments were consistent with Item 10(e) guidance regarding adjustments to non-GAAP measures for non-recurring, infrequent or unusual items (*VTTI Energy Partners LP* (May 23, 2016)), and requested additional disclosures that would describe and quantify the specific components of its non-cash operating expense adjustments (*VTTI Energy Partners LP* (July 13, 2016)).

Where narratives in a footnote to a tabulation of per barrel figures appeared to be based on additional non-GAAP measures (*i.e.*, “Production costs before DD&A expense,” and “Net operating margin” involving “adjusted refining profit”), the staff asked the company to expand its disclosures to precede those metrics with comparable per barrel GAAP figures, and provide reconciliations (*Par Pacific Holdings, Inc.* (Aug. 3, 2016)).

Utilities, Etc.

Utilities, utility holding companies and power generators also received comments on their non-GAAP measure presentations. Many companies were criticized for omitting to include comparable GAAP measures or for having their non-GAAP measures presented with equal or greater prominence than the comparable GAAP measures. See, *e.g.*, *Duke Energy Corp.* (Sept. 29, 2016); *Public Service Enterprise Group Inc.* (Sept. 22, 2016); *Ameren Corp.* (June 8, 2016); *Calpine Corp.* (Apr. 25, 2016); *NorthWestern Corp.* (Aug. 14, 2015).

Questar Gas Company’s presentations of non-GAAP measures, “Adjusted earnings” and “adjusted earnings per share-diluted,” excluded pension settlement charges, merger and restructuring charges and abandonment and impairment charges, but did not reflect adjustments to exclude net gains on assets. The staff noted that the company’s presentation was likely inconsistent with Question 100.03 of the C&DIs, which does not permit non-GAAP measures that substitute individually-tailored revenue recognition and measurement methods for those of GAAP. The company had also made adjustments to arrive at certain non-GAAP measures on an after-tax basis, which was inconsistent with Question 102.11 of the C&DIs (*Dominion Questar Corp.* (Sept. 20, 2016)).

A Canadian utility received a comment that its presentation of adjusted net earnings reflected adjustments that eliminated or smoothed items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain was such that it was reasonably likely to recur within two years, or there had been a similar

⁷ FASB ASC 280 sets forth the guidance for segment reporting under U.S. GAAP. Whenever a measure of segment profit/loss or liquidity presented is not in conformity with FASB ASC 280, it is deemed to be a non-GAAP measure.

charge within the prior two years (*Fortis Inc.* (Apr. 13, 2016)). The company contended that its adjustments were non-operating in nature, and that its presentation had been consistent with its public filings in Canada. The staff responded that it remained of the view that the adjustments were operating items, and requested the company to eliminate those adjustments from its presentation (*Fortis Inc.* (May 4, 2016); see also, *Public Service Enterprise Group Inc.* (Sept. 22, 2016)).

Forward-looking Non-GAAP Financial Measures

Forward-looking non-GAAP financial measures are also subject to Regulation G and Item 10(e). Both rules provide that a forward-looking non-GAAP measure must be accompanied by a quantitative reconciliation, to the extent available without unreasonable efforts, showing the differences between the forward-looking non-GAAP measure and the most comparable forward-looking GAAP measure. See, e.g., *Summit Midstream Partners, LP* (Oct. 26, 2016) (disclosed revised guidance for its 2016 adjusted EBITDA without any quantitative reconciliation to a forward-looking GAAP measure, and omitted the identification of the information that was not available, as C&DI Question 102.10 requires when the reconciliation is not provided); *NRG Energy, Inc.* (June 22, 2016) (disclosing a range of forward-looking adjusted EBITDA and free cash flow before growth investments for 2016); *EP Energy Corp.* (Sept. 22, 2016) (forward-looking non-GAAP guidance related to free cash flow and cash operating cost on a barrel of oil equivalent basis); and *EQT Midstream Partners, LP* (June 24, 2016) (adjusted EBITDA guidance for the second fiscal quarter and the full fiscal year).

Conclusion

The new non-GAAP financial measure C&DIs and the recent staff comments make clear that companies must make more nuanced interpretations of the guidance under Regulation G and Item 10(e) in order to satisfy their requirements. In the case of energy companies, the new C&DIs and the staff comments to-date have revealed that:

- Each energy company should carefully re-analyze its non-GAAP measure disclosures in its SEC filings and press releases, at investor conferences and on its websites, to ensure to the degree possible they are consistent with the new and existing C&DIs;
- Adjusting non-GAAP performance measures by excluding recurring items – particularly recurring ordinary cash operating expenses – may draw comments;
- Each company's traditional, customary financial data disclosures should be re-assessed; while metrics such as “core earnings,” “PV-10” and “operating margin per BOE” may be easily described, they are nonetheless non-GAAP financial measures requiring the additional presentation of the most-comparable GAAP measures and reconciliations;
- When presenting numerous non-GAAP measures in a filing or press release, re-examine whether each of them are accompanied by the most comparable GAAP measures having the appropriate degree of prominence, along with a reconciliation;
 - For instance, when non-GAAP measures appear in headlines or captions of an earnings release, C&DI Question 102.10 indicates that the comparable GAAP measures should precede the non-GAAP measures in the headlines or captions; see also, *Clayton Williams Energy, Inc.* (Mar. 24, 2016);
- The continued use of a complex non-GAAP measure that necessitates a complicated explanation and reconciliation should be re-evaluated, and the justification for its use should be re-considered, in light of the staff's recent comments on potentially misleading measures;

- Adjustments to a non-GAAP performance measure like adjusted earnings per share should not be presented “net of tax”; income taxes should be shown as a separate adjustment that should be clearly presented;
- Entities such as MLPs, where per share metrics such as distributable cash flows per unit are important non-GAAP measures, should take care to describe their use and relevancy as performance measures, and not as liquidity measures; and
- If forward-looking non-GAAP measures presented as guidance (such as future net earnings) are not accompanied by a reconciliation to the most comparable forward-looking GAAP measure, the company must disclose the reconciliation’s omission due to information that was not available “without unreasonable efforts,” and identify that unavailable information and its probable significance in a location having equal or greater prominence.

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