

# SEC Issues Additional Guidance Regarding the Use of Non-GAAP Financial Measures

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**PRACTICES** Corporate, Capital Markets and Securities

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On May 17, 2016, the Division of Corporate Finance of the Securities and Exchange Commission (the “SEC”) issued 12 new Compliance & Disclosure Interpretations (“C&DIs”) regarding the use of non-GAAP financial measures. The new C&DIs cover communications subject to Regulation G and filings subject to Item 10(e) of Regulation S-K. These C&DIs were issued in the wake of increasing rhetoric from the SEC highlighting a growing concern and scrutiny over usage of non-GAAP financial measures in a manner that may mislead investors. Reporting registrants should monitor their disclosures to ensure that any non-GAAP financial measures in public communications or applicable SEC filings comply with the updated guidance in these new C&DIs. For the complete list of C&DIs addressing non-GAAP financial measures, click [here](#).

## Background

Use of non-GAAP financial measures by issuers subject to the reporting requirements under the Securities Exchange Act of 1934 is governed by Regulation G for public disclosures and other communications and by Item 10(e) for filings made with the SEC. Generally, when a reporting registrant discloses a non-GAAP financial measure in a public communication or an SEC filing, it must also present the most directly comparable GAAP measure and provide a reconciliation of the differences between the non-GAAP financial measure and the GAAP measure. When disclosing a non-GAAP financial measure in an SEC filing (including in an earnings release furnished pursuant to Item 2.02 of Form 8-K), registrants are further required to present the most directly comparable GAAP measure with equal or greater prominence to the non-GAAP financial measure, provide a rationale for its use and disclose any other material purposes for which management uses the non-GAAP financial measure. In all cases, reporting issuers are prohibited from making misleading presentations of non-GAAP financial measures in public disclosures.

## Guidance on Misleading Presentations of Non-GAAP Financial Measures

Several of the new C&DIs provide examples of presentations of non-GAAP financial measures that the SEC believes may be misleading, including the following:

- Performance measures that exclude normal, recurring, cash operating expenses necessary to operate a registrant’s business.
- Inconsistent presentations between periods, such as adjusting for particular charges or gains in one period for which other, similar charges or gains were not also adjusted in prior periods (unless the issuer provides a rationale for the differing presentations or, in cases of significant changes, recasts prior presentations).
- Adjustments only for non-recurring charges when there were also non-recurring gains that occurred during the same period.
- Substitutions of individually tailored revenue recognition and measurement methods for those of GAAP.

## **Equal or Greater Prominence of GAAP Measures**

In SEC filings, including earning releases furnished pursuant to Item 2.02 of Form 8-K, Item 10(e) requires that registrants presenting a non-GAAP financial measure also present the most directly comparable GAAP measure with equal or greater prominence. The C&DIs contain a number of examples in which the SEC believes that a non-GAAP financial measure would be more prominent than the comparable GAAP measures, including:

- Presenting a full income statement of non-GAAP financial measures (even if done so within a reconciliation of a non-GAAP financial measure to the most directly comparable GAAP measure).
- Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP financial measures.
- Presenting a non-GAAP financial measure using a style of presentation (*e.g.*, bold, larger font) that emphasizes the non-GAAP financial measure over the comparable GAAP measure.
- Presenting a non-GAAP financial measure before the comparable GAAP measure (including in an earnings release headline or caption).
- Describing a non-GAAP financial 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 GAAP measures in the same table.
- Excluding a quantitative reconciliation with respect to a forward-looking non-GAAP financial measure in reliance on the “unreasonable efforts” exception in Item 10(e)(1)(i)(B) without prominently disclosing that fact and identifying the information that is unavailable.
- Providing a discussion and analysis of a non-GAAP financial measure without a similar discussion and analysis of the comparable GAAP measure.

## **Other Interpretations**

The new C&DIs provide guidance on several other matters, including the following:

- If EBIT or EBITDA is presented as a performance measure, the most directly comparable GAAP measure to which they should be reconciled is net income and not operating income.
- Item 10(e)(ii)(B) prohibits a registrant from making adjustments to arrive at 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. The SEC clarified that this prohibition only relates to the manner in which the charge or gain is described and does not mean that a registrant cannot adjust for charges or gains of that nature for another reason.
- The presentation of “free cash flow,” which is typically calculated as cash flows from operating activities less capital expenditures, does not violate Item 10(e)(1)(ii). The SEC does not believe, however, that its title describes how it is calculated. Accordingly, the calculation of “free cash flow” should be described and a reconciliation should be provided.

- Item 10(e) does not prohibit the inclusion of non-GAAP per share performance measures in documents filed or furnished with the SEC. Any such measures should be reconciled to GAAP earnings per share. Non-GAAP liquidity measures that measure cash generated may not, however, be presented on a per share basis in documents filed or furnished with the SEC. Whether per share data is prohibited depends on its substance and whether the non-GAAP measure can be used as a liquidity measure, even if management presents it solely as a performance measure.
- The income tax effects related to adjustments in arriving at a non-GAAP financial measure depend on the nature of the non-GAAP financial measure, such as by adjusting for taxes paid in cash for a liquidity measure and for current and deferred tax expense for a performance measure.
- Adjustments to arrive at a non-GAAP financial measure should not be presented “net of tax.” Rather, the income tax effects should be shown as a separate adjustment.

## Conclusion

The SEC has recently increased its focus and scrutiny on the use of non-GAAP financial measures. Registrants should not continue to rely on the SEC’s previous acceptance of their disclosures of non-GAAP financial measures or those of their peers. Instead, in light of this new guidance and enhanced scrutiny, registrants should carefully review and update their use of any non-GAAP financial measures in SEC filings and other public disclosures. In certain cases, registrants may consider reducing their reliance on non-GAAP financial measures.

If you have any questions about this topic, please contact a member of our [Capital Markets and Securities Practice Group](#).