



## SEC Staff Warns about Non-GAAP Financial Measures

The SEC staff recently updated its guidance about how companies are allowed to use non-GAAP financial measures, and specifically listed prohibited practices.<sup>1</sup> The new guidance follows recent comments by the SEC chair and SEC staff warnings that enforcement action will be taken against companies that don't comply with guidance outlining how a company must present non-GAAP financial measures.

### Key Facts

The updated SEC Compliance & Disclosure Interpretations (C&DIs) specifically prohibit practices for non-GAAP financial measures including:

- Misleading financial measures;
- Per share non-GAAP liquidity measures; and
- Inappropriate adjustments for tax expenses.

### Key Impacts

- Companies may have to revise or eliminate certain non-GAAP financial measures in filings and press releases, particularly those that include adjustments to revenue.
- Before the new guidance was issued, the SEC staff said that:
  - Management should reassess the controls and oversight procedures that it applies to non-GAAP financial measures; and
  - Audit committees should pay close attention to non-GAAP financial measures, including related disclosures, and consider what measures are appropriate and reliable.<sup>2</sup>

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<sup>1</sup> [SEC Compliance & Disclosure Interpretations](#) ("C&DIs"), Non-GAAP Financial Measures, issued May 17, 2016, available at [www.sec.gov](http://www.sec.gov).

<sup>2</sup> [Wesley R. Bricker](#), SEC Deputy Chief Accountant, at the 2016 Baruch College Financial Reporting Conference, May 5, 2016, available at [www.sec.gov](http://www.sec.gov).



The SEC staff is “troubled by the extent and nature of the adjustments to arrive at alternative financial measures of profitability...” said James V. Schnurr, SEC Chief Accountant.

## Misleading Financial Measures

The new interpretations provide examples about adjustments that, while not explicitly prohibited, result in non-GAAP financial measures that may be misleading.<sup>3</sup> The SEC first adopted its guidance in 2003 and updated it in 2010 to eliminate some unintended consequences.

### Excluding Normal Operating Expenses

Presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a business could be misleading and violate SEC rules.

### Inconsistency in Presentation between Periods

Non-GAAP financial measures may be misleading if not presented consistently between periods. For example, a non-GAAP financial measure that adjusts a specific charge or gain in the current period but did not adjust other, similar charges or gains in prior periods could violate SEC rules unless the change is disclosed and the reasons stated. Depending on the significance, it may be necessary to recast prior measures to conform to the current presentation and place the disclosure in the appropriate context.

### Adjustments for Nonrecurring, Infrequent, or Unusual Items

The SEC staff guidance prohibits adjusting a non-GAAP performance measure to eliminate or smooth items labeled as nonrecurring, infrequent, or unusual if the charge or gain is reasonably likely to recur within two years or had occurred within the past two years. The guidance identifies specified criteria that a charge or gain must meet to be deemed non-recurring, infrequent, or unusual. Those criteria notwithstanding, a company may adjust a charge or gain if it believes that the adjustment is appropriate, subject to SEC rules.

Non-GAAP financial measures may be misleading if they exclude charges, but include gains. For example, a non-GAAP financial measure that adjusts for only nonrecurring charges but includes nonrecurring gains during the same period could violate SEC rules.

### Individually Tailored Accounting Principles

The C&DI update said that non-GAAP measures that substitute individually tailored revenue recognition and measurement principles for GAAP could violate Regulation G. For example, a company that uses a non-GAAP performance measure to adjust revenue to recognize it as income when it is billed rather than recognizing it over time as it is earned, is violating Regulation G.

During an accounting seminar at Baruch College, Wesley R. Bricker, SEC Deputy Chief Accountant, cited an example of a company with a subscription-based business that bills the full subscription at the outset of the transaction. However, because it will deliver over time, it earns and recognizes GAAP revenue over that same period. But, the company also presents a non-GAAP earnings measure that assumes revenue is recognized when the full subscription price is billed.

<sup>3</sup> Rule 100(b) of Regulation G says: A registrant, or a person acting on its behalf, shall not make public a non-GAAP financial measure that, taken together with the information accompanying that measure and any other accompanying discussion of that measure, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading.

“The effect of the measure is that the company accelerates revenue recognition to the billing date.” He concluded that the company was replacing an important accounting principle with an alternate accounting model that does not match its business or earnings process, which is over time.

### **EBIT or EBITDA**

If a company presents earnings before interest and taxes (EBIT) or earnings before interest, taxes, depreciation, and amortization (EBITDA) as performance measures, it must reconcile those measures to net income as presented in the statement of operations under GAAP. Operating income would not be considered the most directly comparable GAAP financial measure because EBIT and EBITDA adjust for items that are not included in GAAP net income.

### **Free Cash Flow**

Some companies present free cash flow, which is typically calculated as cash flows from operating activities as presented in the statement of cash flows under GAAP, less capital expenditures. However, free cash flow is not defined and its title does not describe how it is calculated. A company should provide a clear description of how this measure is calculated and provide a reconciliation to GAAP when it is used. A company also should avoid inappropriate or potentially misleading implications about the usefulness of that measure (e.g., implying that free cash flow represents cash available for discretionary expenditures if mandatory debt payments have not been included).

### **Prominent Non-GAAP Financial Measures**

Non-GAAP financial measures may not be presented more prominently than GAAP financial measures. The updated C&DIs provide examples of presentation approaches that would cause a non-GAAP measure to be more prominent than GAAP measures and potentially violate SEC rules. Determining whether a non-GAAP measure is more prominent than the comparable GAAP measure generally depends on the facts and circumstances in which the disclosure is made.

#### **SEC Staff’s Examples of Non-GAAP Financial Measures That Are More Prominent Than GAAP Financial Measures**

- Presenting a full income statement of non-GAAP measures, including 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.
- Placing a non-GAAP measure before the 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.

### SEC Staff's Examples of Non-GAAP Financial Measures That Are More Prominent Than GAAP Financial Measures

- Providing tabular disclosure of non-GAAP financial measures without an equally prominent preceding tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the table.
- Excluding a quantitative reconciliation with respect to a forward-looking non-GAAP measure by relying on the “unreasonable efforts” exception in Item 10(e)(1)(i)(B) 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 about the comparable GAAP measure in a location with equal or greater prominence.

During the Reuters' Summit in May, SEC Chair Mary Jo White reiterated that presentation of a GAAP measure has to be of equal or greater prominence than presentation of a non-GAAP measure.<sup>4</sup>

## Per Share Non-GAAP Liquidity Measures

While non-GAAP per share performance measures may provide meaningful information about operations, per share non-GAAP liquidity measures are prohibited. Determining whether the per share data is prohibited depends on whether the non-GAAP financial measure can be used as a liquidity measure, even if management presents it solely as a performance measure.

In the updated C&DIs the SEC staff accepted a definition of “funds from operations” provide by the National Association of Real Estate Investment Trusts as a performance measure, and will not object to its presentation on a per share basis. Funds from operations may also be presented on other bases, however adjustments must comply with the requirements for a performance measure. Some adjustments may trigger the prohibition of a per share presentation because that presentation may look like a liquidity measure.

The C&DIs also specify that EBIT or EBITDA and free cash flow must not be presented on a per share basis because they are liquidity measures.

When analyzing whether per share non-GAAP liquidity measures are appropriate, the SEC staff will focus on the substance of the measure, not on management's characterization.

## Tax Expense Adjustments

The updated C&DIs state that a company should provide income tax effects on its non-GAAP financial measures depending on the nature of the measures. If a measure is a liquidity measure that includes income taxes, it might be

<sup>4</sup> SEC Chair Mary Jo White was interviewed at the Reuters Financial Regulatory Summit in Washington, May 17, 2016.

acceptable to adjust GAAP taxes to show taxes paid in cash. If a measure is a performance measure, the registrant should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. However, adjustments to arrive at a non-GAAP financial measure should not be presented “net of tax.” Rather, income taxes should be shown as a separate adjustment and clearly explained.



The SEC will not hesitate to bring enforcement action against a company if it uncovers an “actionable violation,” said SEC Chair Mary Jo White.

## Recent SEC and IASB Comments

For several months, SEC officials have been warning that they will begin to crack down on companies that use inappropriate non-GAAP financial measures. Earlier this month, Mark Kronforst, the Chief Accountant of the SEC’s Division of Corporation Finance, said that the SEC staff will begin to crack down on companies that are disclosing earnings measures that aren’t sufficiently based on U.S. GAAP.<sup>5</sup>

In March, James V. Schnurr, SEC Chief Accountant, urged preparers to “carefully consider whether significant adjustments to profitability outside of customary measures such as EBITDA or nonrecurring items or other charges to the business” help investors understand how these events affect trends and future performance and are appropriate. Schnurr said that if adjustments are appropriate, they should be reconciled to cash flows from operations.<sup>6</sup>

It isn’t only U.S. standard setters who are raising the alarm. Hans Hoogervorst, IASB Chairman, stated that growing evidence suggests a significant increase in non-GAAP financial measures that present results “in more favorable light” and that are “become increasingly misleading.”<sup>7</sup>

## Non-GAAP Financial Measure Disclosures

The following table summarizes the SEC rules related to non-GAAP financial measures and identifies disclosure requirements and prohibitions.

| Disclosures  | Reg. G | Item 10(e) Reg. S-K | Item 2.02 Form 8-K (furnished) | Item 2.02 Form 8-K (filed) |
|--|--------|---------------------|--------------------------------|----------------------------|
| <b>Non-GAAP Financial Measure Disclosure Requirements</b>  |        |                     |                                |                            |
| Presentation of most directly comparable U.S. GAAP measure | X      | X                   | X                              | X                          |

<sup>5</sup> Mark Kronforst, Chief Accountant of the SEC’s Division of Corporation Finance, spoke May 5, 2016, at the 2016 Baruch College Financial Reporting Conference.

<sup>6</sup> [James V. Schnurr](#), SEC Chief Accountant, Remarks at the 12th Annual Life Sciences Accounting and Reporting Congress, March 22, 2016, available at [www.sec.gov](http://www.sec.gov).

<sup>7</sup> [Hans Hoogervorst](#), Chairman of the International Accounting Standards Board (IASB), speaking at the Annual Conference of the European Accounting Association in Maastricht: Performance reporting and the pitfalls of non-GAAP metrics, May 2016, available at [www.ifrs.org](http://www.ifrs.org).

| Disclosures  | Reg. G | Item 10(e) Reg. S-K | Item 2.02 Form 8-K (furnished) | Item 2.02 Form 8-K (filed) |
|--|--------|---------------------|--------------------------------|----------------------------|
| Reconciliation of non-GAAP financial measure to most directly comparable GAAP measure      | X      | X                   | X                              | X                          |
| Presentation not more prominent than the most directly comparable GAAP measure             |        | X                   | X                              | X                          |
| Statement about why management believes the measure helps investors                        |        | X                   | X                              | X                          |
| Statement about the additional purposes, if any, for which management will use the measure |        | X                   | X                              | X                          |
| <b>Non-GAAP Financial Measure Prohibitions</b>   |        |                     |                                |                            |
| Certain presentations ( <a href="#">Item 10(e)(1)(ii) of Regulation S-K</a> )              |        | X                   |                                | X                          |
| Per share measures of liquidity  |        | X                   | X                              | X                          |

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