

# GOODWIN PROCTER ALERT

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## SEC Non-GAAP Guidance: Impact on Earnings Releases, SEC Reports and Other Disclosures

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### *Speed Read*

*The compliance and disclosure interpretations, or C&DIs, published by the staff, or Staff, of the Division of Corporation Finance of the Securities and Exchange Commission in May 2016 will require many companies to make changes in how they present non-GAAP financial measures in their upcoming SEC reports, earnings releases and other public disclosure materials. This client alert discusses the principal impacts of the new C&DIs on upcoming earnings releases, SEC reports and other public materials that contain non-GAAP financial measures. See our "New Non-GAAP Guidance Review Checklist," attached as Appendix A, for a one-page list of items to consider when reviewing communications associated with the next earnings release/SEC reporting cycle.*

As discussed in our recent client alert "[SEC Issues Important Non-GAAP Interpretations](#)" (May 19, 2016), the SEC recently released [a series of new C&DIs](#) on the use of non-GAAP financial measures by reporting companies and new SEC registrants in public communications and SEC filings. These C&DIs were published after most public companies had completed their reporting and disclosure process for the quarter ended March 31. As a result, most companies will be considering the Staff's interpretive views reflected in the new C&DIs for the first time when they prepare their earnings releases, SEC reports and other public disclosure materials for the fiscal quarter (or year) ending June 30.

Given the positions taken by the Staff in the new C&DIs, we expect that many companies will need to revise their historical disclosure practices relating to non-GAAP financial measures. Accordingly, companies should allow adequate time for their financial, legal and investor relations staff to review drafts of their earnings releases, SEC reports and other public disclosure materials for the upcoming fiscal quarter (or year), as well as for preparation of any revised or additional disclosure that may be required in order to address these new Staff interpretations.

The C&DIs will most significantly affect the following areas, although other disclosures may also be affected:

- the adjustments a company makes in presenting non-GAAP financial measures in all public communications;
- the relative prominence of, and emphasis on, non-GAAP financial measures in comparison to comparable GAAP financial measures in SEC filings and information furnished to the SEC under Item 2.02 of Form 8-K, which typically includes earnings releases;
- the presentation of forward-looking non-GAAP financial measures, such as guidance or similar forward-looking information presented in a company's earnings release or the MD&A section of its Form 10-Q and Form 10-K reports; and
- the presentation of per-share non-GAAP financial measures in SEC filings and information furnished to the SEC under Item 2.02 of Form 8-K.

This client alert discusses the new C&DIs and their practical impact in these four areas, as well as other potential disclosure concerns relating to non-GAAP financial measures reflected in recent SEC comment letters.

### Potentially Misleading Adjustments

The new C&DIs include four new interpretations (Questions 100.01-100.04) that deal generally with adjustments companies make to calculate non-GAAP financial measures, as well as a significantly revised interpretation that deals with adjustments for taxes (Question 102.11). In many cases, the impact of these C&DIs will be clear when companies review the non-GAAP financial measures included in their disclosures.

The C&DIs provide that the following may be misleading and may therefore violate Regulation G, which is applicable to all public disclosures, as well as to periodic and current reports, registration statements and other documents filed with or furnished to the SEC:

- excluding normal, recurring, cash operating expenses necessary to operate the company's business from a performance measure (Question 100.01);
- changing the types of adjustments made to a particular non-GAAP financial measure from one period to the next without disclosing the change and explaining the reasons for the change, with this C&DI further indicating that, depending on the significance of the change, Regulation G may require the company to recast prior disclosures to conform to the current presentation and place the current period's non-GAAP disclosure in the appropriate context (Question 100.02);
- presenting a non-GAAP financial measure that excludes charges but does not exclude gains – for example, a non-GAAP financial measure that is adjusted only for non-recurring charges when there were non-recurring gains during the same period (Question 100.03); and
- presenting a non-GAAP performance measure that substitutes individually tailored recognition and measurement methods for GAAP line items, particularly including revenues (Question 100.04).

In question 100.04, the Staff specifically indicates that it does not believe a company can present a non-GAAP performance measure that is adjusted to accelerate revenue recognized ratably over time in accordance with GAAP as though it earned revenue when customers are billed.

In addition, Question 102.11 states that companies should calculate and present the income tax effects on non-GAAP financial measures based on the nature of the non-GAAP financial measure:

- if the non-GAAP financial measure is a liquidity measure that includes income taxes, the C&DI indicates that it "might be acceptable" for a company to adjust GAAP taxes to show taxes paid in cash;
- if the measure is a performance measure, the company should include current and deferred income tax expense commensurate with the non-GAAP financial measure of profitability; and
- companies should not present adjustments to arrive at a non-GAAP financial measure "net of tax," but should instead show income taxes as a separate adjustment with a clear explanation.

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The Staff's general use of "may" and "could" in Questions 100.01-100.04 is worth considering when companies review their non-GAAP disclosures. Although the Staff has indicated that the non-GAAP disclosures discussed in these C&DIs "may" or "could be" misleading, the C&DIs generally do not reflect bright-line categorical judgments that non-GAAP financial measures making particular adjustments will always be viewed as misleading. Nevertheless, companies that decide to present non-GAAP financial measures that these C&DIs have specifically identified as potentially misleading should understand that they may face greater scrutiny from the SEC, which could include responding to comments from the Staff or inquiries from the SEC Division of Enforcement. Accordingly, companies that are considering presenting these types of non-GAAP financial measures should carefully consider how they present these financial measures, as they may be able to mitigate the possibility that the Staff will view their presentation adversely by including clear explanations that could reduce potential concerns about whether the disclosure is misleading.

### Prominence of GAAP Financial Measures

Item 10(e)(1)(i) of Regulation S-K, which applies to both SEC filings and to earnings releases and other materials furnished pursuant to Item 2.02 of Form 8-K, requires that when a company presents a non-GAAP financial measure it must also present the most directly comparable GAAP financial measure with equal or greater prominence. This requirement does not apply to materials that are not filed with or furnished to the SEC or that are furnished under Item 7.01 of Form 8-K.

The new C&DI relating to this requirement, Question 102.10, provides a number of specific examples of disclosure that the Staff does not view as meeting this requirement, including a number of practices that are commonplace today. The Staff has indicated in Question 102.10 that it would view the following as examples of disclosures that would cause a non-GAAP financial measure to be more prominent than the most directly comparable GAAP financial measure:

- Non-GAAP financial measures that precede the most directly comparable GAAP financial measure (including in an earnings release headline or caption).
- Omitting the most directly comparable GAAP financial measure from an earnings release headline or caption that includes non-GAAP financial measures.
- Using a style of presentation for non-GAAP financial measures (for example, a bold or larger font) that emphasizes the non-GAAP financial measure over the most directly comparable GAAP financial measure.
- Describing a non-GAAP financial measure as, for example, "record performance" or "exceptional" without at least an equally prominent descriptive characterization of the most directly comparable GAAP financial measure.
- Providing discussion and analysis of a non-GAAP financial measure without a similar discussion and analysis of the most directly comparable GAAP financial measure in a location with equal or greater prominence (that is, before the discussion of the non-GAAP financial measure). Companies will need to consider the emphasis and detail they provide for non-GAAP financial measures, and provide equally or more prominent descriptions and analysis of the comparable GAAP financial measures. Simply presenting the GAAP financial measure before the non-GAAP financial measure but then presenting detailed discussion and analysis of only the non-GAAP financial measure is not likely to satisfy the Staff's interpretation of the "equal or greater prominence" requirement.
- Providing tabular disclosure of non-GAAP financial measures without preceding this disclosure with an equally prominent tabular disclosure of the most directly comparable GAAP financial measures or including the comparable GAAP financial measures in the same table.
- Projections of non-GAAP financial measures that do not include reconciliations to the most directly comparable GAAP financial measures in reliance on the exception for cases where a reconciliation for the forward-looking non-GAAP financial measure cannot be provided "without unreasonable efforts," unless the company provides, in a location of equal or greater prominence, disclosure that indicates that the company is relying on this exception and identifies the information that is unavailable and the probable significance of that information.

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- Presenting a full income statement of non-GAAP financial measures or presenting a full non-GAAP income statement when reconciling non-GAAP financial measures to the most directly comparable GAAP financial measures.

In order to comply with Item 10(e)(1)(i) of Regulation S-K, as interpreted by the Staff in the new C&DIs, many companies will need to change their current disclosure practices. In many cases, companies may need to add more prominent and lengthier discussions of GAAP financial measures to their earnings releases or other disclosures that are furnished under Item 2.02 of Form 8-K, notwithstanding that this information may not be as useful to analysts and investors and may obscure non-GAAP information that they may view as more important. In some cases, companies may determine that they should no longer disclose certain non-GAAP financial information. While companies and their investment audiences may question the policy decisions that led the Staff to issue interpretive guidance that discourages companies from providing information to investors that they find useful, this is now the landscape within which companies will need to operate.

### Per-Share Liquidity Measures

The SEC has taken the position for many years that non-GAAP liquidity measures should not be presented on a per-share basis. The new C&DIs expand and clarify the Staff's position on per-share presentations of non-GAAP financial measures as follows:

- companies may not present EBITDA or EBIT (or adjusted variations) on a per-share basis in documents filed with or furnished to the SEC (Question 103.02) – note that by stating that EBITDA and EBIT may not be presented on a per-share basis, the Staff appears to be taking the position that these measures are at least presumed to be liquidity measures;
- companies may not present free cash flow on a per-share basis in documents filed with or furnished to the SEC (Question 102.07); and
- companies may not present other non-GAAP financial measures that can be used as a liquidity measure on a per-share basis in documents filed with or furnished to the SEC, even if management characterizes the measure solely as a performance measure (Question 102.05).

The C&DIs continue to state that REITs may present FFO, as currently defined by NAREIT, on a per-share basis, and may make certain adjustments to FFO (Question 102.01). The C&DIs also continue to indicate that adjustments may be made to FFO provided that the presentation of the adjusted FFO metric continues to comply with applicable rules, which, depending on the nature of the adjustments, may include the prohibitions on making certain adjustments to liquidity measures and presenting liquidity measures on a per share basis (Question 102.02).

The Staff applies its prohibition on the presentation of per-share non-GAAP liquidity measures to earnings releases, investor presentations and other materials furnished to the SEC. Accordingly, companies should carefully review these documents for compliance with this prohibition and be aware that the Staff could seek to characterize non-GAAP financial measures that the company believes are performance measures as liquidity measures to which this prohibition applies. We believe that the Staff's interpretive view would likely extend to other common measures, such as Adjusted Earnings Per Share (Adjusted EPS) if an adjustment relates to an item that could be viewed as impacting liquidity, such as an adjustment for cash interest payments on outstanding borrowings, even if management views this measure as primarily a performance measure.

### Other Disclosures

In addition to the non-GAAP disclosures covered by the C&DIs, the Staff has also recently commented on disclosures in company filings that attempt to address the requirement to disclose the reasons why management believes that presentation of a non-GAAP financial measure provides useful information to investors. Staff comments on this disclosure have called attention to inconsistencies between disclosure stating that providing a specific non-GAAP financial measure facilitates comparisons with other companies, on the one hand, and cautionary disclosure that other companies may calculate the non-GAAP financial measure differently, on the other hand, which the Staff has indicated may reduce the usefulness of the non-GAAP financial measure as a comparative measure. The Staff has also expressed concern in recent comment letters that disclosures about why a company believes its non-GAAP

financial measures are useful to management, how the company uses those measures, and why those measures are useful to investors are often boilerplate explanations that do not adequately address these disclosure requirements.

Another topic reflected in some Staff comment letters is disparity between the non-GAAP financial measures discussed in the company's earnings release and earnings calls and the non-GAAP financial measures included in the company's periodic reports on Form 10-Q and Form 10-K. It is unclear if these comments will continue in light of the new C&DIs, but companies that attempt to address the new C&DIs by discussing non-GAAP financial measures only during earnings calls or in earnings releases may receive Staff comments asking them to explain why they believe their SEC reports are consistent with their other public disclosures.

### The New Roadmap

The new C&DIs will require many companies to revise their presentation of non-GAAP financial measures. Companies should review how they currently use non-GAAP financial information and determine what, if any, changes they plan to make in response to the new C&DIs. Companies should consider the following steps, as appropriate to their circumstances:

- Review all public communications that include non-GAAP financial measures on a *de novo* basis. This includes disclosures in quarterly and annual SEC reports, earnings releases and other materials that the company files with or furnishes to the SEC. This also includes all other public disclosure materials, such as materials used in connection with investor or business meetings, calls and conferences, as well as materials posted on the company's website.
- Determine whether earnings-related communications will be filed with the SEC, furnished to the SEC or made publicly available in another manner, such as posted on the company's website. Changes in how a communication will be made public may require the company to revise the relevant disclosures.
- Remember to review proxy statement disclosure, to the extent applicable. A [recent article in \*The Wall Street Journal\*](#) reported that the term "non-GAAP" appeared in 58% of proxy statements filed through May 2016 by companies in the S&P 500, compared to 27% five years ago, according to Audit Analytics. There are limited exceptions for certain uses of non-GAAP financial measures in compensation disclosure in proxy statements without complying with Regulation G and Item 10(e). Companies that disclose non-GAAP financial measures in proxy statements should ensure that these disclosures are drafted with applicable SEC guidance in mind.
- Ensure that the company's disclosure controls and procedures are broad enough to encompass all non-GAAP financial measures disclosed in SEC filings, and consider applying appropriate controls to all public communications, regardless of how they are used. For example, companies should consider extending appropriate controls to non-GAAP financial measures disclosures exclusively in marketing materials or investor relations slides to the extent they do not already do so.
- Involve the company's audit committee in reviewing non-GAAP financial measures that are to be publicly disclosed, especially the methodologies used to calculate non-GAAP disclosures, if the audit committee is not already doing so, with emphasis on the new C&DIs and other recent SEC discussions and comments about non-GAAP financial measures. Recent speeches by [SEC Chair Mary Jo White](#) and [SEC Chief Accountant James Schnurr](#) have stressed the audit committee's role with respect to the use of non-GAAP financial measures. NYSE-listed companies should also consider the requirements of the NYSE rules that the audit committee review "the type and presentation of information to be included in earnings press releases (paying particular attention to any use of 'pro forma,' or 'adjusted' non-GAAP, information), as well as review any financial information and earnings guidance provided to analysts and rating agencies."
- Ensure that the names of any non-GAAP financial measures are not confusingly similar to either GAAP financial measures or other non-GAAP financial measures, and provide clear disclosure, rather than boilerplate explanations, about how non-GAAP financial measures are calculated and why they are useful to management and investors.

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- Review carefully all adjustments used to calculate non-GAAP financial measures. In particular, consider whether charges and gains are treated consistently within a single fiscal period and whether potential inconsistencies with prior periods may require prior periods to be recast.
- Determine whether the company's non-GAAP financial measures substitute individually tailored revenue recognition and measurement methods for those of GAAP, regardless of whether the document is filed with or furnished to the SEC or simply made public in some other manner, and likewise determine whether other non-GAAP financial measures use individually tailored recognition and measurement methods for other financial statement line items. If so, consider whether the non-GAAP financial measure should continue to be presented or if additional disclosures may be required to avoid claims that the presentation of the measure is misleading.
- Evaluate the company's non-GAAP disclosures under all other applicable elements of Regulation G and Item 10(e) of Regulation S-K, including among others the requirements for reconciliations to the most directly comparable GAAP financial measure and explanations of how the non-GAAP financial measures are used.
- Ensure that non-GAAP financial measures are not more prominent than the most directly comparable GAAP financial measure, with special emphasis on the examples contained in the C&DIs. This includes the use of non-GAAP financial measures in headlines, captions, management quotes and tables. Without minimizing the importance of specific, item-by-item review, step back from the document and consider whether the overall disclosure – or any portion of the disclosure – emphasizes the importance of non-GAAP financial measures over GAAP financial measures.
- Review per-share non-GAAP disclosures to determine if any of these could be considered per-share liquidity metrics, including free cash flow (and, potentially, measures such as Adjusted EPS) in the company's SEC filings or earnings releases. Remember that the SEC has explicitly stated that it will not be bound by management's disclosure about whether a non-GAAP financial measure is a liquidity measure, which cannot be presented on a per-share basis, or a performance measure, which SEC rules permit to be presented on a per-share basis. Determine whether non-GAAP liquidity measures (other than EBITDA and EBIT) exclude charges or liabilities that require cash settlement, or would have required cash settlement absent an ability to settle in another manner, which Item 10(e)(1)(ii) prohibits.

## Appendix A

### New Non-GAAP Guidance Review Checklist

All public communications containing non-GAAP financial measures should be carefully scrutinized under Regulation G and Regulation S-K Item 10(e)(1)(i), including among others the requirements for reconciliations to the most directly comparable GAAP financial measure and explanations of how the non-GAAP financial measures are used, as well as the recent SEC C&DI guidance summarized in this client alert. In particular:

- Has the company's internal legal team, disclosure committee and audit committee been made aware of the new SEC guidance related to non-GAAP financial measures?
- Has time been set aside during the next audit committee meeting to discuss this new SEC guidance and evaluate the company's methodology and use of non-GAAP financial measures?
- Are any of the names of any non-GAAP financial measures confusingly similar to either GAAP financial measures or other non-GAAP financial measures?
- Are there clear "non-boilerplate" disclosures about how non-GAAP financial measures are calculated and why they are useful to management and investors?
- Are adjustments to the company's non-GAAP financial measures for charges and gains treated consistently within a single fiscal period? Are all non-recurring gains included in the non-GAAP financial measure?
- Do any of the company's non-GAAP financial measures substitute individually tailored revenue recognition and measurement methods for those of GAAP?
- Are any of the company's non-GAAP financial measures listed before the most directly comparable GAAP financial measure?
- Are there any non-GAAP financial measures in the headlines, captions, management quotes and tables without the most directly comparable GAAP financial measure?
- Are any non-GAAP financial measures characterized in terms such as "record" or "exceptional" without equally prominent descriptions of the most directly comparable GAAP financial measures?
- Do all forward-looking non-GAAP financial measures include quantitative reconciliations to GAAP or explicit disclosures that the company is relying on the "unreasonable efforts" exception in Item 10(e)(1)(i)(B) of Regulation S-K?
- Overall, does the communication emphasize the importance of non-GAAP financial measures over GAAP financial measures, for example are non-GAAP financial measures bolded, italicized or otherwise highlighted?
- Does the company use any per-share liquidity metrics, free cash flow and, potentially, Adjusted EPS disclosures in its SEC filings or earnings releases? Does the company use per-share EBITDA or EBIT in its SEC filings or earnings releases?
- Would any of the changes made to the current period's non-GAAP disclosures require the company to recast prior period calculations to improve an investor's understanding and avoid potential inconsistencies?
- Has the company reviewed non-GAAP disclosures across all corporate communications, including current, quarterly and annual SEC reports, proxy statements, CEO letters, earnings releases, earnings presentations, investor presentations, social media, call scripts and the corporate website?

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