

May 25, 2016

Applying the New SEC Staff Guidance on Non-GAAP Measures to Your Next Earnings Announcement

On May 17, 2016, the SEC's Division of Corporation Finance escalated the SEC's efforts to curb perceived misuse of non-GAAP financial measures with the issuance of a revised set of Compliance and Disclosure Interpretations (CDIs). This action follows a series of speeches by SEC Chair Mary Jo White and SEC senior staff members, and an uptick in comment letter activity, all focused on what a member of the SEC staff described in one speech as a "troubling increase over the past few years in the use of, and nature of adjustments within, non-GAAP measures by companies."

All public companies should consider and address the SEC staff's new guidance, as well as other recent developments regarding the use of non-GAAP measures, as they prepare for their next earnings announcement. To help you work through the implications of the new guidance, we discuss below the new and revised CDIs, and offer our analysis of key takeaways and action items.

Equal or Greater Prominence

For many companies, the most significant changes will result from the more prescriptive approach the staff has taken to the "equal or greater prominence" requirement. As explained below, the guidance unambiguously sets forth the staff's view that GAAP measures must be presented first, and must also be discussed and analyzed narratively. While companies may be unhappy about this new rigid approach, implementation of new CDI 102.10 should ultimately be more straightforward than the application of some of the other changes discussed below.

Question 102.10

Question: Item 10(e)(1)(i)(A) of Regulation S-K requires that when a registrant presents a non-GAAP measure it must present the most directly comparable GAAP measure with equal or greater prominence. This requirement applies to non-GAAP measures presented in documents filed with the Commission and also earnings releases furnished under Item 2.02 of Form 8-K. Are there examples of disclosures that would cause a non-GAAP measure to be more prominent?

Answer: Yes. Although 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, the staff would consider the following examples of disclosure of non-GAAP measures as more prominent:

- Presenting a full income statement of non-GAAP measures or presenting a full non-GAAP income statement 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;
- A non-GAAP measure that precedes 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;
- 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 comparable GAAP measures in the same table;
- 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) 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 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. [May 17, 2016]

Key Takeaways and Action Items

- The equal or greater prominence rule applies to SEC filings and to communications, such as the earnings release, that are furnished to the SEC under Item 2.02 of Form 8-K. It does not apply to communications that are not filed or furnished at all or that are furnished under Item 7.01 of Form 8-K. When drafting earnings-related communications, it is important to know whether and how the communication will be filed or furnished, and extra care must be taken in the event of any last-minute changes to the company’s communications plan.
- While the equal or greater prominence rule does not apply to the typical earnings conference call or supplemental materials a company may make available in connection with its earnings announcement (unless those items are furnished under Item 2.02 of Form 8-K or filed), you should nevertheless ensure that such communications are not misleading. As discussed below, the staff is now reading the “not misleading” prohibition in Regulation G more broadly than in the recent past.
- For communications that are subject to the equal or greater prominence rule, present the GAAP measure before the related non-GAAP measure. The current practice of having subheadings that lead off with a non-GAAP measure and end with the related GAAP measure is simply no longer permissible under the staff’s new guidance.
- Beyond always presenting the GAAP measure first, companies that currently limit their discussion and analysis of results to non-GAAP measures will now need to add a more prominent discussion and analysis of their GAAP measures. Merely presenting the GAAP number once (notwithstanding that it comes first), followed by pages of only non-GAAP numbers, discussion and analysis, is not consistent with the staff’s new guidance and will invite staff comment.
- The prominence requirement affects management quotes just as it affects other parts of the earnings release, so care will need to be taken to draft those quotes in a way that does not give greater prominence to non-GAAP measures (for example, by only talking about “record performance” in the context of the company’s non-GAAP measures without also talking about the

GAAP results—as specifically noted in the new interpretations).

- Companies that provide guidance on only a non-GAAP basis will need to make more prominent and fulsome their explanations of why it would be unreasonably burdensome to provide guidance on a GAAP basis, known adjustment items and the significance of unknown adjustment items.

Practices That May Be Considered Misleading

The most challenging new CDIs to apply are likely to be the four new ones that highlight practices that the SEC staff has indicated it believes may be misleading, and therefore prohibited under Regulation G from any public disclosure.

Question 100.01

Question: Can certain adjustments, although not explicitly prohibited, result in a non-GAAP measure that is misleading?

Answer: Yes. Certain adjustments may violate Rule 100(b) of Regulation G because they cause the presentation of the non-GAAP measure to be misleading. For example, presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business could be misleading. [May 17, 2016]

Question 100.02

Question: Can a non-GAAP measure be misleading if it is presented inconsistently between periods?

Answer: Yes. For example, a non-GAAP measure that adjusts a particular charge or gain in the current period and for which other, similar charges or gains were not also adjusted in prior periods could violate Rule 100(b) of Regulation G unless the change between periods is disclosed and the reasons for it explained. In addition, depending on the significance of the change, it may be necessary to recast prior measures to conform to the current presentation and place the disclosure in the appropriate context. [May 17, 2016]

Question 100.03

Question: Can a non-GAAP measure be misleading if the measure excludes charges, but does not exclude any gains?

Answer: Yes. For example, a non-GAAP measure that is adjusted only for non-recurring charges when there were non-recurring gains that occurred during the same period could violate Rule 100(b) of Regulation G. [May 17, 2016]

Question 100.04

Question: A registrant presents 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. Can this measure be presented in documents filed or furnished with the Commission or provided elsewhere, such as on company websites?

Answer: No. Non-GAAP measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could violate Rule 100(b) of Regulation G. Other measures that use individually tailored recognition and measurement methods for financial statement line items other than revenue may also violate Rule 100(b) of Regulation G. [May 17, 2016]

Key Takeaways and Action Items

- This series of CDIs generally refers to items that “can,” “could” or “may” be misleading. While this leaves some discretion to companies to address potential concerns via fulsome disclosure, it also preserves an opportunity for the SEC staff to second-guess the company.
- Be transparent about any changes made to how you define your non-GAAP measures, or any changes to the methodology used to calculate them. Particular care should be taken with respect to changes that arise in the context of integrating recently acquired companies.
- The reference in CDI 100.01 to “normal, recurring, cash operating expenses” does not affect the common practice of companies excluding stock compensation expense, since that is a non-cash item.
- Carefully evaluate whether there are positive items (like litigation victories, disposition gains, or other non-recurring or unusual gains) comparable in character, significance or magnitude to items that the company adjusts out of its non-GAAP measures and that should likewise be adjusted for. A longtime criticism of non-GAAP measures has been that they are used to highlight “everything but the bad stuff.” When used properly, non-GAAP measures should adjust for items that affect period-to-period comparability, whether favorably or unfavorably.
- CDI 100.04, relating to adjustments to revenue measures, is likely to be the most difficult of all the new CDIs for companies that currently present such adjustments. Companies that provide operational metrics regarding bookings or billings will also want to be careful to avoid any suggestion that these operational metrics are being presented as an alternative measure of revenue.
- Among other things, avoiding being misleading means being very clear about whether numbers discussed are on a GAAP or non-GAAP basis and avoiding ambiguous titles for non-GAAP measures. In the current environment, it may also be prudent to include and discuss GAAP measures in communications that are not subject to the equal or greater prominence requirement to a greater extent than in the past or than is technically required by the rules. In any event, as required by current rules, any public communication containing non-GAAP measures must include the most directly comparable GAAP measures and a reconciliation.

Presenting Liquidity Measures on a Per Share Basis

Three CDIs were revised (as shown below in the redline comparison to the prior versions of these CDIs) to emphasize the staff’s longstanding position that liquidity measures, such as free cash flow, may not be presented on a per share basis.

Question 102.05

Question: While Item 10(e)(1)(ii) of Regulation S-K does not prohibit the use of per share non-GAAP financial measures, the adopting release for Item 10(e), Exchange Act Release No. 47226, states that “per share measures that are prohibited specifically under GAAP or Commission rules continue to be prohibited in materials filed with or furnished to the Commission.” In light of Commission guidance, specifically Accounting Series Release No. 142, Reporting Cash Flow and *Other Related Data*, and Accounting Standards Codification 230, are non-GAAP earnings per share numbers prohibited in documents filed or furnished with the Commission?

Answer: No. Item 10(e) recognizes that certain non-GAAP per share performance measures may be meaningful from an operating standpoint. Non-GAAP per share performance measures should be reconciled to GAAP earnings per share. On the other hand, non-GAAP liquidity measures, ~~such as that measure cash flow, should generated must~~ not be presented on a per share basis in documents filed or furnished with the Commission, consistent with Accounting Series Release No. 142. ~~[Jan. 11, 2010]~~ [Whether per share data is prohibited depends on whether the non-GAAP measure can be used as a](#)

[liquidity measure, even if management presents it solely as a performance measure. When analyzing these questions, the staff will focus on the substance of the non-GAAP measure and not management's characterization of the measure. \[May 17, 2016\]](#)

Question 102.07

Question: Some companies present a measure of "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. Does Item 10(e)(1)(ii) of Regulation S-K prohibit this measure in documents filed with the Commission?

Answer: No. The deduction of capital expenditures from the GAAP financial measure of cash flows from operating activities would not violate the prohibitions in Item 10(e)(1)(ii). However, companies should be aware that this measure does not have a uniform definition and its title does not describe how it is calculated. Accordingly, a clear description of how this measure is calculated, as well as the necessary reconciliation, should accompany the measure where it is used. Companies should also avoid inappropriate or potentially misleading inferences about its usefulness. For example, "free cash flow" should not be used in a manner that inappropriately implies that the measure represents the residual cash flow available for discretionary expenditures, since many companies have mandatory debt service requirements or other non-discretionary expenditures that are not deducted from the measure. ~~[Jan. 11, 2010]~~ [Also, free cash flow is a liquidity measure that must not be presented on a per share basis. See Question 102.05. \[May 17, 2016\]](#)

Question 103.02

Question: If EBIT or EBITDA is presented as a performance measure, to which GAAP financial measure should it be reconciled?

Answer: If a company presents EBIT or EBITDA as a performance measure, such measures should be reconciled 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 make adjustments for items that are not included in operating income. ~~[Jan. 11, 2010]~~ [In addition, these measures must not be presented on a per share basis. See Question 102.05. \[May 17, 2016\]](#)

Key Takeaways and Action Items

- Whether a non-GAAP measure is used as a liquidity or performance measure also has implications under Item 10(e)(1)(ii) of Regulation S-K regarding certain adjustments that are prohibited in SEC filings, so it is important to be clear about how the company views the non-GAAP measures it discloses.
- The staff takes the view, based on language in the original adopting release for the non-GAAP rules to the effect that non-GAAP liquidity measures may not be presented on a per share basis in documents filed with or furnished to the Commission, that per share liquidity measures also cannot be included in an earnings release.
- Presenting per share amounts for measures that are presented as performance measures, but that may also be used as liquidity measures, raises real risks of staff comment as CDI 102.05 makes clear that the staff plans to focus on the substance of the non-GAAP measure, not management's characterization of the measure. Consistent with this, CDI 103.02 indicates that EBIT and EBITDA (which are typically viewed as liquidity measures) may not be presented on a per share basis.

Other CDI Changes

There are four other new or revised CDIs, two of which relate to the measure “funds from operations” as defined by the National Association of Real Estate Investment Trusts and which are not otherwise addressed in this memorandum, one of which adds a cross-reference to one of the new CDIs, and the following new CDI regarding disclosure of the income tax effect of adjustments.

Question 102.11

Question: How should income tax effects related to adjustments to arrive at a non-GAAP measure be calculated and presented?

Answer: A registrant should provide income tax effects on its non-GAAP measures depending on the nature of the measures. If a measure is a liquidity measure that includes income taxes, it might be 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. In addition, adjustments to arrive at a non-GAAP measure should not be presented “net of tax.” Rather, income taxes should be shown as a separate adjustment and clearly explained. [May 17, 2016]

Key Takeaways and Action Items

- As a general matter, you should separately quantify, and provide an explanation for, each adjusted item. For example, you should not lump together a series of unrelated adjustment items as “other.”
- Consistent with this general principle, CDI 102.11 makes clear that items should not be presented net of taxes. Rather, the related tax adjustment should be separately quantified and explained.

General Considerations

In preparing for your next earnings announcement, don’t just focus on the specific changes to the CDIs to the exclusion of the forest—that is, the overall context of speeches, newspaper articles and comment letters in which the new CDIs were issued.

For example, although not addressed in the CDIs, recent staff speeches and comment letters suggest that the SEC is also likely to push for more robust explanations of why a company believes its non-GAAP measures are useful and how it uses those measures.

Another general trend in staff comments has been to question why items discussed on earnings calls are not also included in the company’s filings. To the extent companies respond to the new CDIs by deciding to only discuss some or all of their non-GAAP measures on their calls, they may face staff questions about whether their filings are consistent with their other public disclosures.

The use of non-GAAP measures continues to be permitted under applicable SEC rules, and can provide meaningful information to investors. However, the new CDIs provide a roadmap for the staff to object that the use of non-GAAP measures is inconsistent with the revised guidance, even if the non-GAAP measures have been used in the same way for a long time and even if investors have come to expect them and find them useful. Companies that do not make a meaningful effort to come within the new guidance risk not only staff comment, but, potentially, referrals to the Enforcement Division in egregious cases.

Finally, you will also want to involve your audit committee in the process, as recent speeches have focused on the audit committee’s oversight role with respect to the decision to use non-GAAP measures. Audit committees already review earnings releases and periodic filings, so that review should include specific discussion of the company’s non-GAAP measures in light of the new guidance.

The next quarter end is not far away, so while the timing (and immediate effectiveness) of the staff's new guidance has made it impossible to start planning early, you should start planning now.

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