

# Client Update

## Non-GAAP Metrics in the Crosshairs: SEC Issues New Guidance

### NEW YORK

Matthew E. Kaplan  
mekaplan@debevoise.com

Alan H. Paley  
ahpaley@debevoise.com

Steven J. Slutzky  
sjslutzky@debevoise.com

Anne C. Meyer  
acmeyer@debevoise.com

Earlier this week, the SEC issued twelve new Compliance and Disclosure Interpretations (“C&DIs”) on the use of non-GAAP financial measures, following recent warnings from the SEC against perceived abuses of non-GAAP financial measures. SEC Chair Mary Jo White and senior members of the SEC staff have expressed serious concerns about overly aggressive use of non-GAAP financial measures and the potential for investor confusion. In particular, the SEC has been scrutinizing some of the more aggressive adjustments to GAAP measures and has noted that companies are giving more prominence to non-GAAP results, particularly on websites and other venues, and that companies and the media are focusing on non-GAAP reporting but not on the accompanying disclosure required by the SEC’s existing non-GAAP disclosure rules (Item 10(e) of Regulation S-K and Regulation G).

Registrants should expect renewed focus on the use of non-GAAP financial measures, in filed documents as well as press releases and on websites and other venues, by the staff of the Division of Corporation Finance in comment letters. We recommend that prior to the next quarterly reporting cycle companies revisit their use and presentation of non-GAAP measures, in light of the SEC’s rules and new guidance.

The new guidance touches on several key issues, including:

- misleading non-GAAP financial measures;
- prominence of non-GAAP financial measures;
- non-GAAP revenue recognition;
- use of non-GAAP per share measures;
- presentation of “free cash flow”;
- income tax effects related to adjustments;

- EBITDA reconciliation; and
- presentation of “funds from operations.”

The newly published C&DIs, which are summarized below, are set forth in Annex A to this Client Update. The complete set of C&DIs on non-GAAP financial measures is available on the SEC’s website at [www.sec.gov/divisions/corpfin/guidance](http://www.sec.gov/divisions/corpfin/guidance).

### MISLEADING NON-GAAP MEASURES

Several of the C&DIs address situations in which the SEC cautions that a non-GAAP financial measure may be considered misleading, even if the adjustment isn’t prohibited, including:

- presenting a non-GAAP performance measure that excludes normal, recurring, cash operating expenses necessary to the operation of the business;
- adjusting a particular charge or gain in a non-GAAP measure inconsistently across periods, unless the change between periods is disclosed and adequately explained (which may include recasting prior measures to the current presentation to provide appropriate context); and
- presenting a non-GAAP measure that excludes charges, but does not exclude gains.

In addition, the SEC is concerned that companies may be adjusting non-GAAP financial performance measures to eliminate or smooth items improperly identified as non-recurring, infrequent or unusual. One of the C&DIs clarifies that the prohibition relates to the description of such charges as non-recurring, infrequent or unusual and not to the underlying nature of the charge. The CDI permits an adjustment for charges or gains even if the nature of such 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, so long as the charge or gain is not described as non-recurring, infrequent or unusual and the adjustment otherwise conforms to the SEC’s rules and guidance.

### PROMINENCE OF NON-GAAP FINANCIAL MEASURES

For several years, the SEC has issued comment letters questioning whether companies are giving “undue prominence” to non-GAAP financial measures. The C&DIs include eight examples of disclosure that the SEC would consider to give such undue prominence. These include several practices that are not uncommon in public disclosures, such as:

- omitting comparable GAAP measures from earnings release headlines or captions;
- placing the non-GAAP measure before the most directly comparable GAAP measure;
- adding descriptions such as “record performance” to non-GAAP measures without an equally prominent descriptive characterization of the comparable GAAP measure; 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.

### **NON-GAAP REVENUE RECOGNITION**

Non-GAAP measures that present revenue or other financial statement line items using recognition and measurement methods that are not in accordance with GAAP, such as accelerating revenue recognition, may violate Rule 100(b) of Regulation G. The SEC would not permit companies to present such measures in documents filed or furnished with the SEC or provided elsewhere, such as on a company website.

### **PER-SHARE NON-GAAP MEASURES**

The C&DIs acknowledge that certain non-GAAP per share performance measures may be meaningful from an operating standpoint and can therefore be presented and reconciled to GAAP earnings per share. However, non-GAAP liquidity measures that measure cash generated may not be presented on a per share basis in documents furnished or filed with the SEC. The C&DIs clarify that the SEC focuses on whether the non-GAAP measure can be used as a liquidity measure, regardless of whether management presents or characterizes it as a performance measure.

### **FREE CASH FLOW**

The C&DIs caution that there is no uniform definition of “free cash flow” and that companies that present a non-GAAP free cash flow measure should include a clear and accurate description of how the company calculates the measure, as well as the necessary reconciliation. Because free cash flow is a liquidity measure, it must not be presented on a per share basis.

### **INCOME TAX EFFECTS RELATING TO ADJUSTMENTS**

The C&DIs clarify that adjustments to reflect income tax effects on a non-GAAP measure may be treated differently depending upon whether the measure is a liquidity or a performance measure and provide examples of appropriate adjustments. In addition, companies should show and explain adjustments for income taxes separately rather than simply labeling the presentation “net of tax.”

### **EBIT AND EBITDA**

The C&DIs clarify that when a company presents EBIT or EBITDA as a performance measure, it should be reconciled to GAAP net income rather than operating income and may not be presented on a per share basis.

### **PRESENTATION OF FUNDS FROM OPERATIONS**

Two C&DIs address the presentation by REITs of funds from operations (“FFO”). The SEC clarifies that they accept the definition of FFO adopted by the National Association of Real Estate Investment Trusts, that they will not object to its presentation as a performance measure and that issuers may make adjustments to FFO if those adjustments comply with Item 10(e) of S-K and Rule 100(b) of Regulation G.

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Please do not hesitate to contact us with any questions.

**SEC COMPLIANCE AND DISCLOSURE INTERPRETATIONS: NON-GAAP FINANCIAL MEASURES  
NEW C&Ds ISSUED MAY 17, 2016**

**Section 100. General**

**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]

**Section 102. Item 10(e) of Regulation S-K**

**Question 102.01**

**Question:** What measure was contemplated by "funds from operations" in footnote 50 to Exchange Act Release No. 47226, Conditions for Use of Non-GAAP Financial Measures, which indicates that

companies may use "funds from operations per share" in earnings releases and materials that are filed or furnished to the Commission, subject to the requirements of Regulation G and Item 10(e) of Regulation S-K?

**Answer:** The reference to "funds from operations" in footnote 50, or "FFO," refers to the measure defined as of January 1, 2000, by the National Association of Real Estate Investment Trusts (NAREIT). NAREIT has revised and clarified the definition since 2000. The staff accepts NAREIT's definition of FFO in effect as of May 17, 2016 as a performance measure and does not object to its presentation on a per share basis. [May 17, 2016]

#### **Question 102.02**

**Question:** May a registrant present FFO on a basis other than as defined by NAREIT as of May 17, 2016?

**Answer:** Yes, provided that any adjustments made to FFO comply with Item 10(e) of Regulation S-K and the measure does not violate Rule 100(b) of Regulation G. Any adjustments made to FFO must comply with the requirements of Item 10(e) of Regulation S-K for a performance measure or a liquidity measure, depending on the nature of the adjustments, some of which may trigger the prohibition on presenting this measure on a per share basis. See Section 100 and Question 102.05. [May 17, 2016]

#### **Question 102.03**

**Question:** Item 10(e) of Regulation S-K prohibits adjusting a non-GAAP financial 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. Is this prohibition based on the description of the charge or gain, or is it based on the nature of the charge or gain?

**Answer:** The prohibition is based on the description of the charge or gain that is being adjusted. It would not be appropriate to state that a charge or gain is non-recurring, infrequent or unusual unless it meets the specified criteria. The fact that a registrant cannot describe a charge or gain as non-recurring, infrequent or unusual, however, does not mean that the registrant cannot adjust for that charge or gain. Registrants can make adjustments they believe are appropriate, subject to Regulation G and the other requirements of Item 10(e) of Regulation S-K. See Question 100.01. [May 17, 2016]

#### **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 that measure cash 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. 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. 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 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]

### **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]

### **Section 103. EBIT and EBITDA**

#### **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. In addition, these measures must not be presented on a per share basis. See Question 102.05. [May 17, 2016]