Disclosure of Non-GAAP Measures – An SEC Focus

By Patricia Gorham, Lisa Morgan and Dwuane Dupree

Companies sometimes use numerical measures of financial position and performance that are not prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP). Those non-GAAP measures may be disclosed as part of the management discussion and analysis presentation in annual reports, in public statements like press releases and investor calls, or otherwise. Non-GAAP measures may be useful as a supplement to GAAP financial reporting, and may convey information relevant to historical performance or performance within an industry. GAAP financial reporting, however, is designed to provide a consistent reporting template by which financial performance can be measured. Thus, using non-GAAP measures, if not handled carefully, may interfere with the purpose of consistent GAAP reporting.

The disclosure of non-GAAP measures by public companies has been an area of increasing focus for the Securities and Exchange Commission (SEC). In speeches
by commission staff, the statements of Chair Mary Jo White, and the May 17, 2016 release of updated Compliance and Disclosure Interpretations by the Division of Corporation Finance, the SEC has continued to highlight concerns about potential confusion created by using non-GAAP measures. Likewise, the SEC’s Division of Enforcement is carefully scrutinizing whether using non-GAAP measures is potentially misleading to the investing public.

While acknowledging that SEC rules require a company to include a discussion of its GAAP financial statements in its reports, Chair White emphasized that non-GAAP measures may supplant or confuse the required GAAP presentation when, for example:

- GAAP measures are not given equal or greater prominence
- Normal, recurring cash operating expenses are excluded from the metrics
- The company presents individually tailored non-GAAP revenues
- There is a lack of consistency in presentation
- The company cherry-picks the measures presented
- Cash per share data is used

Chair White also emphasized the important role of audit committees in evaluating the presentation of non-GAAP measures.

The SEC’s rules addressing the use of what is referred to in the Sarbanes-Oxley Act as “pro forma” financial information encompass the use of such financial measures both outside (Regulation G) and inside (Item 10(e) of Regulation S-K) a company’s disclosure documents, including SEC filings and press releases. The interpretive guidance, updated in May of this year, provides additional detail about SEC positions on the use of these kinds of measures.

Regulation G prohibits fraud in SEC filers’ public disclosures—companies may not use a non-GAAP financial measure that includes a false statement of material fact or omits a statement of fact needed to render the use of the measure not misleading. It also requires that the disclosure include the presentation of the most directly comparable GAAP financial measure and a reconciliation between the two measures.

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Regulation S-K imposes a more restrictive regulatory scheme on the use of non-GAAP measures in SEC filings. Among its directives, the regulation requires that not only must the most directly comparable GAAP measure be identified, but also that it be given equal or greater prominence than the non-GAAP measure. A company must include a statement detailing why management believes the non-GAAP measure is useful and identifying any additional purposes for which management uses the measure.

The Division of Corporation Finance’s May guidance builds on this regulatory structure by explaining the ways in which non-GAAP financial measures might be misleading. Companies using non-GAAP financial measures can view the SEC’s guidance through the lens of the overarching principles of transparency and consistency. For example, non-GAAP financial measures that reflect non-recurring charges without disclosing recurring charges; inconsistent treatment of a charge between periods; a measure that is adjusted for non-recurring charges, but not for non-recurring gains during the same period; or a measure that accelerates revenue as though earned when billed rather than recognizing it in accordance with GAAP could be viewed as misleading. Some variations of EBIT and EBITDA may be impermissible, and others may be allowable if appropriately titled to reflect that they vary from the standard calculation. Filers are instructed not to adjust a non-GAAP financial measure to eliminate or smooth items identified as non-recurring, infrequent or

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unusual when the charge or gain is likely to recur within two years. The newly released interpretations continue to reflect the SEC’s position that liquidity measures should not be presented on a per share basis in filings.

In addition to providing guidance on what kinds of measures and metrics may not be used, the SEC has increased its focus on transparency in disclosures regarding non-GAAP measures. Much of the SEC’s focus is on avoiding confusion between GAAP financial statements and non-GAAP financial measures. Labeling non-GAAP financial measures as well as fully disclosing how the non-GAAP measures are calculated and identifying their components will help avoid confusion about the meaning of the non-GAAP measures. The SEC has continued to focus on Regulation S-K’s requirement that comparable GAAP financial measures be presented with equal or greater prominence. The staff’s view is that the GAAP measures should be presented first and must also include discussion and analysis of both the GAAP and the comparable non-GAAP measures.

As the SEC continues to increase its scrutiny of non-GAAP financial measures, companies should evaluate each non-GAAP financial measure used to determine what useful information the measure provides, whether there are appropriate disclosures regarding the method of calculation, and whether investors are informed about the measure’s nature and importance. Companies also will want to review their presentations of non-GAAP financial measures, including placement of comparable GAAP financial measures and reconciliation of the financial measures.

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