

SEC's Division of Corporation Finance Releases New Guidance Related to Non-GAAP Financial Measures

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On May 17, 2016, the Division of Corporation Finance of the Securities and Exchange Commission (SEC) issued 12 new or revised Compliance and Disclosure Interpretations (C&DIs) to its existing body of interpretations relating to the use of non-GAAP financial information. Companies often supplement their financial reporting under U.S. generally accepted accounting principles (GAAP) with non-GAAP financial measures that management believes more appropriately reflect the performance of their business. The SEC permits companies to present non-GAAP financial measures under certain circumstances, provided that such disclosures comply with Regulation G in all cases and Item 10(e) of Regulation S-K when such information is included or incorporated into a document that is filed with the SEC. In recent years, the SEC has voiced concerns over how companies have been presenting non-GAAP financial measures in their disclosures, such as apparent “cherry-picking” of adjustments within a non-GAAP measure and the use of adjustments to remove normal, cash operating expenses, or providing per-share data for non-GAAP performance measures that look like liquidity measures. While reaffirming the notion that non-GAAP financial measures can provide useful information to investors, with its most recent guidance the SEC has clearly signalled that non-GAAP financial information cannot be presented more prominently than GAAP information or in a way that makes the relevant disclosure misleading. The guidance generally applies to foreign private issuers (FPIs). Certain specific implications for FPIs are discussed herein.

The C&DIs have immediate effect and may impact the quarterly earnings releases of some companies significantly. In advance of their next earnings release, companies should evaluate their use and presentation of non-GAAP financial measures in light of the new guidance, including disclosures about the reasons why management believes that presentation of the non-GAAP financial measures provides useful information to investors.

Instances When Non-GAAP Measures May Be Misleading

A number of the new and revised C&DIs explore instances when non-GAAP measures might be considered misleading in violation of Rule 100(b) of Regulation G, which applies to a registrant's public disclosures, making clear that:

- Certain adjustments, although not explicitly prohibited, could result in a non-GAAP measure that is misleading, such as presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business. (Question 100.01)
- A non-GAAP measure might be misleading if it is presented inconsistently between periods, such as a non-GAAP measure that adjusts a particular charge or gain in the current period but for which other, similar charges or gains were not adjusted in prior periods. Further, 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. (Question 100.02)
- A non-GAAP measure might be misleading if it excludes charges, but does not exclude any gains, such as a non-GAAP measure that is adjusted only for non-recurring charges when there were non-recurring gains that occurred during the same period. (Question 100.03)
- Non-GAAP measures that accelerate revenue (as if the issuer earned the revenue when customers are billed) are prohibited in all circumstances. The new guidance makes clear that non-GAAP revenue measures that substitute individually tailored recognition and measurement methods for those of GAAP are considered misleading under Rule 100(b). They are thus prohibited not only in documents filed with or furnished to the SEC, but also elsewhere, such as on company websites. Non-GAAP measures that substitute individually tailored recognition and measurement methods for other financial statement line items may also violate Rule 100(b). (Question 100.04)

Per-Share Measures

The SEC also revised its prior guidance concerning the ability of public companies to disclose non-GAAP financial measures on a per-share basis:

- Only non-GAAP performance measures, not liquidity measures, should be presented on a per-share basis. The guidance states that the staff will analyze whether a particular non-GAAP measure is effectively a liquidity measure or a performance measure, rather than simply defer to management's characterization. (Question 102.05)
- The use of the non-GAAP measure "free cash flow" is not prohibited under Item 10(e), but this is a liquidity measure that cannot be presented on a per-share basis. Companies using this measure should include a clear description of how it is calculated, along with the necessary reconciliation, and are cautioned to avoid potentially misleading inferences about its usefulness. (Question 102.07)
- Neither EBIT nor EBITDA may be presented on a per-share basis. (Question 103.02)
- Real estate investment trusts may continue to present "funds from operations" (FFO), as defined by the National Association of Real Estate Investment Trusts (NAREIT), as a performance measure on a per-share basis. (Question 102.01)
- Companies presenting FFO on a basis other than as defined by NAREIT are cautioned that any adjustments made to FFO must comply with the requirements of Item 10(e) for either a performance measure or a liquidity measure, as applicable, some of which may trigger the prohibition on presenting this measure on a per-share basis. (Question 102.02)

Equal Prominence

Item 10(e) requires that when non-GAAP measures are used, the comparable GAAP measure must be displayed with equal or greater prominence. While relative prominence depends on the facts and circumstances in which the disclosure is made, the SEC offered the following examples of disclosure where non-GAAP measures would be considered 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. (Question 102.10)

Adjustments for Non-recurring, Infrequent or Unusual Items

Item 10(e) prohibits adjusting a non-GAAP financial performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual if 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. The new guidance makes clear that the prohibition applies to the *description* of the item as non-recurring, infrequent or unusual. A registrant can still adjust for that item if it believes an adjustment is appropriate, subject to Regulation G and the other requirements of Item 10(e). (Question 102.03)

Non-GAAP Financial Information Calculated Net of Taxes

The SEC’s updated guidance also indicates that any adjustments as a result of taxes should be shown and explained as a separate adjustment in calculating a non-GAAP financial measure, rather than using adjustments which themselves are net of the relevant effect of taxes. (Question 102.11)

Considerations for Foreign Private Issuers

The new SEC guidelines generally apply to FPIs, including those that report their results of operations using International Financial Reporting Standards (IFRS) or local GAAP. In addition, where not explicitly required, FPIs would generally be advised to follow the guidelines as a matter of best practice.

Subject to limited exemptions as discussed in this Alert, FPIs are subject to Regulation G with respect to any public announcements of material information that contain non-GAAP financial measures. FPIs are subject to the requirements of Item 10(e) of Regulation S-K with respect to any filings under the Securities Act of 1933 (the “Securities Act”), such as registration statements on Form F-1 or F-3, and the Securities Exchange Act of 1934, such as annual reports on Form 20-F (although filings by Canadian issuers on Form 40-F under the Multi-Jurisdictional Disclosure System are not subject to Item 10(e) of Regulation S-K). The Item 10(e) requirements, including the “equal prominence” guidance in Question 102.10, *do not* apply to an earnings release of an FPI furnished to the SEC on Form 6-K, *unless* the Form 6-K, or any specifically designated portion thereof, is incorporated by reference into a Securities Act registration statement or an annual report on Form 20-F.

In addition, Item 10(e) permits FPIs to use a non-GAAP financial measure that it is otherwise prohibited under Item 10(e) if: (1) the non-GAAP financial measure relates to the GAAP used in the FPI’s primary financial

statements included in its filing with the SEC; (2) the non-GAAP financial measure is required or expressly permitted by the standard-setter that is responsible for establishing the GAAP used in such financial statements; and (3) the non-GAAP financial measure is included in the annual report prepared by the FPI for use in the home jurisdiction or for distribution to its security holders.

Regulation G does not apply to a disclosure of a non-GAAP financial measure that is made by or on behalf of a FPI if the following conditions are satisfied: (1) the securities of the FPI are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States; (2) the non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with U.S. GAAP; and (3) the disclosure is made by or on behalf of the FPI outside the United States, or is included in a written communication that is released by or on behalf of the FPI outside the United States. The exemption applies notwithstanding the existence of one or more of the following: (1) a written communication is released in the United States as well as outside the United States, so long as the communication is released in the United States contemporaneously with or after the release outside the United States and is not otherwise targeted at persons located in the United States; (2) foreign journalists, U.S. journalists or other third parties have access to the information; (3) the information appears on one or more websites maintained by the FPI, so long as the websites, taken together, are not available exclusively to, or targeted at, persons located in the United States; or (4) following the disclosure or release of the information outside the United States, the information is included in a submission by the FPI to the SEC made under cover of a Form 6-K.

Although FPIs are afforded certain exemptions from this regime, in the absence of blanket exemption, FPIs should carefully consider their use of non-GAAP measures to ensure they are compliant with the rules and that their financial presentations are consistent with current best practices.

Current State of Non-GAAP Reporting Regulations and Tips for Compliance

Recent SEC staff remarks and the newly-issued guidance make clear that the SEC continues to pay close attention to companies' use of non-GAAP measures. In addition to assuring technical compliance with SEC rules and guidance, management and audit committees should take this opportunity to re-examine their companies' use of non-GAAP financial measures in SEC filings and other public disclosures. Particular areas of focus include:

- *Inconsistencies between public disclosures and filed documents.* The SEC staff has indicated that when reviewing a company's periodic reports it will also review its earnings calls, press releases and other information it makes publicly available, in order to identify any inconsistencies, and will issue comments on a company's filed documents to bring the two types of information in line with each other and ensure that the company provides consistent public disclosure.
- *Ensuring Non-GAAP measurements are appropriate and not misleading.* Non-GAAP measurements should be used to supplement, not supplant, information in the financial statements. Registrants should take care to ensure that such non-GAAP measures would not be considered misleading. Preparers should carefully consider whether significant adjustments to profitability outside of customary measures such as EBITDA or non-recurring items, are appropriate and properly presented.
- *Management oversight of the use of non-GAAP measures.* In a recent speech, SEC Chief Accountant James Schnurr indicated that a company's management and audit committee should increase their focus on the use of non-GAAP measures beyond merely determining that they comply with SEC rules and consider *why* the proposed non-GAAP measure is an appropriate way to measure the company's performance and is useful to investors. Companies should consider the application of disclosure controls and procedures to non-GAAP measures.
- *Appropriate use of, and clear explanations regarding, non-GAAP measures.* Recently, the staff has issued a number of comments objecting to the use of, or disclosures regarding, non-GAAP measures, in particular, companies' disclosures as to why their non-GAAP measures are useful. Companies should pay particular attention to providing thorough, thoughtful explanations for the use of non-GAAP measures.

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