SEC to Focus on Non-GAAP Financial Measures in 2016

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On March 16, 2016, Securities and Exchange Commission Chair Mary Jo White cautioned an audience of industry professionals at the U.S. Chamber of Commerce that the SEC continues to focus on companies' use of financial measures based on customized methodologies rather than in accordance with generally accepted accounting principles (GAAP). Although the SEC has relied on comment letters and, less frequently, enforcement actions to control aggressive adjustments in non-GAAP measures, White's comments suggest that the SEC also may consider rulemaking on the topic to address specific areas of concern. While non-GAAP measures give companies the flexibility to present the results that best reflect their performance, their increasing popularity has prompted the SEC to ensure their use is not misleading and does not undermine disclosure effectiveness and investors' ability to assess financial results.

Non-GAAP measures adjust a company's historical or future performance, financial position or cash flows by excluding or including amounts from the most directly comparable GAAP measure. For instance, companies often present earnings before interest, taxes, depreciation and amortization (EBITDA) as an alternative to net income, EBITDA's most directly comparable GAAP measure. The SEC permits companies to present non-GAAP measures in public disclosures, registration statements and periodic reports, subject to compliance with Regulation G and Item 10(e) of Regulation S-K.[1] While non-GAAP measures may provide useful information about a company's business that reflects management's assessment of a company's performance — such as the ability to meet debt service, capital expenditure and working capital requirements or comply with covenants in debt agreements — the SEC has expressed concern that their use may be confusing to investors.

Although the number of SEC comment letters issued in connection with Form 10-K and Form 10-Q reviews continues to decline, the proportion of letters that address non-GAAP measures has increased. According to Deloitte, during the 12 months ended July 31, 2015, 14 percent of all comment letters included a comment with respect to a non-GAAP measure — a 1 percent increase from the prior period. Use of non-GAAP measures is now the fourth most common topic for SEC comments, after management's discussion and analysis, fair value measurement and estimates, and revenue recognition.

At a conference of the American Institute of Certified Public Accountants on December 9, 2015, White identified four questions for companies to consider when using non-GAAP measures:

- Why are you using the non-GAAP measure, and how does it provide investors with useful information?
- Are you giving non-GAAP measures no greater prominence than the GAAP measures, as required under the rules?
- Are your explanations of how you are using the non-GAAP measures — and why they are useful for your investors — accurate and complete, drafted without boilerplate?
- Are there appropriate controls over the calculation of non-GAAP measures?

Accordingly, we expect to see further scrutiny of non-GAAP measures this year. In particular, companies should consider the following areas of SEC focus with respect to their disclosure of non-GAAP measures, in addition to the disclosure guidelines of Item 10(e) and Regulation G and the SEC's related guidance:

[1] *See* "The Use of Non-GAAP Financial Measures — A Disclosure Guide" (Skadden's *Corporate Finance Alert*, May 2013).

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- **Clear Justifications for Using Non-GAAP Measures.** Item 10(e) requires that companies provide a statement disclosing the reasons why management believes that presentation of non-GAAP results provides useful information to investors regarding their financial condition and results of operations. Although companies routinely provide these justifications, the SEC has urged companies to avoid using boilerplate in such statements, such as generic language that non-GAAP measures give investors additional data to evaluate their operations. Vague references to management's belief that non-GAAP measures are useful in understanding a company's performance may draw SEC comments. Moreover, where multiple non-GAAP measures appear together, a company should separately disclose for each the reasons that measure is useful to investors.
- **Clear Labeling of Non-GAAP Measures.** To avoid comment letters, companies should appropriately name any non-GAAP measures presented — whether "as adjusted" or "attributable to" an item or simply "non-GAAP." Item 10(e) prohibits companies from using titles or descriptions of non-GAAP measures that are the same as, or confusingly similar to, those used for GAAP. This issue often arises when a company presents net income or some other measure for comparison with a prior period in a narrative and states that "certain items" are excluded, or that such measure is "pro forma" when it is not a true Regulation S-X pro forma calculation.
- **Careful Use of Infrequent or Nonrecurring Adjustments.** Another area of focus in comment letters has been on the elimination of infrequent, nonrecurring or noncore business adjustments. Item 10(e) prohibits adjusting a non-GAAP result to eliminate or smooth a nonrecurring, infrequent or unusual item where such item is reasonably likely to recur within two years or where there has been a similar charge or gain within the prior two years. Companies that identify adjustments as nonrecurring should be prepared to provide additional detail regarding how they meet the definition in Item 10(e) or remove the reference to "nonrecurring" altogether.
- **Coordination Between Management, the Audit Committee and Other Teams.** White's recent comments highlight the need for coordination between management and investor relations teams on the one hand, and audit committees and legal and finance teams on the other. Companies should ensure that the audit committee gatekeeping function extends to the use of non-GAAP measures and compliance with the applicable rules and regulations. In particular, companies should confirm that any reconciliations of non-GAAP measures that appear in investor presentations or other public disclosures are consistent with those in registration statements and periodic reports, per the reconciliation rules in Regulation G and Item 10(e). Future changes to auditors' reporting models may provide companies additional support for non-GAAP measures. The Public Company Accounting Oversight Board is currently considering the issue of whether to offer auditor assurance of a company's compliance with the SEC's rules and regulations for use of non-GAAP measures to improve consistency and comparability of financial statements and promote investor confidence.

Given the SEC's renewed focus on the topic since it last issued guidance in 2013, companies should re-examine their use of non-GAAP measures to ensure compliance with not only the technical requirements of Item 10(e) and Regulation G but also the spirit of those rules and regulations. Presentation of non-GAAP measures can be valuable to investors and analysts, and companies should be mindful of the need to present the measures in such a way that an investor can sufficiently understand the differences between a company's GAAP and non-GAAP results.