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Corporate Finance Alert

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How Companies Should Respond to New Non-GAAP Financial Disclosure Guidance

On May 17, 2016, the staff of the Division of Corporation Finance (Staff) of the U.S. Securities and Exchange Commission (SEC) released new and revised Compliance and Disclosure Interpretations (CDIs) regarding the use of non-GAAP financial measures. The issuance of these CDIs followed a number of public statements by SEC Chair Mary Jo White, SEC Chief Accountant James Schnurr and other SEC staff members about the renewed focus on the use of non-GAAP financial measures.[1] We expect the Staff to closely scrutinize company SEC filings for compliance with the new guidance.

Although some of the new guidance is consistent with existing practice, we expect a number of the matters addressed by the Staff in the CDIs to result in companies revising their non-GAAP presentations. Prior to releasing earnings information and filing quarterly and annual periodic reports on Form 10-Q and Form 10-K, respectively, we recommend companies consider and address the following points.

Review all non-GAAP adjustments to ensure they will not be viewed as misleading and revise or eliminate adjustments, as necessary. Rule 100(b) of Regulation G prohibits the use of non-GAAP financial measures that are misleading when viewed in context of the information and/or discussion accompanying such measures. The new guidance provides that some presentations and adjustments, although not specifically prohibited, may cause a non-GAAP financial measure to be deemed by the Staff as misleading, including adjustments that:

- exclude normal, recurring, cash operating expenses necessary to operate the business;
- are presented inconsistently between periods;
- accelerate revenue recognition;
- include nonrecurring charges, but not nonrecurring gains; and
- do not show current and deferred income tax expense commensurate with the non-GAAP measure of profitability and the income tax effects of the adjustments as a separate item (*i.e.*, adjustments cannot be shown as "net of tax").

[1] Copies of some of those statements are available here, here and here.

Confirm that each non-GAAP financial measure is presented with the comparable GAAP financial measure and that the GAAP financial measure is presented with equal or greater prominence. Item 10(e) of Regulation S-K mandates that whenever a non-GAAP financial measure is presented in an SEC filing,[2] the most directly comparable financial measure or measures calculated and presented in accordance with GAAP be presented with equal or greater prominence. The equal or greater prominence requirement was one of the key areas of focus in the updated CDIs. The new guidance provides several examples where the Staff would likely find the disclosure of a non-GAAP financial measure impermissibly more prominent than the most directly comparable GAAP measure, including:

- presenting a non-GAAP measure before the most directly comparable GAAP measure (including in an earnings release headline or caption) or omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures;
- emphasizing a non-GAAP measure by using bold or larger font than used for the comparable GAAP measure;
- presenting a full income statement of non-GAAP financial measures or presenting a full non-GAAP income statement when providing a GAAP reconciliation;
- describing a non-GAAP financial measure without at least an equally prominent descriptive characterization of the comparable GAAP financial measure;
- providing tabular disclosure of non-GAAP financial measures without preceding it with, or including in the table, 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 greater or equal prominence.

Revise disclosures regarding inability to present a quantitative reconciliation of a forward-looking non-GAAP measure to include certain required disclosures and confirm that the required disclosures are included in a location of greater or equal prominence. Both Regulation G and Item 10(e) require companies to provide quantitative reconciliations of forward-looking non-GAAP measures to the comparable GAAP measure, to the extent available without unreasonable efforts. The guidance does not change this requirement. Companies that conclude that the reconciliation of the forward-looking non-GAAP measure cannot be provided without unreasonable effort, therefore, do not need to provide the reconciliation. But the CDIs state that the presentation of forward-looking non-GAAP measures that omit quantitative reconciliation may be considered to have greater prominence if the presentation does not also disclose:

- that the forward-looking reconciliation information is not available; and
- the probable significance of the missing information.

The CDIs also require that these additional disclosures be included "in a location of greater or equal prominence."

Do not disclose non-GAAP per share liquidity measures. Neither Regulation G nor Item 10(e) prohibits the presentation of non-GAAP financial measures on a per share basis so long as they are measures of performance (provided that they are reconciled to GAAP earnings per share). However, the presentation of non-GAAP financial measures on a per share basis as a measure of liquidity is prohibited. For instance, the Staff cited free cash flow as a liquidity measure that must not be presented on a per share basis. The new guidance indicates that the Staff will focus on whether the non-GAAP measure actually can be used as a liquidity measure to determine whether the per share data is prohibited, even if the company characterizes it as a performance measure.

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We will continue to monitor developments related to the use of non-GAAP disclosure measures and provide relevant updates. We are available to discuss any specific questions regarding the new guidance or our recommendations on how to respond.

The CDIs are here. We also prepared a marked copy of the revised CDIs to show the changes the Staff announced on May 17, 2016. The marked copy of the CDIs is available here. For additional information regarding the requirements for use of non-GAAP financial measures, please see our updated disclosure guide available here.

[2] It is important to note that the equal or greater prominence requirement in Item 10(e) only applies to filings made with the SEC, as well as earnings releases furnished to the SEC pursuant to Item 2.02 of Form 8-K. It does not to apply to public disclosures that are not also filed with the SEC, such as presentations that accompany the release of earnings information or transcripts of earnings calls that are posted on company websites. In addition, while Regulation G applies to all public disclosures of non-GAAP measures, it does not include a similar equal or greater prominence requirement.

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