Capital Markets Alert

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SEC Staff Continues to Focus on Non-GAAP Financial Disclosures

The SEC staff has recently increased its scrutiny of the disclosure of non-GAAP financial measures, including disclosure reviews by the Division of Corporation Finance staff and investigations by the Division of Enforcement staff. We have identified a number of trends we believe companies should consider as they prepare their public disclosures. In addition, prior to releasing earnings information and filing quarterly and annual reports, companies should consider and address the Corporation Finance staff guidance issued in May.

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In recent months, companies have experienced greater scrutiny of their use of non-GAAP financial measures by the staff of the U.S. Securities and Exchange Commission (SEC). This greater scrutiny follows the release earlier this year by the staff of the SEC's Division of Corporation Finance (CF Staff) of new and revised Compliance and Disclosure Interpretations (CDIs) regarding the use of non-GAAP financial disclosures.[1] The SEC staff's focus has included disclosure reviews by the CF Staff of, and investigations by the staff of the SEC's Division of Enforcement (Enforcement Staff) into, non-GAAP financial disclosures made by certain companies.

CF Staff Focus

A number of companies have received written comments on their use of non-GAAP financial measures from the CF Staff. These comments generally have been issued in connection with the CF Staff's normal review of periodic and transactional filings, although some of the comments have been issued in connection with the review of recent earnings releases furnished on Forms 8-K. While the CF Staff's review of non-GAAP disclosures continues, and it may be some time before we understand fully the impact of this new focus, we have identified the following trends in the comments received to date.

- **Equal or greater prominence.** Regulation S-K Item 10(e), which applies to SEC filings and furnished earnings releases, requires that the most comparable GAAP measure be presented with equal or greater prominence relative to each non-GAAP measure a company chooses to present. New CDI 102.10 identifies a number of presentation formats that the CF Staff believes would violate the equal or greater prominence requirement. The CF Staff continues to issue comments asking companies to comply with this requirement, particularly in light of this new CDI. For example, the CF Staff has issued variations of the following sample comment:

  > We note that you present certain non-GAAP measures on the first page of your earnings release without also presenting the comparable GAAP measures with equal or greater prominence, as required by Item 10(e)(1)(i)(A) of Regulation S-K, which is inconsistent with the updated Compliance and Disclosure Interpretations issued on May 17, 2016. Please review the updated guidance when preparing future earnings releases.

[1] For additional information about the CF Staff's new guidance, see our alert on "How Companies Should Respond to New Non-GAAP Financial Disclosure Guidelines," available here.

- **Liquidity measures on a per-share basis.** The CF Staff has been questioning whether certain non-GAAP measures characterized as performance measures actually are liquidity measures and therefore, with limited exception, are not allowed to be presented on a per-share basis. Consistent with the updated guidance, such comments have focused on the substance of the relevant non-GAAP measure, rather than management's characterization of the measure. These comments tend to cite the nature, magnitude and number of adjustments made to the most comparable GAAP performance measures (*e.g.*, net income).

  According to public comments by the CF Staff, there is a heightened risk of receiving a comment about presenting a liquidity measure on a per-share basis if the adjustments reflected in the measure mirror the adjustments it would take to reconcile net income to operating cash flow. For example, the CF Staff has issued variations of the following sample comment:

  > We note you use Adjusted EBITDA to evaluate not only your operating performance, but also your ability to generate cash flows and repay debt obligations. It appears that you use this measure as both a non-GAAP operating performance measure and a non-GAAP liquidity measure. Please note that non-GAAP liquidity measures that measure cash generated must not be presented on a per share basis. Please remove this per share measure or explain to us why you believe your presentation of Adjusted EBITDA per share is consistent with Item 10(e) of Regulation S-K. Refer to Question 102.05 of the updated Compliance and Disclosure Interpretation issued on May 17, 2016.

- **Normal, recurring, cash operating expenses.** New CDI 100.01 issued as part of the updated guidance states that presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business could be misleading. Some companies exclude certain cash expenses from their non-GAAP performance measures based in part on the view that such expenses are not necessary to the operation of their business and are not otherwise normal or recurring. Recent CF Staff comments, however, have taken issue with the exclusion of certain expenses related to acquisitions, litigation, restructurings and other activities that occur so frequently that they appear to represent normal cash operating expenses. Companies that have engaged in such activities period after period for a number of years may be asked to cease making those adjustments or provide the CF Staff with support for why such expenses are not generally attendant to the normal course of business in light of the way the company has been operated. For example, the CF Staff has issued variations of the following sample comment:

  > We note that several line items in your reconciliation of EBITDA to Adjusted EBITDA adjust for recurring cash operating expenses, such as consulting and professional fees, costs associated with new store openings, relocation and employee recruiting costs, and management fees and expenses. Please tell us how your disclosure complies with Question 100.01 of the May 17, 2016 updated CDIs on Non-GAAP Financial Measures.

- **Tax effects of non-GAAP adjustments.** New CDI 102.11 indicates that companies should disclose the income tax effects on its non-GAAP measures depending on the nature of the particular measures. For instance, companies that disclose non-GAAP performance measures, such as net income and earnings per share, should reflect current and deferred income tax expense commensurate with those measures. Companies that disclose non-GAAP liquidity measures that include income taxes are asked to consider adjusting GAAP taxes to show taxes paid in cash.

  The new CDI also states that adjustments to arrive at a non-GAAP measure should not be presented "net of tax," as some companies have done in the past. Instead, companies are required to present the income tax effects of such adjustments as a separate adjustment and to clearly explain how those income tax effects are calculated. A number of companies already have received comments on these points following the new guidance. For example, the CF Staff has issued variations of the following sample comment:

  > Your presentation of diluted earnings per share attributable to shareholders, excluding certain items appears to be presented net of tax, which may be inconsistent with Question 102.11 of the updated Compliance and Disclosure Interpretations on Non-GAAP Financial Measures issued on May 17, 2016. Please review this guidance when preparing your next filing.

- **Usefulness disclosures.** Item 10(e) requires companies to state in their SEC filings and furnished earnings releases the reasons that management believes each non-GAAP measure provides useful information to investors regarding the company's financial condition and results of operations and, to the extent material, the additional reasons, if any, for which management uses such non-GAAP measure. Recent CF Staff comments have asked companies to provide a more substantive and concise usefulness discussion. Such requests appear to be seeking disclosure that is tailored more closely to the use of each non-GAAP measure in light of the company's business. For example, the CF Staff has issued variations of the following sample comment:

  > You state that management believes your non-GAAP measures provide investors with useful supplemental information regarding the performance of the Company´s ongoing operations. This statement does not appear to provide adequately detailed information specific to your circumstances as to why your non-GAAP measures are useful to investors. Please refer to Item 10(e)(1)(i)(C) of Regulation S-K and revise your disclosures accordingly.

- **Identification of non-GAAP measures.** The CF Staff also has asked companies to clearly label their non-GAAP measures as non-GAAP and in some cases to distinguish their title from similar GAAP measures. To address this comment, it appears that it is sufficient for companies to undertake to identify measures as non-GAAP the first time they appear, or by way of a footnote or similar notation, in future disclosures. For example, the CF Staff has issued variations of the following sample comment:

  > We note your disclosure of net income before income taxes at the bottom of page X. In future filings please identify this measure as a non-GAAP measure and provide disclosures required by item 10(e) of Regulation S-K. Also, please revise the title of this measure to be different from the GAAP measure. Within your response, please provide us an example of your proposed disclosure.

Enforcement Staff Inquiries

It is our understanding that, beginning in August 2016, a number of companies received inquiries from the Enforcement Staff regarding their disclosures of non-GAAP financial measures. These inquiries, captioned "Certain Non-GAAP Financial Measure Disclosures Deficiencies," have stated that there is an indication that the company's historical disclosure of non-GAAP financial measures may have violated Regulation G and/or Regulation S-K Item 10(e). The Enforcement Staff has requested that the company provide it with information and documents regarding the disclosure of certain non-GAAP financial measures, so that they can determine if there had been any violations of SEC rules.

It is not clear what criteria the Enforcement Staff used to select the companies that have received these inquiries or whether the Enforcement Staff's focus on the potential violations is related to the CF Staff's new guidance. Most companies believed that any enforcement action based on the new CF Staff guidance would not proceed until some period after the new guidance had been assessed and addressed by companies and the CF Staff had a chance to sort out any questions through its normal review process. It is possible that these enforcement inquiries were triggered by compliance issues with historical CF Staff guidance or other more specific compliance issues. Nonetheless, companies that receive these Enforcement Staff inquiries will need to consider how best to respond in the absence of any potential future guidance from the CF Staff or insights gleaned from the CF Staff reviews.

What Companies Should Do Now

Prior to releasing earnings information and filing quarterly and annual reports on Form 10-Q and Form 10-K, respectively, we recommend companies consider and address the new CF Staff guidance. For additional information regarding the new guidance and the requirements for use of non-GAAP financial measures, please see our recent alert here and our updated disclosure guide available here. Companies that have received inquiries from the Enforcement Staff should consider contacting securities enforcement counsel regarding how best to respond to the matter.

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We are available to discuss any specific questions regarding the new guidance or the requests for information.

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