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SEC's Radar is on Non-GAAP Financial Measures

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If you have been reading financial newspapers recently, you are bound to have come across articles about the Securities and Exchange Commission's (SEC) renewed focus on the use of non-GAAP financial measures in public disclosures. The Wall Street Journal recently reported that only 5.7 percent of companies in the S&P 500 index reported 2015 financials using solely GAAP measures. According to research firm Audit Analytics, this figure was 25 percent in 2006. The SEC's concern with the prevalent presentation and misleading use of non-GAAP financial measures was summed up by SEC Chairman Mary Jo White at a Senate hearing where she was quoted saying: "In too many cases, the non-GAAP information, which is meant to supplement the GAAP information, has become the key message to investors, crowding out and effectively supplanting the GAAP presentation." As promised, the SEC has continued to scrutinize non-GAAP disclosures and, in May 2016, issued formal guidance on this topic.

The Existing Rules

In the wake of the Enron scandal and the dot-com crash in the early 2000s, the Sarbanes Oxley Act of 2002 directed the SEC to regulate the use of non-GAAP financial measures. In 2003, the SEC - adopted Regulation G and Item 10(e) of Regulation S-K, which govern the public disclosure of non-GAAP financial measures.

Regulation G requires that a company that publicly discloses a non-GAAP financial measure also disclose the most directly comparable GAAP measure and include a quantitative reconciliation between the two measures showing how the company arrived at the non-GAAP measure from the GAAP measure. For forward-looking information, a quantitative reconciliation should also be - included "to the extent available without unreasonable efforts." Regulation G applies to the use of - non-GAAP financial measures in any public disclosure, whether in writing or orally, such as earnings releases, website disclosures and earnings calls.

Item 10(e) of Regulation S-K applies to the use of non-GAAP financial measures in filings with the SEC, such as periodic reports and registration statements. Due to the SEC's heightened concern over the use of misleading non-GAAP financial measures in SEC filings, the disclosure requirements under Item 10(e) are more stringent than under Regulation G. As in Regulation G, under Item 10(e), a company that includes a non-GAAP financial measure in a filing must also provide the most directly comparable GAAP measure and present a quantitative reconciliation to such GAAP measure. However, the presentation of the most directly comparable GAAP measure under Item 10(e) must have "equal or greater prominence" than the non-GAAP financial measure. This prominence requirement has been the subject and focus of recent SEC guidance.

Item 10(e) also requires, subject to certain exceptions, that a company disclose the reasons why its management believes that presentation of the non-GAAP measure provides useful information to investors about the company's financial condition and results of operations. Additionally, a company must also disclose any additional purposes for which management uses the non-GAAP measure, if not otherwise disclosed. Unlike Regulation G, Item 10(e) specifically prohibits certain practices with respect to presenting non-GAAP measures.

While the less stringent Regulation G typically applies to public disclosures (whether filed or not), under Instruction 2 to Item 2.02 of Form 8-K, the prominence requirement and certain other requirements of Item 10(e), apply to earnings releases that are furnished under Item 2.02 of Form 8-K. Therefore, companies that furnish their earnings releases must also take into account these requirements of Item 10(e).

Definition of a Non-GAAP Financial Measure

The definition of a "non-GAAP financial measure" under Regulation G and Item 10(e) are the same. Under Rule 101(a)(1) of Regulation G and Item 10(e)(2), a non-GAAP financial measure is a numerical measure of a company's historical or future financial performance, financial position or cash flows that either: excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the company; or includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented. This definition is intended to include both performance measures and liquidity measures. Some examples of non-GAAP financial measures are EBITDA, adjusted EBITDA and free cash flow.

Recent SEC Guidance

In May 2016, the SEC issued several new compliance and disclosure interpretations (C&DI) on the topic of non-GAAP measures. With respect to the prominence requirement, the SEC in C&DI 102.10 provided examples of when disclosures of non-GAAP measures would be viewed as 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) 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.

SEC Comment Letters

Mark Kronforst, the chief accountant at the SEC's Division of Corporation Finance, recently suggested that the SEC will pay close attention to how companies adjust their disclosures in their filings and earnings releases after the May guidance and is expecting to continue to issue comments on second quarter earnings releases. According to Audit Analytics, based on comment letters that became available publicly between January to May 2016, the SEC had already issued comments on the use of non-GAAP financial measures by many public companies. One area of focus of the comment letters, where the SEC has indicated compliance has been weak is the reconciliation of forward-looking non-GAAP measures and whether a company qualifies for the unreasonable efforts exception referenced above.

Practical Implications

In a March 2016 speech, James Schnurr, Chief Accountant at the SEC's Office of the Chief Accountant, emphasized that that the prevalence of non-GAAP financial measures requires increased attention by management and audit committees. He noted that the focus should be not only on whether the measures comply with SEC rules, but also whether a particular non-GAAP financial measure is appropriate in measuring the company's performance and is actually helpful to investors.

To further its objective to prevent abuse of the use of non-GAAP measures, we expect that the SEC will continue to issue more comment letters evaluating companies' compliance with the rules and new guidance. Companies should be proactive and examine their disclosures, especially in their - earnings releases, in light of the new guidance and identify areas where their disclosure of non-GAAP measures can be improved. Companies should also encourage their audit committees to play a larger role in evaluating the purpose of the use of the non-GAAP measure, its usefulness and whether there are appropriate controls in place in the alculation of the non-GAAP measure.

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