INTRODUCTION

The use of non-GAAP financial measures by public companies continues to draw regulatory scrutiny and media attention. The Securities and Exchange Commission (SEC) has the threefold mandate to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. The SEC has been focused recently on the prevalence and increased prominence of non-GAAP financial measures in company disclosures, amid concerns of their potential to distort actual company performance numbers and mislead the investing public.

In May 2016, the staff (Staff) of the SEC’s Division of Corporation Finance (Corp Fin) released its updated Compliance and Disclosure Interpretations (C&DIs) on the use of non-GAAP financial measures (Updated C&DIs) in an effort to clarify and amplify the SEC’s existing rules and regulations in this area to rein in problematic practices by companies involving the use of these measures. Since the release of the Updated C&DIs to date, the Staff has issued more than 700 comment letters involving over 600 public companies related to non-GAAP financial measures. In the same timeframe, the topic of non-GAAP financial measures has become one of the most frequently-cited issues in Staff comment letters.

The heightened SEC attention has also piqued the media’s interest. Throughout the past year, the media has reported on the SEC’s crackdown on ‘fuzzy math’, ‘novel earnings measures’ and ‘made-up accounting metrics’, as well as the Staff’s specific interactions with a high number of public-profile companies in relation to the review of their non-GAAP financial reporting disclosures.1 In September 2016, the SEC’s Division of Enforcement brought civil charges against the former chief accounting officer and former chief financial officer of a publicly traded real estate investment trust (REIT) for purposely inflating a key non-GAAP financial measure used by analysts and investors to assess the REIT’s performance. A parallel criminal action brought by the US Attorney’s Office for the Southern District of New York culminated in a securities fraud conviction on June 30 2017.

In this publication, we describe the nature of non-GAAP financial measures and the disclosure rules governing them, including the Updated C&DIs. We focus on recent SEC comment letters addressing non-GAAP financial measures and examine common themes or areas of concern identified by the Staff. We also highlight pronouncements by senior members of the Staff on the important ‘critical gatekeeper’ role audit committee members play in ensuring credible and reliable financial reporting. In addition, we discuss industry initiatives aimed at improving the dialogue among management, audit committee members, external auditors and other stakeholders with respect to the use and disclosure of non-GAAP financial measures. Finally, we also offer some practical advice for public companies on complying with the updated SEC guidance.

HISTORY

The concern with non-GAAP financial measures is not new. In December 2001, the SEC issued a warning to public companies that present to the public their earnings and results of operations on the basis of methodologies other than generally accepted accounting principles (GAAP). Such presentation was commonly referred to then as pro forma financial information. While there is no prohibition on companies publishing interpretations of their results or summaries of their GAAP financial statements, the SEC cautioned that such pro forma financial information can mislead investors if it obscures GAAP results. The SEC stated that, because this pro forma financial information by its very nature departs from traditional accounting conventions, its use can make it hard for investors to compare an issuer’s financial information with other reporting periods and with other companies. Since pro forma financial information is derived by selective editing of financial information compiled in accordance with GAAP, the SEC noted that companies should be particularly mindful of their obligation not to mislead investors when using such information.

In the beginning of 2002, the SEC instituted an enforcement action against a well-known public company, alleging it knowingly and recklessly issued false and materially misleading statements in the form of pro forma financial information in its earnings press release, in violation of the anti-fraud provisions of the federal securities laws. In that case, the subject registrant presented non-GAAP net income figures that excluded a one-time charge, without disclosing that such figures had included a similar and material one-time gain, thereby showing an increase in its earnings from the prior year’s comparable quarter and beating analysts’ expectations. The company then touted in its earnings release that operational improvements at the company drove the increase in quarterly earnings, when in fact this was not the case. In other words, the increase in earnings resulted from an improper accounting gain, which, had it been properly excluded (similar to the company’s exclusion of the one-time charge), would have shown that the company’s earnings actually declined for the quarter and had fallen short of analyst expectations. The company settled the case with the SEC and agreed to cease and desist from committing such violations then and in the future.

On May 19 2002, the technical committee of the International Organisation of Securities Commissions (IOSCO Committee) released its Cautionary Statement Regarding Non-GAAP Results Measures. The IOSCO Committee observed that it had become common practice for many issuers to publish company-specific measurements of earnings other than those prescribed by GAAP. This would often occur in the form of company press releases, and in periodic reports to shareholders and other documents filed with securities regulators and stock exchanges. The IOSCO Committee remarked that non-GAAP earnings measures, when properly used and presented, could assist investors in gaining a better understanding of a company’s financial performance. However, the IOSCO Committee noted that problems arose if non-GAAP earnings measures were used inconsistently or were inadequately defined, or if such measures were used in such a way as to obscure the financial results determined according to GAAP or provide an incomplete description of true financial results. Issuers, investors and other users of financial information were reminded to use care when presenting and interpreting non-GAAP results measures.

On July 30 2002, the Sarbanes-Oxley Act of 2002 (SOX) was signed into law. The law, enacted in response to the
accounting scandals at Enron and Worldcom in the early 2000s, sought to enhance financial disclosures of public companies to investors, among other statutory objectives. Section 401(b) of SOX mandated that the SEC issue final rules providing that "pro forma" financial information included in any periodic or other report filed with the SEC pursuant to the federal securities laws, or in any public disclosure or press or other release, be presented in a manner that: (1) does not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the "pro forma" financial information, in light of the circumstances under which it is presented, not misleading; and, (2) reconciles it with the financial condition and results of operations of the issuer under GAAP.

In line with its mandate under SOX, on November 4 2002, the SEC issued SEC Release 33-8145 (Proposing Release). Among other things, the Proposing Release proposed the adoption of a new disclosure regulation under the Securities Act of 1933, as amended (Securities Act), which is now known as Regulation G under the Securities Act (Regulation G), along with amendments to item 10(e) of Regulation S-K under the Securities Act (Regulation S-K) and conforming amendments to Form 20-F. The Proposing Release also sought to require registrants to file their earning releases or similar announcements on Form 8-K under the Securities Exchange Act of 1934, as amended (Securities Exchange Act), and subject those filings to the requirements under amended item 10(e) of Regulation S-K.

According to the Proposing Release, Regulation G and the proposed amendments were intended to implement the requirements of SOX and to provide investors with balanced financial disclosure when non-GAAP financial measures are presented. Since the term 'pro forma financial information', as used in section 401(b) of SOX, was actually being used by the SEC in its rules and regulations in different contexts (in particular, with respect to certain "pro forma" financial information requirements of Regulation S-X under the Securities Act (Regulation S-X)), the SEC decided to adopt the term ‘non-GAAP financial measures’ instead. After receiving substantial public comment on the Proposing Release, the SEC issued SEC 33-8176 (the Final Rule Release and, together with the Proposing Release, the SEC Releases) on January 15 2003, adopting the new regulation and proposed amendments effective March 28 2003.

**WHAT ARE NON-GAAP FINANCIAL MEASURES?**

Regulation G and item 10(e) of Regulation S-K define a non-GAAP financial measure as a numerical measure of historical or future financial performance, financial position or cash flows, that:

- 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 issuer's statement of income, balance sheet or statement of cash flows (or equivalent statements); 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.

The SEC Releases further provide that the definition of a non-GAAP financial measure is intended to capture all measures that have the effect of depicting either:

- a measure of performance that is different from that presented in the financial statements, such as income or loss before taxes, or net income or loss as calculated in accordance with GAAP; or,

- a measure of liquidity that is different from cash flow or cash flow from operations computed in accordance with GAAP.

Therefore, if a company takes a defined GAAP measure (such as GAAP net income), and thereafter adjusts for (that is, excludes or includes) one or more expense or revenue items that are components of that GAAP measure (for instance, excluding a restructuring expense identified as non-recurring), then the
resulting measure (called ‘adjusted net income’, for example) is a non-GAAP financial measure. In the same vein, EBITDA (earnings before interest, taxes, depreciation and amortisation) is another common and widely used non-GAAP financial measure. It is a non-GAAP financial measure because the company takes GAAP earnings (that is, net income as presented in the statement of operations under GAAP) and then adjusts for interest, taxes, depreciation and amortisation components (which are elements derived from GAAP financial presentations) to arrive at a measure (EBITDA) that is not presented in accordance with GAAP.

Other common examples of non-GAAP financial measures include variants of EBITDA, such as: EBIT (earnings before interest and taxes), EBITA (earnings before interest, taxes and amortisation), EBITD (earnings before interest, taxes and depreciation) (which is also sometimes called PBDIT, or profit before depreciation, interest and taxes), EBITDAR (earnings before interest, taxes, depreciation, amortisation, and restructuring or rent costs), adjusted EBITDA, core earnings, adjusted earnings, adjusted earnings per share, adjusted revenues, free cash flow, funds from operations (FFO), and adjusted FFO (AFFO).

The definition of a non-GAAP financial measure, however, excludes:

- operating and other statistical measures (such as unit sales, number of employees, number of subscribers, or number of advertisers);
- ratios or statistical measures that are calculated using exclusively one or both:
  - financial measures calculated in accordance with GAAP (such as operating margin, where GAAP revenue is divided by GAAP operating income); and,
  - operating measures or other measures that are not non-GAAP financial measures (such as sales per square foot or same store sales, assuming that the sales figures were calculated in accordance with GAAP); and,
- financial measures required to be disclosed by GAAP, SEC rules, or a system of regulation of a government or governmental authority or self-regulatory organisation that is applicable to the registrant (such as measures of capital or reserves calculated for regulatory purposes).

**WHY DO COMPANIES USE NON-GAAP FINANCIAL MEASURES?**

A company often uses non-GAAP financial measures in the Management’s Discussion and Analysis of Results of Operation (MD&A) section of its periodic reports, as well as in its earnings releases, investor presentations and other communications. It does so to supplement its GAAP financial presentations and to provide investors with a better understanding of the company’s performance, liquidity and financial position. Often, non-GAAP operating measures are used by research analysts, rating agencies, and other financial professionals in evaluating or comparing the performance of comparable companies. For instance, EBITDA is commonly used in debt covenants and widely used by analysts in valuing businesses (for example the enterprise value of a company is often calculated as a multiple of its EBITDA) and making financial projections. It is also frequently used as a proxy or estimate for a company’s operating cash flow or cash available to service its debt. Non-GAAP financial measures are allowed by the SEC in order for a registrant to convey information to investors that the registrant believes is relevant and useful in understanding its performance or liquidity. Non-GAAP financial measures also enable management to convey a picture of how it sees the company’s financial condition or results of operations in a manner that GAAP results alone may not be able to convey.

**NON-GAAP FINANCIAL MEASURES USED IN CERTAIN INDUSTRIES**

Certain non-GAAP financial measures have gained wide acceptance and use in specific industries. In a number of instances, the definitions of these non-GAAP financial measures have become fairly standardised and companies have generally adopted them in their disclosures, subject to certain adjustments specific to a particular registrant’s business.

In the REIT industry, FFO (funds from operations) and NOI (net operating income) are two commonly used and accepted non-GAAP financial measures. The National Association of Real Estate Investment Trusts (NAREIT), an industry trade group, has published a standardised measure of performance known as FFO, which is used in the REIT industry as a supplemental performance measure. A number of REITs use and adopt FFO as a non-GAAP financial measure, consistent with the standards set forth in the white paper on FFO approved by the Board of Governors of NAREIT, as revised in February 2004 (White Paper). The White Paper defines FFO as net income or loss computed in accordance with GAAP, but excluding gains or losses from sales of property and real estate-related impairments, plus real estate-related depreciation and amortisation, and after adjustments for unconsolidated partnerships and joint ventures. FFO has become the most commonly accepted and reported measure of REIT operating performance. In question 102.01 of the Updated C&DIs, the Staff indicated that it will accept NAREIT’s definition of FFO as in effect on May 17 2016 (the adoption of the Updated C&DIs) as a performance measure and will not object to its presentation on a per share basis.

NOI is also commonly used in the REIT industry. NOI is defined by some REITs as total revenue (including rental revenue, tenant reimbursements, management, leasing and development services revenue and other income) less property-level operating expenses including allocated overhead, and excluding depreciation and amortisation, general and administrative expenses, impairments, gain/loss on sale of real estate, and other non-operating items. A number of REITs have stated in their disclosures that they consider NOI to be an appropriate supplemental measure to GAAP net income because it helps both investors and management understand the core operations of their properties and because the measure reflects only those income and expense items that are incurred at the property level and presents such items on an unlevered basis.

Other non-GAAP financial measures that are commonly used in the REIT industry include MFFO (modified funds...
from operations) and ‘core earnings’ (particularly for mortgage REITs). MFFO is a measure of performance that has been published and standardised by the Investment Programme Association (IPA), an industry trade group. The IPA has recommended MFFO as a supplemental measure for publicly registered, non-listed REITs.

Mortgage REITs are REITs that make or own loans and other obligations, including government agency mortgage-backed securities, which are secured by real estate collateral. This makes them different from equity REITs, which own, or have an equity interest in, real estate or rental real estate (rather than making loans secured by real estate collateral). Mortgage REITs also frequently use core earnings as a supplemental measure for GAAP net income, with adjustments for certain items such as excluding gains or losses on disposals of investments and termination of interest rate swaps, gains or losses on foreign currency transactions, depreciation and amortisation charges, and acquisition related expenses.

‘Broadcast cash flow’ (BCF) is a non-GAAP financial measure that is commonly used in the radio, television and cable industry. Some registrants define it as consisting of operating income or loss before corporate expenses, gain or loss on sale of assets, depreciation and amortisation and non-cash stock-based compensation in operating expenses. Others define it as operating income plus corporate expense, depreciation and amortisation (including amortisation of programme broadcast rights), loss on disposal of assets, and expense of common stock contributed to 401(k) retirement plans, less gain on disposal of assets, payments for programme broadcast obligations, and network compensation revenue and network payment. A number of media companies state in their disclosures that BCF is used by industry analysts, investors and lenders as a measure of valuation for broadcast companies as well as a benchmarking tool to compare their results to the corresponding results of other companies in the broadcast industry.

Certain public utilities use different formulations of ‘gross margin’ (for example, revenue less cost of sales (such as cost of fuel and purchased power) less depreciation) or ‘gross operating margin’ (for example, revenue less cost of operations, exclusive of depreciation and amortisation expense) as non-GAAP financial measures.

In the airline industry, ROIC or (return on invested capital) is commonly used, although variations exist with respect to specific adjustments made to the measure (for example, for aircraft operating leases, special items, operating lease obligations, etc.). A number of airline companies state in their disclosures that ROIC is a meaningful measure because it quantifies how well the company generates operating income relative to the capital the company has invested in the airline business, and that ROIC is commonly used as a measure of capital efficiency used by industry analysts, investors and lenders.

In the banking industry, ‘efficiency ratio’ is a commonly used non-GAAP financial measure that is calculated to measure the cost of generating one dollar of revenue (the percentage of one dollar which must be expended to generate that dollar of revenue). Some banks calculate this ratio by dividing non-interest expense by the sum of net interest income and non-interest income. Some banks exclude certain gains, losses and expenses not considered to be a core part of their business, to arrive at an adjusted efficiency ratio. In addition, banks and financial services companies also disclose in their filings that they use and present different non-GAAP financial measures such as ‘tangible book value per common share’, ‘return on average tangible assets’, ‘return on average tangible equity’, and ‘average tangible equity to average tangible assets’. These measures are determined by methods other than in accordance with GAAP.
WHEN DO REGULATION G AND ITEM 10(E) OF REGULATION S-K APPLY? WHAT IS COVERED AND TO WHOM DO THE RULES APPLY?

In general

Regulation G applies whenever a registrant, or a person acting on its behalf, publicly discloses material information that includes a non-GAAP financial measure. Item 10(e) of Regulation S-K applies whenever a registrant includes one or more non-GAAP financial measures in a filing with the SEC.

In both cases, the term ‘registrant’ refers to a public company, or rather an entity that has a class of securities registered under section 12 of the Securities Exchange Act or is required to file reports under section 15(d) of the Securities Exchange Act.

Exceptions for proposed business combinations and registered investment companies

The requirements of Regulation G and item 10(e) of Regulation S-K do not, however, apply to:

- any non-GAAP financial measure included in a disclosure relating to a proposed business combination, the entity resulting therefrom or an entity that is a party thereto, if the disclosure is contained in a communication that is subject to the SEC’s communication rules applicable to business combination transactions; and,
- investment companies registered under section 8 of the Investment Company Act of 1940, as amended (Investment Company Act).

According to the SEC Releases, registered investment companies are excluded from the application of Regulation G and item 10(e) of Regulation S-K. This is because section 405 of SOX exempts investment companies registered under section 8 of the Investment Company Act from section 401 of SOX and any rules adopted by the SEC under section 401 of SOX. In turn, non-GAAP financial measures included in proposed business combination disclosures are already subject to a separate set of SEC rules (for example, Securities Exchange Act rules 14a-12 and 14d-2, Securities Act rules 165 and 425, and item 1015 of Regulation M-A).

Application to foreign private issuers

In addition to domestic registrants that are not registered investment companies, Regulation G and item 10(e) of Regulation S-K generally apply to foreign private issuers, subject to the limited exceptions outlined below.

Under rule 100(c) of Regulation G, Regulation G does not apply to a disclosure of a non-GAAP financial measure that is made by or on behalf of a registrant that is a foreign private issuer if the following conditions are satisfied:

- the securities of the registrant are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States;
- the non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with GAAP in the United States; and,
- the disclosure is made by or on behalf of the registrant outside the United States, or is included in a written communication that is released by or on behalf of the registrant outside the United States.

Further, the exemption from Regulation G in favour of foreign private issuers will continue to apply, notwithstanding the existence of one or more of the following circumstances below:

- 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;
- foreign journalists, US journalists or other third parties have access to the information;
- the information appears on one or more websites maintained by the registrant, so long as the websites, taken together, are not available exclusively to, or targeted at, persons located in the United States; or,
- following the disclosure or release of the information outside the United States, the information is included in a submission by the registrant to the SEC made under cover of a current report on Form 6-K.

Under Regulation G and item 10(e) of Regulation S-K, the term ‘GAAP’ as used in such rules refers to US GAAP, except that, for foreign private issuers, the term ‘GAAP’:

- in the case of foreign private issuers whose primary financial statements are prepared in accordance with non-US GAAP or IFRS, must refer to the principles under which those primary financial statements are prepared; and,
- in the case of foreign private issuers that include a non-GAAP financial measure derived from a measure calculated in accordance with US GAAP, must refer to US GAAP for purposes of the application of the requirements of Regulation G or item 10(e) of Regulation S-K, as applicable, to the disclosure of that measure.

Therefore, outside of the exceptions described above, a foreign private issuer that publicly discloses material information that includes a non-GAAP financial measure is subject to Regulation G.

If the foreign private issuer in turn makes a filing with the SEC (or incorporates the filing by reference into a registration statement) that includes one or more non-GAAP financial measures, then item 10(e) of Regulation S-K also applies, subject to a few exceptions outlined below.

A non-GAAP financial measure that would otherwise be prohibited by item 10(e) of Regulation S-K will be permitted in a Form 20-F filing of a foreign private issuer if:
• the non-GAAP financial measure relates to the GAAP used in the registrant’s primary financial statements included in its filing with the SEC;

• 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,

• the non-GAAP financial measure is included in the annual report prepared by the registrant for use in the jurisdiction in which it is domiciled, incorporated or organised or for distribution to its security holders.

Moreover, the SEC has clarified in question 106.04 of the Updated C&DI’s that neither Regulation G nor Item 10(e) of Regulation S-K applies to Canadian companies that include non-GAAP financial measures in their annual report on Form 40-F under the multi-jurisdictional disclosure system. Foreign private issuers that include non-GAAP financial measures in their annual report on Form 20-F are, however, subject to Item 10(e) of Regulation S-K as the SEC Releases also amended Form 20-F to incorporate the requirements of Item 10(e) of Regulation S-K.

Application to earnings releases, webcasts and other materials posted to websites

As noted above, Regulation G applies to all public disclosures by registrants, whether in writing or made orally, that contain non-GAAP financial measures. Therefore, public disclosures in the form of earnings releases, webcasts, investor presentations and other materials posted to websites are within the scope of Regulation G. If a non-GAAP financial measure is made public orally, telephonically, by webcast, by broadcast, or by similar means, then the reconciliation requirement under Regulation G would be satisfied if:

• the required information (that is, the presentation and reconciliation) is provided on the registrant’s website at the time the non-GAAP financial measure is made public; and,

• the location of the website is made public in the same presentation in which the non-GAAP financial measure is made public.

In contrast, Item 10(e) of Regulation S-K applies to all filings by the registrant with the SEC under the Securities Act and the Exchange Act. These would include: registration statements, annual reports on Form 10-K, quarterly reports on Form 10-Q, free writing prospectuses (if included or incorporated by reference into a registration statement), proxy statements and current reports on Form 8-K.

With respect to earnings releases in particular, Item 10(e) applies to Item 2.02 Form 8-K, under which earnings releases are furnished to the SEC. In addition, Item 2.02 of Form 8-K contains a conditional exemption from its requirement to furnish a Form 8-K where earnings information is presented orally, telephonically, by webcast, by broadcast or by similar means.

Among other conditions, the registrant must provide on its website any material financial and other statistical information not previously disclosed and contained in the presentation, together with any information that would be required by Regulation G. In question 105.01 of the Updated C&DI’s, the Staff also stated that an audio file of the initial webcast would satisfy the requirement provided that (1) the audio file contained all material financial and other statistical information included in the presentation that was not previously disclosed, and, (2) investors could access it and replay it through the registrant’s website.

REQUIREMENTS UNDER REGULATION G

Regulation G contains a reconciliation requirement and a general disclosure requirement. The reconciliation requirement provides that whenever a registrant or a person acting on its behalf publicly discloses (whether in an SEC-filed report or in an earnings call or investor presentation) material information that includes
a non-GAAP financial measure, that non-GAAP financial measure must be accompanied by:

- a presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP; and,
- a quantitative reconciliation of the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure.

To illustrate, if a registrant presents EBITDA as a performance measure, then EBITDA should be reconciled to net income as presented in the statement of operations under GAAP since, in this case, net income is the most directly comparable financial measure calculated and presented in accordance with GAAP.

A quantitative reconciliation is required for historical non-GAAP financial measures. For forward-looking information, however, a quantitative reconciliation is required only to the extent available without unreasonable efforts on the part of the registrant. In this latter case, however, the SEC has clarified that the registrant must: (i) disclose the fact that the GAAP financial measure is not accessible on a forward-looking basis; and, (ii) identify the information that is unavailable and disclose its probable significance.

In turn, the general disclosure requirement provides that a registrant or a person acting on its behalf, should not make public a non-GAAP financial measure that, taken together with any accompanying information, contains a material misstatement or omits material facts needed to make the measure not misleading, in light of the circumstances under which the measure is presented.

Regulation G applies to all public disclosures and is not limited to the registrant’s public filings. If a non-GAAP financial measure is made public orally, telephonically, by webcast, by broadcast, or by similar means, then the reconciliation requirement under Regulation G would be satisfied if:

- the required information (that is, the presentation and reconciliation) was provided on the registrant’s website at the time the non-GAAP financial measure was made public; and,
- the location of the website was made public in the same presentation in which the non-GAAP financial measure was made public.

**REQUIREMENTS UNDER ITEM 10(E) OF REGULATION S-K**

Item 10(e) applies to non-GAAP financial measures that are included in SEC filings. To comply with item 10(e) of Regulation S-K, the registrant must include the following in its SEC filing:

- a presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with GAAP;
- a quantitative reconciliation of the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure;
- a statement disclosing why the registrant’s management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant’s financial condition and results of operations; and,
- to the extent material, a statement disclosing the additional purposes, if any, for which the registrant’s management uses the non-GAAP financial measure.

The general requirements of item 10(e) of Regulation S-K above are similar to the requirements in Regulation G, except that item 10(e) of Regulation S-K also adds the ‘equal or greater prominence’ requirement in the presentation and requires disclosure regarding management’s reasons and purposes for using the non-GAAP financial measure.

In addition, item 10(e) of Regulation S-K contains a number of specific prohibitions. Item 10(e) prohibits:

- non-GAAP financial measures of liquidity that exclude charges or liabilities requiring cash settlement, other than EBIT and EBITDA;
- adjustments to non-GAAP financial measures of performance that eliminate or smooth items identified as ‘non-recurring, infrequent or unusual’, when 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 preceding two years;
- the presentation of non-GAAP financial measures on the face of the registrant’s financial statements prepared in accordance with GAAP or in the accompanying notes;
- the presentation of non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by article 11 of Regulation S-X; and,
- the use of titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.

According to the SEC Releases, these requirements for filed information are more extensive and detailed than those of Regulation G, and are generally consistent with the Staff’s historical practice in situations where they have reviewed filings containing non-GAAP financial measures.

**APPLICATION OF PARAGRAPH (1)(I) OF ITEM 10(E) OF REGULATION S-K TO ITEM 2.02 OF FORM 8-K**

Instruction 2 to item 2.02 of Form 8-K provides that the requirements of paragraph (1)(i) of item 10(e) of Regulation S-K apply to disclosures made by a registrant under item 2.02. Item 2.02 is captioned ‘Results of Operations and Financial Condition’ and pertains to earnings release disclosures that are made by a registrant (either in the body of the current report on Form 8-K or as an exhibit thereto) and are furnished to the SEC. Under item 10(e), a registrant must include, either in the body of the Form 8-K or in the
earnings release exhibit to the Form 8-K:

• a statement disclosing why the registrant’s management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant’s financial condition and results of operations; and,

• to the extent material, a statement disclosing the additional purposes, if any, for which the registrant’s management uses the non-GAAP financial measure.

**SEC GUIDANCE ON NON-GAAP FINANCIAL MEASURES**

Subsequent to the adoption of Regulation G, the amendments to item 10 of Regulation S-K and the other related amendments under the SEC Releases in March 2003, the SEC has continued to provide guidance on the topic of non-GAAP financial measures. The SEC has engaged registrants, the investing public and other stakeholders through both formal and informal channels. Formal guidance has taken the form of: (1) FAQs and C&DIs related to non-GAAP financial measures, which the Staff update from time to time; (2) written comments provided to and communications with registrants as a result of the SEC comment letter process during which the Staff review registration statements and periodic filings submitted by registrants; and (3) updates to the SEC financial reporting manual provisions relating to non-GAAP financial measures, among other things. Informally, senior members of the Staff and the SEC have regularly commented on the use of non-GAAP financial measures, delivering speeches, participating in webcasts, panel discussions and Q&A sessions with accounting and legal practitioners, industry groups and other stakeholders, and addressing the public in general about the topic.

**2003 FAQs, 2010 C&DIs and 2011 C&DIs**

On June 13 2003, the Staff issued 33 FAQs regarding the use of non-GAAP financial measures (2003 FAQs) that focused on the implementation and interpretation of the rules adopted in the SEC Releases a few months earlier. The 2003 FAQs dealt with a number of topics that included, among others, questions and answers dealing with transition issues, proposed business combination transactions, segment information, EBIT and EBITDA, and the applicability of the rules to foreign private issuers.

The 2003 FAQs contained a number of provisions that restricted the use and inclusion of certain non-GAAP financial measures in SEC filings. One such restriction was the Staff’s guidance with respect to the permissibility of non-GAAP financial measures that adjusted for recurring items. To illustrate, item 10(e) of Regulation S-K prohibits adjustments that eliminate or smooth items identified as nonrecurring, infrequent or unusual, when 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 preceding two years. Questions subsequently arose from companies and practitioners whether a registrant was prohibited altogether from using a non-GAAP financial measure that eliminated recurring items, or whether it was permissible to use a non-GAAP financial measure that eliminated recurring items if those items were not labelled as non-recurring. The Staff, in question 8 of the 2003 FAQs, stated that: ‘...while there is no *per se* prohibition against removing a recurring item, companies must meet the burden of demonstrating the usefulness of any measure that excludes recurring items, especially if the non-GAAP financial measure is used to evaluate performance.’ Further, question 9 of the 2003 FAQs stated that the Staff’s practice had been to object to the use of non-GAAP financial measures that eliminated the effect of recurring items by describing them as non-recurring. The Staff advised that management should consider the substantive nature of the item when determining whether to classify it as recurring or non-recurring, because merely labelling an item as non-recurring does not make it so.

As a result of these stringent requirements under item 10(e) of Regulation S-K as interpreted by the 2003 FAQs, companies avoided using non-GAAP financial measures that adjusted for recurring items in their SEC filings. However, they
continued to present such non-GAAP financial measures in their press releases, earnings calls and other public disclosures other than SEC filings, as those were not subject to item 10(e) of Regulation S-K.

In 2009, the Staff began to review its interpretative guidance on non-GAAP financial measures. At the December 2009 American Institute of Certified Public Accountants (AICPA) Conference, senior members of the Staff acknowledged that registrants may be omitting non-GAAP measures in their SEC filings while still using these measures in their press releases and public disclosures, because of concerns with receiving future Staff comments on SEC filings. Senior members of the Staff confirmed at the AICPA conference that they were reviewing the 2003 FAQs to ensure that the way they were not being read in a fashion that causes companies to keep key information out of their filings, which they are otherwise using to tell investors their story [through communications such as earnings calls and press releases] and which they believe is the most meaningful indicator of how they are doing.4

On January 11 2010, the Staff issued C&DIs related to non-GAAP financial measures (2010 C&DIs), which superseded the 2003 FAQs. The 2010 C&DIs relaxed a number of the prohibitions and restrictions in the 2003 FAQs (including those contained in questions 8 and 9 therein) and offered registrants more flexibility to use and disclose their non-GAAP financial measures. In particular, new question 102.03 of the 2010 C&DIs (which remains the same in the Updated C&DIs) states that the prohibition in item 10(e) of Regulation S-K that prohibits adjusting a non-GAAP financial measure that eliminates or smooths items identified as nonrecurring, infrequent or unusual, is based on the description of the charge or gain, and not on the nature of the charge or gain. The Staff also stated that 'the fact that a registrant cannot describe a charge or gain as non-recurring, infrequent or unusual, however, does not mean that the registrant cannot adjust for that charge or gain. Registrants can make adjustments they believe are appropriate, subject to Regulation G and the other requirements of item 10(e) of Regulation S-K.'5 In a March 2010 speech delivered at the Westchester/Fairfield County chapter of the Association of Corporate Counsel conference, then SEC Commissioner Elisse B Walter stated that the guidance contained in the new 2010 C&DIs 'seeks to encourage you to at least think about including non-GAAP measures in commission filings if your company uses those measures in earnings releases and other communications with the investor and analyst community.'6

The 2010 C&DIs were updated on July 8 2011 (2011 C&DIs) to add a new question 108.01. The latter clarified that Regulation G and item 10(e) of Regulation S-K applied to non-GAAP financial measures disclosures, other than target-level disclosures, that were included in a registrant’s proxy statement. With respect to pay-related disclosures, the Staff said it would not object if a registrant included the required GAAP reconciliations in a prominently cross-referenced annex to the proxy statement. Alternatively, if the non-GAAP financial measures were the same as those included in the Form 10-K that was incorporating by reference the proxy statement, a prominent cross-reference to the pages in the Form 10-K containing the required GAAP reconciliation could be provided.

2015 and 2016 speeches of Senior SEC Staff

The years that followed showed a marked increase in the use of non-GAAP financial measures by public companies. A December 2015 Audit Analytics report that examined earnings releases of S&P 500® companies for the third quarter of 2015 showed that (i) 88% of the S&P 500 companies disclosed non-GAAP financial measures in their earnings releases, (ii) non-GAAP adjustments increased net income 82% of the time, (iii) the average quarterly impact of non-GAAP income adjustments was an increase of $176 million, and, (iv) acquisition and divestiture adjustments were the most common type of non-GAAP income items.6 Media reports also indicated that a number of companies had been resorting to non-GAAP financial measures to paint a rosier, more favourable, but often misleading picture of their financial condition and performance.

On June 27 2016, then SEC Chair Mary Jo White, speaking at the International Corporate Governance Network’s Annual Conference in San Francisco, reiterated the SEC’s growing concern regarding the use by public companies of non-GAAP financial measures. In her keynote address, Chair White lamented that '[i]n 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.7 While companies are allowed to present non-GAAP financial measures in their public disclosures to enable them to convey a clearer picture of their results of operations and tell their own stories to investors, Chair White, in the same address, voiced her concern that companies had been ‘taking this flexibility too far and beyond what is intended and allowed by our rules.’8

Chair White’s comments echoed a statement she made in a December 2015 speech that non-GAAP financial measures may be a source of confusion.9 Similar sentiments were expressed by senior Staff in early 2016, articulated in speeches and pronouncements by James Schnurr, the SEC’s then chief accountant; Wesley R Bricker, the SEC’s then deputy chief accountant; and, Mark Kronforst, the chief accountant in Corp Fin. In a March 2016 speech delivered at the 12th Annual Life Sciences Accounting and Reporting Congress, Mr Schnurr pointed out that the Staff had observed a substantial and ‘troubling increase’ over the previous few years in the use of non-GAAP financial measures, the nature of non-GAAP adjustments being made by companies, as well as the prominence being given by analysts and the media to these non-GAAP financial measures in their coverage.9 In early May of 2016, Mr Bricker noted that certain company practices related to non-GAAP financial measures had caused SEC concern for being potentially misleading to investors. These practices included, among others, (1) apparent cherry picking adjustments within a non-GAAP financial measure, (2) adjustments to remove normal, cash operating expenses, and, (3) the use of individually tailored accounting principles to calculate non-GAAP earnings.10 In May 2016, Mr Kronforst declared that there would be an ‘uptick’ in the number of SEC comments to companies with respect to their non-GAAP financial measure disclosures and expressed the view that the next reporting quarter would be a great opportunity for companies to self-correct their disclosures.11

10| MORRISON & FOERSTER | NON-GAAP FINANCIAL MEASURES
THE UPDATED C&DIS

On May 17, 2016, the Staff issued the Updated C&Dis on the use of non-GAAP financial measures. The Updated C&Dis expanded on the C&Dis issued by the Staff in 2010 and 2011 and provided further SEC guidance on Regulation G, and item 10(e) of Regulation S-K, the two principal rules enacted by the SEC in 2003 to address the use of non-GAAP financial measures.

The Updated C&Dis issued by the Staff can be grouped into four main areas: (1) potentially misleading non-GAAP financial measure practices; (2) equal or greater prominence presentation of GAAP measures; (3) non-GAAP financial measures of liquidity that are presented on a per share basis; and, (4) other C&Dis relating to FFO and income tax effects of adjustments. We discuss each of these in turn.

Potentially misleading non-GAAP financial measure practices

Questions 100.01 to 100.04 of the Updated C&Dis illustrate certain practices concerning non-GAAP financial measures that the Staff believes could be potentially misleading and, therefore, are prohibited under Regulation G. The Staff’s guidance, along with examples where adjustments to non-GAAP financial measures or their presentation could be potentially misleading, is summarised below:

• Certain adjustments, although not explicitly prohibited, may violate rule 100(b) of Regulation G because they cause the presentation of the non-GAAP financial measure to be misleading. C&DI question 100.01 provides, as an example, that presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant’s business could be misleading.

• A non-GAAP financial measure may be misleading if it is presented inconsistently between periods. As an example, C&DI question 100.02 states that a non-GAAP financial measure that adjusts a particular charge or gain in the current period and for which other, similar charges or gains were not also adjusted in prior periods, could violate rule 100(b) of Regulation G, unless: (1) the change between periods is disclosed; (2) the reasons for the change are explained; and, (3) if the change is sufficiently substantial, the related non-GAAP financial measures presentation in the prior periods is recast to conform to the most recent presentation and to place the disclosure in the appropriate context.

• Non-GAAP financial measures that exclude charges but do not exclude any gains could violate rule 100(b) of Regulation G for being misleading. As an example, C&DI question 100.02 provides that a non-GAAP financial measure that is adjusted only for non-recurring charges when there were non-recurring gains that occurred during the same period could violate rule 100(b) of Regulation G.

• Non-GAAP financial measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could violate rule 100(b) of Regulation G. As an example, C&DI question 100.04 provides a situation where a registrant presents a non-GAAP performance measure that is adjusted to accelerate revenue recognised ratably over time in accordance with GAAP as though the registrant earned revenue when customers were billed. Aside from revenue, C&DI question 100.04 also states that individually tailored recognition and measurement methods for other financial statement line items may also violate rule 100(b) of Regulation G for being misleading.

With respect to C&DI question 100.04, the Staff has stated that it would not object to a non-GAAP financial measure that adjusted revenue to reflect the upcoming change in revenue recognition accounting standards. The Staff added that these disclosures, which seek to bridge the old GAAP revenue measure with the new GAAP revenue measure, help investors understand the transition from the old to the new accounting standard.
Equal or greater prominence presentation of GAAP measures

Question 102.10 of the Updated C&DI presents the Staff’s prescriptive approach to the ‘equal or greater prominence’ requirement under item 10(e) of Regulation S-K. In order to comply with item 10(e), the registrant must include in its SEC filing a presentation, with equal or greater prominence, of the most directly comparable GAAP measure. In question 102.10 of the Updated C&DI, the Staff provides examples where this requirement is not met. To clarify, in the following instances, the non-GAAP financial measures may be considered to be more prominent than the GAAP measures, and therefore, such presentation does not comply with item 10(e):

- 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 (for example, bold, or larger font) that emphasises the non-GAAP measure over the comparable GAAP measure;
- including 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 characterisation 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 importance in a location of equal or greater prominence; and,
- providing discussion on and analysis of a non-GAAP measure without a similar discussion on and analysis of the comparable GAAP measure in a location with equal or greater prominence.

While the Staff acknowledges that whether a non-GAAP financial measure is more prominent than the comparable GAAP measure generally depends on the facts and circumstances in which the disclosure was made, it will consider the above as examples where disclosure of non-GAAP financial measures were more prominent than GAAP measures.

Non-GAAP financial measures of liquidity that are presented on a per share basis

The Staff updated existing C&DI questions 102.05, 102.07 and 103.02 emphasize that a non-GAAP financial measure that is used as a liquidity measure cannot be presented on a per share basis. SEC guidance under these questions may be summarised as follows:

- Non-GAAP per share performance measures may be meaningful from an operating standpoint and are allowed under item 10(e). Non-GAAP per share performance measures should be reconciled to GAAP earnings per share.

- On the other hand, non-GAAP liquidity measures that measure cash generated must not be presented on a per share basis in documents filed with or furnished to the SEC, consistent with Accounting Series Release number 142.

- Whether per share data is prohibited depends on whether the non-GAAP measure can be used as a liquidity measure, even if management presents it solely as a performance measure. When analysing these questions, the Staff will focus on the substance of the non-GAAP measure and not on management’s characterisation of the measure.

- Free cash flow is a liquidity measure that must not be presented on a per share basis.

- EBIT or EBITDA must not be presented on a per share basis.

The Staff uses a range or a spectrum in determining whether a particular measure is used as a liquidity measure or a performance measure: on the liquidity side of the spectrum, there is operating cash flow; and on the performance side of the spectrum, there is net income. While there are other measures in the middle of the spectrum, the Staff has indicated that, for now, it will focus on analysing the liquidity end of the spectrum.13

Other C&DI relating to FFO and income tax effects of adjustments

The Updated C&DI made certain updates to questions 102.01 and 102.02 of the existing C&DI that pertain to the use of the metric FFO, a non-GAAP financial measure traditionally used by NAREIT. The Staff stated that it will continue to accept NAREIT’s definition of FFO as in effect as of May 17 2016, as a performance measure and will not object to such presentation on a per share basis. The Staff also stated that a registrant may present FFO on a basis other than as defined by NAREIT, provided that any adjustments made to FFO complied with the requirements of item 10(e) of Regulation S-K for a performance measure or a liquidity measure. Depending on the nature of the adjustments, if FFO is presented or adjusted as a liquidity measure, then the presentation of FFO on a per share basis is prohibited.

Finally, the Updated C&DI updated question 102.11. The SEC’s guidance therein regarding the income tax effects
related to adjustments is as follows:

- A registrant should provide income tax effects on its non-GAAP measures, depending on the nature of the measures.

- If a measure is a liquidity measure that includes income taxes, it might be acceptable to adjust GAAP taxes to show taxes paid in cash.

- If a measure is a performance measure, the registrant should include existing and deferred income tax expense commensurate with the non-GAAP measure of profitability.

In addition, adjustments to arrive at a non-GAAP measure should not be presented net of tax. Rather, income taxes should be shown as a separate adjustment and clearly explained.

**RECENT SEC COMMENT LETTERS AND AREAS OF FOCUS**

An examination of comment letters issued by the Staff since the Updated C&DIs were released in May 2016 reveals the continuing focus of the Staff on the use of non-GAAP financial measures by registrants in their filings. In what follows, we identify common themes or areas of concern identified by the Staff in the SEC comment letter/review process, as they relate to the use of non-GAAP financial measures.

In general, the Staff routinely asked registrants to explain and demonstrate whether and how their non-GAAP disclosures complied with the Updated C&DIs, Regulation G, and item 10(e) of Regulation S-K. The comment letters we reviewed focused on the non-GAAP disclosures made by registrants not only in their SEC filings, such as their Form 10-Ks, Form 10-Qs, proxy statements and Form 8-Ks, but also non-GAAP disclosures included in earnings releases, websites, investor presentations and earnings calls. The Staff’s comments are focused on the specific areas of concern described below.

**Reconciliation to the most directly comparable GAAP financial measure**

This topic received a large number of comments from the Staff. The Staff challenged registrants’ practice of using non-GAAP financials in their disclosures without presenting the most directly comparable GAAP financial measure and without providing the required quantitative reconciliation from the non-GAAP financial measure to the most directly comparable GAAP financial measure.

- **No reconciliation or incorrect reconciliation.** In many instances, registrants either failed to identify a particular measure they used as a non-GAAP financial measure (and hence omitted the required presentation or reconciliation altogether), or improperly reconciled the non-GAAP financial measure to a GAAP financial measure that was not the most directly comparable GAAP financial measure. Examples of non-GAAP financial measures used by registrants without the required presentation and reconciliation include the following: adjusted earnings, EBITDA margin, debt/adjusted EBITDA, adjusted dividend payout ratio, non-GAAP net loss, working capital intensity, return on net assets, cash burn, non-GAAP operating expenses, non-GAAP net operating loss, and free cash flow. Examples of incorrect reconciliations include: (1) reconciling EBITDA and adjusted EBITDA (when used as operating performance measures) to gross profit (where each such measure should have been reconciled to GAAP net income or net loss instead); (2) reconciling free cash flow (used as a liquidity measure) to adjusted operating income (where such measure should have been reconciled not to a non-GAAP financial measure, but to GAAP cash flow from operating activities); and, (3) reconciling core EBITDA to operating income (where such measure should have been reconciled to net income). In a few instances, the Staff noticed that the slides provided by registrants in relation to their earnings calls used non-GAAP measures such as free cash flow and adjusted EBITDA but no reconciliations were provided therein. In another example, a registrant did not include the reconciliations of its non-
GAAP financial measures such as EBITDA and operating cash cost in its earnings release but instead provided a URL address at which those reconciliations could be found. The Staff challenged this practice and asked the company to include the required reconciliations within the filing itself. The Staff also reminded registrants that the reconciliation must begin with the GAAP measure (rather than the non-GAAP measure to which it is reconciled) and thereafter, the GAAP measure should be reconciled to the non-GAAP measure.

- **Separate presentation of each non-GAAP adjustment in reconciliation.** In some comment letters, the Staff asked registrants to provide more detail and expand their disclosures with respect to the non-GAAP adjustments presented in their reconciliation. For example, in one instance, the Staff pointed out that the registrant’s non-GAAP reconciliation had combined all non-GAAP adjustments to the GAAP financial measure into just one line item, and this made it difficult to understand fully the nature and amounts of each of the adjustments. Specifically, in reconciling its non-GAAP financial measure ‘industrial segment organic revenue’ to arrive at GAAP ‘segment revenue,’ the registrant presented in only one line item ‘acquisitions, business dispositions (other than dispositions of businesses acquired for investment) and currency exchange rates.’ The Staff asked the registrant to revise its reconciliations in future filings and earnings releases to present each of such non-GAAP adjustments separately in the reconciliation, and the registrant agreed it would do so going forward. In a number of cases, the Staff also asked registrants to include separate line items for each major reconciling item or provide explanations in a note. For instance, registrants were asked to provide a further breakout and explanation of each major item within ‘acquisition and integration activities’, or to disaggregate ‘acquisition-related charges’ into multiple types of expenses, in order to provide a method of reconciliation that was easier to understand.

**Equal or greater prominence presentation of GAAP financial measures**

This was an area that generated a substantial number of comments from the Staff. The Staff encountered some of the situations and examples outlined in question 102.10 of the Updated C&DI, where non-GAAP financial measures may be considered to be more prominent than the GAAP financial measures. The Staff examined the content, formatting, sequence or ordering and labelling of the registrant’s public disclosures and issued comments to registrants aimed at ensuring that their GAAP financial measures were given equal or greater prominence than their non-GAAP financial measures in their public disclosures.

- **Labelling, captions, reordering and formatting to give GAAP financial measures equal or greater prominence.** The Staff observed that a number of registrants were presenting numerous non-GAAP financial measures throughout their earnings releases, Form 10-Ks, Form 10-Qs and Form 8-Ks without clearly labelling them as such, preventing investors from distinguishing easily the non-GAAP financial measures from the GAAP financial measures.

In a number of comment letters, the Staff asked registrants to add headers, captions, bullets and statements to clearly indicate that a particular metric was a non-GAAP financial measure and to specify whether it was being used as either a performance measure or a liquidity measure. The Staff also noted that the location or presentation of non-GAAP financial measures and the required reconciliations in the public filings made them appear more prominent than the GAAP financial measures. For example, in one comment letter, the Staff asked the registrant why its supplemental non-GAAP disclosures and reconciliations were provided only as an exhibit 99 to its Form 10-Q filing whereas a large number of its non-GAAP financial measures were located within the body of the Form 10-Q itself. In another comment letter, the Staff asked the registrant to add an additional bullet providing for the GAAP financial measure ‘net cash flow from operating activities’ right before the bullet for the non-GAAP financial measure ‘adjusted free cash flow’ in its quarterly earnings release. In another case, the Staff asked the registrant to make a representation that it would discuss its GAAP earnings before its non-GAAP earnings in its future earnings releases. In a number of cases, registrants were also directed to ensure in future earnings releases and filings that their GAAP measures would precede their non-GAAP measures such as adjusted EBITDA and net adjusted EBITDA margin. Registrants whose headlines in earnings releases appeared to give more prominence to non-GAAP measures were also challenged by the Staff.

- **Omitting comparable GAAP financial measures, or discussing a non-GAAP financial measure without a similar discussion of the comparable GAAP financial measure in a location with equal or greater prominence.** In a number of comment letters addressing earning releases, the Staff asked registrants why comparable GAAP financial measures were omitted altogether in disclosures, especially where the GAAP financial measures differed directionally from the non-GAAP financial measure being presented. For example, in one comment letter, the Staff pointed out that while the registrant disclosed a percentage increase in its non-GAAP earnings per share metric, it did not disclose that its GAAP earnings per share actually declined more than 80% from the prior year. In another comment letter, a registrant that presented non-GAAP earnings per share from continuing operations was asked to explain why it did not also present GAAP net earnings (loss) per share amounts. In a number of cases, the Staff also asked registrants to present the three major categories of GAAP statements of cash flows with equal or greater prominence each time the registrants presented their non-GAAP free cash flow. A number of comment letters asked registrants to balance their presentation by including the comparable GAAP measures (for example, GAAP gross profit percentage) and presenting them with equal or greater prominence to the non-GAAP performance measure in their filings.

- **Excluding quantitative reconciliations with respect to forward-looking non-GAAP financial measures in reliance on the ‘unreasonable efforts’ exception.** The Staff reminded registrants
that included forward-looking non-GAAP financial measures in their earning releases and investor presentations that they needed to either provide the required quantitative reconciliation to the most directly comparable GAAP financial measure or explain why they could not provide such information without unreasonable efforts. To rely on the ‘unreasonable efforts’ exception, however, the registrant must both disclose the fact that such GAAP financial measure was not accessible on a forward-looking basis, and identify the information that was unavailable and its probable importance, in a location of equal or greater prominence. In one case, the Staff asked a registrant that had previously indicated to the Staff in writing (in response to a prior comment letter) that it could not produce the required GAAP financial guidance projection numbers without unreasonable efforts to explain subsequent remarks made by its chief executive officer in an earnings conference call that the registrant did in fact maintain such GAAP projections. In response, the registrant explained that the chief executive officer did not intend to indicate that the registrant had or used projections of GAAP net income. The registrant also indicated that, while it provided guidance with respect to GAAP revenues and non-GAAP adjusted EBITDA, it was unable to reconcile adjusted EBITDA to GAAP net income because of the inherent difficulty in forecasting and qualifying the amounts necessary under GAAP guidance. In a number of cases, the Staff observed that registrants were providing guidance only for their non-GAAP financial measures (for example, AFFO, NOI growth, FFO and adjusted EBITDA), but not for GAAP numbers, and were thus asked to include GAAP guidance and provide a quantitative reconciliation between the GAAP and non-GAAP measures.

Potentially misleading non-GAAP financial measure practices

Registrants also were asked by the Staff to show that certain non-GAAP financial measures they used or particular adjustments they adopted were not misleading in light of the examples cited in questions 100.01, 100.03, 100.04 and 102.03 of the Updated C&DIs that characterised such practices as potentially misleading.

- **Non-recurring, infrequent or unusual items.** Item 10(e) prohibits registrants from adjusting a non-GAAP financial measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years or if there was a similar charge or gain within the preceding two years. In addition, using non-GAAP financial measures that exclude normal, recurring, cash operating expenses that are necessary to operate a registrant’s business is potentially misleading under questions 100.01, 100.03 and 102.03 of the Updated C&DIs. While the number, nature and scope of permissible adjustments would vary by industry, and ultimately depend on facts and circumstances specific to a particular registrant, examples of excluded adjustments that the Staff scrutinised include the following: (1) engineering, product maintenance and product development costs that appeared to be an integral part of the registrant’s technology platform business; (2) third party business expenses, such as maintenance, ground handling and catering services for third-parties and fuel expenses, claimed to be not directly related to an airline’s core business; (3) management fees, transaction fees and IPO ‘readiness’ costs excluded from adjusted EBITA, notwithstanding the historical occurrence of these costs that suggested these were integral in continuing operations of the company; (4) restructuring, integration and deal costs, new store openings, relocation and employee recruiting costs, termination of certain supply and distribution agreements costs, and legal settlement and legal proceedings, investigations and inquiries costs that all appeared to be recurring and usual in the ordinary course of business; (5) certain pension costs; and, (6) other charges and gains that appeared normal and recurring in the registrant’s operations and were to be settled in cash. In a number of cases, the Staff asked registrants not to refer to adjustments (for example, legal charges and credits, gain on sale of assets, operational improvement initiatives and acquisition-related costs) as being non-recurring unless these items met the two-year ‘non-recurring, infrequent or unusual’ criteria in item 10(e) of Regulation S-K. If registrants determine that some charges are non-operational but recurring, then they should revise their
- **Acquisition-related expenses; ‘core vs non-core’ distinctions.** The Staff also asked registrants whose operations included large, frequent and seemingly routine acquisitions of other businesses or entities why they were excluding the impact of acquisition-related expenses and the amortisation of intangible assets they acquired, given that the registrants appeared to grow through acquisitions and the acquisition of businesses appeared to be a critical strategy. In certain cases, the Staff also asked registrants to accurately describe how they defined their core activities *vis-à-vis* their non-core activities. Registrants often employ a non-GAAP financial measure such as core earnings or core revenues to characterise their core businesses and exclude adjustments that they consider as non-core expenses or activities in their business. In a few cases, the Staff asked registrants why certain expenses were designated non-core even though they appeared to be normal, recurring, cash operating expenses that were directly attributable to the registrant’s operations and lines of business.

- **Non-GAAP measures that only exclude charges but not gains.** Question 100.03 of the Updated C&DIs provides that a non-GAAP measure that is adjusted only for non-recurring charges and not for non-recurring gains even if there were non-recurring gains that occurred during the same period, could violate rule 100(b) of Regulation G for being misleading. In a number of comments, the Staff observed that the non-GAAP financial measures employed by registrants such as adjusted EBITDA, adjusted net income, and adjusted diluted EPS appeared to only exclude charges and not gains. For instance, the Staff pointed out to a registrant that its non-GAAP financial measures excluded a court-mandated settlement and acquisition integration costs but did not exclude income related to a settlement, the reduction of an earn-out liability for an acquired business, and gains on sales of equipment.

- **Individually tailored measures.** Question 100.04 of the Updated C&DIs provides that non-GAAP financial measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could violate rule 100(b) of Regulation G. In addition, individually tailored recognition and measurement methods for financial statement line items other than revenue may also violate rule 100(b) of Regulation G for being misleading. The Staff asked registrants to explain why their non-GAAP financial measures and adjustments did not represent individually tailored measurement methods substituted for that of GAAP, including in the following examples: (1) adjusting non-GAAP pro rata balance sheets and income statements for the registrant’s proportionate economic ownership of each asset in its portfolio that were not wholly owned by the registrant; (2) presenting adjusted earnings and adjusted EBITDA by excluding step-up depreciation and amortisation; (3) removing only portions of depreciation expense (associated with the fair value step-up in acquisition accounting) and share-based compensation from the registrant’s non-GAAP income measure; (4) presenting adjusted EBITDA excluding inventory revaluation; (5) presenting non-GAAP adjusted operating corporate costs and non-GAAP segment earnings that excluded normal, recurring, operating items such as certain pension costs, restructuring and other charges and gains; and, (6) presenting a measure of non-GAAP gross profit, calculated as non-GAAP gross profit plus change in deferred revenues, less deferred domain expenses.

- **Use of titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, GAAP financial measures.** There were a number of comments requiring registrants to clearly identify that a particular metric was a non-GAAP financial measure and to consistently use titles for the financial measures that were clearly distinguishable from comparable GAAP titles. The Staff asked registrants to stop naming or labelling their non-GAAP financial measures with titles or descriptions that were the same as, or confusingly similar to, the GAAP financial measures. As examples, the Staff asked registrants the following: (1) to re-title their non-GAAP financial measure ‘operating earnings’ since it was confusingly similar to the terms ‘earnings from operations’, ‘operating income’, ‘operating earnings’ and ‘profit from operations’, which are terms used under GAAP to refer to income that is generated by the ordinary and usual activity of a reporting entity; (2) to remove the reference to the word ‘cash’ in their non-GAAP financial measure ‘cash earnings per share’ since this title could be erroneously read to imply that it was related to cash flows; (3) to stop using ‘earnings per share’ as a non-GAAP financial measure and ascribing to it a meaning different from the clear meaning ascribed to the term ‘earnings per share’ under US GAAP; and, (4) to re-title their non-GAAP financial measure ‘operating margin’ since it was confusingly similar to the terms ‘gross margin’ and ‘operating income’ which are terms used under GAAP. In certain instances, the Staff accepted the re-naming of the non-GAAP financial measure by the simple addition of (‘non-GAAP’) in the caption or label of the financial measure in question.

- **Non-GAAP measures labelled as EBITDA, EBIT, FFO or free cash flow but which differ from the typical definitions of these terms.** Registrants were also reminded by the Staff that certain non-GAAP measures had gained wide acceptance among the general investing public, analysts and others, and within specific industries, sectors or asset classes. If a registrant presents a non-GAAP measure that differs from the typical definitions attributed to that term, then it should be properly labelled as such, so as not to create confusion. For instance, the SEC Releases describe EBIT as ‘earnings before interest and taxes’ and EBITDA as ‘earnings before interest, taxes, depreciation and amortisation’. Thus, registrants should not label their non-GAAP measure as ‘EBITDA’ where that measure includes additional adjustments other than interest, taxes depreciation and amortisation. Rather, they should modify the title of this measure to ‘adjusted EBITDA’ or another similar title. The same applies for the term FFO which, as question 103.01 of the Updated C&DIs indicates, refers to ‘funds from operations’ as used and defined by NAREIT. Hence, if the non-GAAP financial measure is calculated differently from
NAREIT's FFO definition, then the same should be called ‘adjusted FFO’ or a similar title. In addition, registrants’ use of the non-GAAP financial measure ‘free cash flow’ received a large number of Staff comments. Consistent with question 102.07 of the Updated C&DIs, the Staff reminded registrants that free cash flow is typically calculated as cash from operating activities as presented in the statement of cash flows under GAAP, less capital expenditures. In a number of instances, the Staff asked registrants whose measure deviated from this typical formula, to rename and revise their measure to ‘adjusted free cash flow’ in order to alert their investors that it had been adjusted from the measure typically referred to as ‘free cash flow. The Staff also emphasised that the term free cash flow did not have a uniform definition and that its title did not describe how it is calculated. Therefore, a clear description of how the measure is calculated, as well as the necessary reconciliation, should accompany the measure where it is used.

Usefulness of non-GAAP financial measures to investors and the reasons management uses them

There was a considerable increase in Staff comments asking registrants to include and expand in their disclosures the reasons why management believed the presentation of non-GAAP financial measures provided useful information to investors regarding the registrants’ financial condition and results of operations. Registrants were asked to provide a more substantive and concise discussion specific to their circumstances of how their non-GAAP financial measures were useful to investors and any additional purposes for which management used the non-GAAP financial measures, rather than just including boilerplate statements and generic disclosures that the financial measures were useful to analysts.

Non-GAAP financial measures of liquidity presented on a per share basis; liquidity versus performance

Questions 102.05, 102.07 and 103.02 of the Updated C&DIs provide that a non-GAAP financial measure that is used as a liquidity measure cannot be presented on a per share basis and, that in analysing whether a financial measure is a performance measure or a liquidity measure, the Staff would focus on the substance of the non-GAAP financial measure and not on management’s characterisation. In a number of comment letters, the Staff determined that non-GAAP financial measures characterised by registrants as performance measures were actually used by them as liquidity measures and, hence, should have been characterised as such and not presented on a per share basis. The Staff reiterated that EBITDA and adjusted EBITDA when used as operating performance measures should be reconciled to GAAP net income, and that adjusted free cash flow when used as a liquidity measure should be reconciled to GAAP cash flows from operating activities. In some cases, the Staff pointed out the inconsistencies in the disclosures made by registrants with respect to their characterisation of the use of the non-GAAP financial measure as being a performance measure or a liquidity measure. In one instance, the Staff noted that, on the one hand, the registrant disclosed that it considered EBITDA and adjusted EBITDA to be indicators of its ability to generate cash to service debt, fund capital expenditures and expand business and had reconciled these measures to net income and cash provided by operating activities. On the other hand, however, the registrant also disclosed that it did not consider these non-GAAP financial measures to be measures of liquidity. The Staff asked the registrant to clarify or revise these inconsistencies in its filing. In another instance, the Staff determined that the registrant’s presentation of adjusted FFO on a per share basis was improper since it appeared that due to the adjustments, including several non-cash adjustments and an adjustment for recurring capital expenditures, the measure could be used as a liquidity measure.

Income tax effects of adjustments

Question 102.11 of the Updated C&DIs provides that adjustments to arrive at a non-GAAP financial measure should not be presented net of tax. The Staff made this comment in a few cases and asked registrants to revise their disclosures and tabular presentations to separately present the income tax impact of their non-GAAP adjustments.
EFFECTIVE DISCLOSURE CONTROLS, AUDIT COMMITTEE INVOLVEMENT AND OTHER INDUSTRY INITIATIVES

Over the last year, senior members of the Staff have emphasised that appropriate and effective disclosure controls and procedures relating to the use of non-GAAP financial measures should be considered and established by registrants. Senior members of the Staff have also emphasised the need for increasing audit committee involvement and dialogue with stakeholders regarding the use of non-GAAP financial measures.

On December 5 2016, SEC chief accountant Wesley R Bricker, speaking at the AICPA conference in Washington DC, highlighted the important ‘critical gatekeeper’ role that audit committee members play in ensuring credible, reliable financial reporting, including compliance with the Updated C&DIs.14 Mr Bricker stated that audit committee members should seek to understand management’s judgement in the design, preparation and presentation of non-GAAP financial measures and how those measures might differ from approaches followed by other registrants. Mr Bricker also highlighted that the oversight of management’s activities was crucial for investor protection. He added that it was important for both auditors and audit committees to keep and maintain a direct and open line of communication, and that audit committees had an important role overseeing external auditors, since auditors are accountable to the board of directors through the audit committee and not to management. In addition, Mr Bricker highlighted that:

- good reporting practices place a premium on audit committee member’s understanding of the registrant’s non-GAAP policies, procedures, and controls;
- it is important to keep in mind that businesses operate in uncertain environments. If non-GAAP adjustments replace that business reality with smooth earnings over time, accelerate unearned revenues, or defer incurred expenses, those adjustments and disclosures should be evaluated closely under the Updated C&DIs;
- it is important for both auditors and audit committees to keep and maintain the direct relationship they share. The following questions from audit committee members to their external auditor may be helpful in generating a dialogue:
  - if you as the auditor were in management’s shoes and solely responsible for preparation of the registrant’s financial statements, would they have in any way been prepared differently?
  - if you as the auditor were in an investor’s shoes, would you believe that you had received the information essential to understanding the registrant’s financial position and performance?
  - is the registrant following the same internal control over financial reporting and internal audit procedures that would be followed if you were in the CEO’s shoes?
  - are there any recommendations that you as the auditor have made and management has not followed?
- audit committees should not underestimate the importance of their role overseeing the external auditor.

In the same vein, the Centre for Audit Quality (CAQ), a non-profit public policy organisation affiliated with the AICPA, has issued suggested discussion questions for key stakeholder groups regarding the preparation and use of non-GAAP financial measures.15 The CAQ identified these stakeholders as management, investors, investment analysts, securities counsellors, audit committee members, internal auditors, independent auditors, regulators, accounting standard setters, and academics. According to the CAQ, the audit committee can act as a bridge between management and investors in assessing management’s reasons for presenting non-GAAP financial measures, evaluating whether these measures present a fair and balanced view of the registrant, and assessing how the non-GAAP financial measures are used by analysts and reported by the financial press to the broader public. The sample discussion questions also aim to promote the transparency, consistency and comparability of non-GAAP financial measures and to assist audit committees with determining whether management is complying with SEC rules and related interpretations with respect to non-GAAP financial measures.

Returning to this theme, in March 2017, Mr Bricker again emphasised the importance of reinforcing and advancing credible financial reporting through effective audit committees.16 Mr Bricker highlighted several ways to advance the role and effectiveness of audit committees, including the following:

- audit committees should understand the businesses they serve and the impact of the operating environment – the economic, technological, and societal changes – on corporate strategies.
- audit committees should consider training and education programmes to ensure that their member have the proper background and stay current as to relevant developments in accounting and financial reporting, including the recently issued accounting standards relating to revenue recognition, leasing, financial instruments, and credit losses.
- balancing audit committee workload is critical, given the need for audit committees to stay current on emerging issues.

On June 8 2017, Mr Bricker emphasised the importance of reliable accounting in protecting investors and the capital markets.17 Mr Bricker also discussed the key roles played by audit committees and independent external auditors in providing assurance to investors that financial statements are disclosed without material misstatements or omissions. Highlights of the speech include the following:

- Auditor independence: Mr Bricker noted that while audit firms are generally more active in raising independence issues to the Staff, audit committees and management may also address with the Staff independence matters that impact their filings or other
interpretive questions. Audit committees and management should also keep in mind that the Staff does occasionally reach out to the audit committee to understand its position about an independence matter that has been submitted to the Staff for its consideration. When selecting a successor auditor, an audit committee should request information to be satisfied that the successor is independent at the start of the audit and professional engagement period. Audit committees should also consider circumstances that might require the registrant to make adjustments to prior period financial statements (for example, the reporting of discontinued operations, retrospective application of an adoption or change in accounting principle, or the correction of an error).

- **Reminders to the audit profession**: Mr Bricker noted that just as management needed to allocate sufficient time and resources to the preparation of the registrant’s books and records (with good internal controls), so too should public accounting firms work with the audit committee and management to agree on appropriate deadlines and audit fees to ensure that audit quality is consistently maintained.

- **Continuing to advance through innovation**: Mr Bricker noted that there had been substantial advances in technology in recent years with an accompanying increase in the use of technology by auditors, which has the potential to enhance audit quality and the detection capabilities of auditors. Mr Bricker also mentioned that some ratings agencies and data aggregators now used data scraping technology and machine learning to review SEC filings and analyse trends over time, which had the potential to help auditors and users of the financial statements identify inappropriate bias in financial statements.

**ENFORCEMENT ISSUES**

**Liability for misusing non-GAAP financial measures**

Rule 102 under Regulation G provides that neither the requirements of Regulation G nor a person’s compliance or non-compliance with its requirements will in itself affect any person’s liability under section 10(b) of the Securities Exchange Act or rule 10b-5 under the Securities Exchange Act.

Registrants continue to be subject to the anti-fraud provisions of the federal securities law. Registrants are also subject to the general disclosure requirement under Regulation G which provides that a registrant or a person acting on its behalf, must not make public a non-GAAP financial measure that, taken together with the information accompanying that measure, contains a material misstatement or omits material facts needed to make the measure not misleading, in light of the circumstances under which it is presented.

In addition, the SEC Releases point out that section 3(b) of SOX provides that a violation of SOX or the SEC’s rules thereunder will be treated for all purposes as a violation of the Securities Exchange Act. Hence, if a registrant or any person acting on its behalf, fails to comply with Regulation G, the registrant and/or the person acting on its behalf could be subject to an SEC enforcement action alleging violations of Regulation G. Additionally, if the facts and circumstances warrant, the SEC could bring an action under both Regulation G and rule 10b-5.

**SEC enforcement actions**

In addition to the Staff’s comment letter process, the topic of non-GAAP financial measures has also attracted interest from the SEC’s enforcement division. Beginning around late autumn of 2016 (and after the release of the Updated C&DIs), the SEC’s enforcement division reached out to a number of registrants regarding their historical non-GAAP financial disclosures. Registrants were asked to provide the SEC’s enforcement division with documents and other information to determine if they may have violated Regulation G or item 10(e), particularly by giving undue prominence to non-GAAP financial measures in earnings releases and other disclosures, in a way that misled investors.
In addition, in September 2016, the SEC charged the former chief financial officer and chief accounting officer of a publicly traded real estate investment trust for purposely inflating AFFO, a key non-GAAP financial measure used by analysts and investors to assess the registrant. In its complaint, the SEC alleged that the officers employed an improper hybrid method of calculating AFFO and AFFO per share and ignored repeated concerns raised by their accounting staff about the impropriety of the method used. Those numbers were included in the registrant’s 10-Q and 8-K filings. The SEC alleged violations of section 10(b) of the Securities Exchange Act and rule 10b-5 under the Securities Exchange Act among other causes of action. Around the same time, a parallel criminal action was brought by the US Attorney’s Office for the Southern District of New York against the two officers. In June 2017, the chief accounting officer pleaded guilty to securities fraud and related charges. After a three-week trial, a federal jury convicted the chief financial officer of one count of conspiracy to commit securities fraud and other offences, one count of securities fraud, two counts of making false filings with the SEC, and two counts of submitting false certifications along with required filings with the SEC. The securities fraud, false filings charges, and false certification charges each carry a maximum prison term of 20 years. The charge of conspiracy carries a maximum prison term of five years. The case is on appeal.

In January 2017, the SEC instituted an enforcement action against a registrant for its failure to comply with item 10(e) of Regulation S-K. The registrant presented a metric called ‘organic revenue growth’ that represented the registrant’s growth in revenue excluding the effects of two reconciling items: acquisitions and foreign exchange impacts. However, from the second quarter of 2012 to year-end 2013, the registrant incorporated a third reconciling item into its calculation without informing investors of the change, which resulted in higher ‘organic revenue growth’ results. The registrant also failed to give GAAP metrics equal or greater prominence compared to its non-GAAP financial measures (for example, EBITDA, EBITDA margin, and free cash flow) in its earnings releases, despite repeated promises to the Staff that it would do so. The registrant was ordered to, and agreed to, cease and desist from such practices and to pay a civil monetary penalty.

**RECOMMENDATIONS**

With the recent SEC focus on the use by public companies of non-GAAP financial measures and the release of the updated SEC guidance in the form of the Updated C&DI, registrants must be extra careful in their public disclosures and filings to ensure that they are complying with Regulation G and item 10(e) of Regulation S-K. We offer the following practical guidance:

- Companies should revisit the updated SEC guidance and their approach to non-GAAP financial measures disclosure. Non-GAAP financial measures should merely supplement GAAP measures and not be a substitute for them.
- Appropriate controls on the use of non-GAAP financial measures should be considered and established by companies. A company’s audit committee should carefully oversee and monitor the use of non-GAAP financial measures and disclosures and this particular function of the audit committee should be expressly included in the audit committee’s charter. The audit committee should ask management to explain the utility of non-GAAP financial measures in the company’s public disclosures.

1. Management should monitor the use of non-GAAP financial measures by comparable companies and financial professionals.
2. Companies should ensure that the non-GAAP financial measures they use are neither misleading nor prohibited by SEC rules.
3. Companies should understand and articulate the reasons for using non-GAAP financial measures in their presentations and SEC filings including how they would be useful for investors.
4. The company’s disclosure committee should review the company’s public filings for non-GAAP financial measures.
5. Companies should ensure that each non-GAAP financial measure is accurately defined, described and captioned and that reconciliation is made to the most directly comparable GAAP measure.
6. Companies should ensure that GAAP measures are presented with equal or more prominence than non-GAAP financial measures. Companies should carefully observe the examples given by the Staff in Updated C&DI question 102.10 where this requirement is not met. For instance, companies should refrain from the following practices:
   - 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 (for example, bold, or a larger font) that emphasises the non-GAAP measure over the comparable GAAP measure;
   - presenting a non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption); and,
   - describing a non-GAAP measure as, for example, ‘record performance’ or ‘exceptional’ without at least an equally prominent descriptive characterisation of the comparable GAAP measure.
7. Companies should ensure that the nature of adjustments being made to arrive at non-GAAP financial measures has a reasonable basis and is customary among peer companies. The SEC has been focusing on apparent cherry picking adjustments within a non-GAAP measure, adjustments to remove normal, cash operating expenses, and the use of individually tailored accounting
principles to calculate non-GAAP earnings.

- Companies should remember that certain adjustments, although not explicitly prohibited, may violate rule 100(b) of Regulation G because they cause the presentation of the non-GAAP financial measure to be misleading. Companies should also ensure that the non-GAAP financial measure they are presenting is balanced (that is, it adjusts not only for non-recurring expenses but also for non-recurring gains).

- Because Regulation G applies to all public disclosures, whether made orally or in writing, companies must take a closer look at how and when they present non-GAAP financial measures in their press releases, webcasts, investor presentations, earnings releases, conference calls and other disclosures. Companies should pay particular attention to earnings calls and scripts. Regulation G requires at the minimum that a company post the required presentation and reconciliation on its website at the time the non-GAAP financial measure is made public and announce the location of its website in the same presentation in which the non-GAAP financial measure is made public.

Companies must always be mindful whether they are using non-GAAP financial measures as a performance measure or as a liquidity measure. The presentation of a non-GAAP liquidity measure on a per share basis is prohibited. The Staff has said that, going forward, it will focus on the substance of the non-GAAP measure and not on management’s characterisation of the measure in making the performance versus liquidity determination.

CONCLUSION

The use of non-GAAP financial measures can be an important tool for registrants to tell their own stories. It allows them to convey information to investors that registrants believe to be relevant, meaningful and useful in understanding their financial performance, financial position or liquidity. The prevalence and wide acceptance of non-GAAP financial measures, the importance and attention accorded by research analysts, rating agencies, financial professionals and the business community in general to these measures, and the adoption and development of these measures by various industry groups, all point to and demonstrate that there are legitimate, meaningful and relevant purposes in using non-GAAP financial measures. However, as the SEC has highlighted, the presentation of non-GAAP financial measures is also prone to misuse and abuse. As shown in a number of cases, non-GAAP financial measures can become tools to distort the truth, conceal, fabricate or inflate the actual performance and financial condition of a given company, confuse investors, and even perpetuate outright fraud. The marked increase in the prevalence and wide use of these measures over the few past years has prompted the Staff to revisit the existing rules and regulations governing the use and disclosure of these measures and to issue updated guidance in the form the Updated C&DIs. The Staff has reminded registrants that non-GAAP financial measures should merely supplement, and not substitute, GAAP financial measures, and that management should understand and articulate the reasons for using non-GAAP financial measures in SEC disclosures and take steps to ensure that such measures are neither misleading nor prohibited by SEC rules. Consistent, transparent, credible and truthful disclosures by registrants are paramount to the effective functioning of the capital markets. Therefore, it is important for registrants to carefully revisit and examine their use and presentation of non-GAAP financial measures in their disclosures and to take concrete steps to comply with the updated SEC guidance and ensure that the presentation of their non-GAAP financial measures is consistent, transparent, credible and truthful.
ENDNOTES:


3. In October 2017, the Staff issued two additional C&DIs on the use of non-GAAP financial measures in business combination projections. In the first C&DI, the Staff clarified that financial measures provided to a financial advisor, including financial measures included in forecasts used in connection with a business combination transaction, would be excluded from the definition of non-GAAP financial measures, and therefore not subject to item 10(e) of Regulation S-K and Regulation G, if and to the extent: (1) the financial measures are included in forecasts provided to the financial advisor for the purpose of rendering an opinion that is materially related to the business combination transaction; and, (2) the forecasts are being disclosed in order to comply with Item 1015 of Regulation M-A under the Securities Act (Regulation M-A) or requirements under state or foreign law, including case law, regarding disclosure of the financial advisor’s analyses or substantive work. Therefore, assuming these two conditions are satisfied, the guidance should provide comfort to M&A deal participants that the disclosure of management projections in merger registration statements, proxy statements and tender offer statements would not be subject to item 10(e) of Regulation S-K and Regulation G. In the second C&DI, the Staff clarified that the exemption from item 10(e) of Regulation S-K and Regulation G for non-GAAP financial measures disclosed in communications relating to a business combination transaction does not extend to the same non-GAAP financial measures disclosed in registration statements, proxy statements and tender offer statements.


7. See Mary Jo White, Chair, U.S. Securities and Exchange Commission, Focusing the Lens of Disclosure to Set the Path Forward on Board Diversity, Non-GAAP, and Sustainability (June 27, 2016), available at: https://www.sec.gov/news/speech/chair-white-icgn-speech.html.

8. Id.


13. See “Non-GAAP Disclosures: The SEC Speaks!” (July 6, 2016), a webcast sponsored by TheCorporateCounsel.net, where Mr. Kronforst, speaking in his personal capacity and neither for the SEC nor for the Staff, answered specific questions regarding the Updated C&DIs. A copy of the transcript and an audio archive for the webcast are available at: https://www.thecorporatecounsel.net/member/Webcast/2016/07_06/transcript.htm (subscription required).


**REFERENCE SOURCES**

**Laws and Regulations**

- Regulation G, 17 C.F.R. Part 244.

**SEC Guidance on Non-GAAP Financial Measures and Related Materials**


**Speeches of SEC Senior Staff**


**SEC and Department of Justice press releases**


**Newspaper Articles**


Other resources


TheCorporateCounsel.net, Non-GAAP Disclosures: The SEC Speaks! (July 6, 2016), webcast transcript and audio archive available at: https://www.thecorporatecounsel.net/member/Webcast/2016/07_06/transcript.htm (subscription required).
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