Practice Pointers: Anticipating and Addressing SEC Comments on Non-GAAP Financial Measures

The use of non-GAAP financial measures by public companies continues to be an area of growing concern for the Securities and Exchange Commission ("SEC"). Since the staff of the SEC's Division of Corporation Finance (the "Staff") released its updated Compliance and Disclosure Interpretations on May 17, 2016, on the use of non-GAAP financial measures (the "Updated C&DIs"), the Staff has issued more than 200 comment letters related to non-GAAP financial measures that have become publicly available.

In this alert, we look at common themes or areas of concern identified by the Staff in these comment letters, as well as responses given by registrants. 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, including compliance with the Updated C&DIs. Finally, we look at 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.[1]

SEC Comment Letters

In general, the Staff routinely asked registrants to explain and demonstrate whether and how their non-GAAP disclosures comply with the Updated C&DIs, Regulation G ("Regulation G") under the Securities Act of 1933, as amended (the "Securities Act"), and Item 10(e) ("Item 10(e)") of Regulation S-K under the Securities Act ("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 10-Ks, 10-Qs, proxy statements and 8-Ks, but also non-GAAP disclosures presented in or on earnings releases, websites, investor presentations and earnings calls. The Staff's comments revolve around the following specific areas of concern:

Reconciliation to the Most Directly Comparable GAAP Financial Measure

This topic received a large number of comments from the Staff. The Staff called out 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 metric 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. Examples of incorrect reconciliations include 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 loss instead).

- **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

[1] For more information regarding the nature of non-GAAP financial measures, the disclosure rules governing them and the Updated C&DIs, *see* our "Practice Pointers on Non-GAAP Financial Measures," available at: https://goo.gl/Qb9tMm.

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 fully understand 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.

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&DIs, 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 labeling 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.

- **Labeling, 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, 10-Ks, 10-Qs and 8-Ks without clearly labeling them as such, preventing investors to easily distinguish 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 is a non-GAAP financial measure and to specify whether it is 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 10-Q filing whereas a significant 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 will discuss its GAAP earnings prior to its non-GAAP earnings in its future earnings releases.

- **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 tackling earning releases, the Staff asked registrants why comparable GAAP financial measures were being 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 another case, the Staff asked the registrant to present the three major categories of GAAP statements of cash flows with equal or greater prominence each time it presented its non-GAAP free cash flow.

- **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 need to either provide the required quantitative reconciliation to the most directly comparable GAAP financial measure or explain why they cannot 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 is not accessible on a forward-looking basis, and identify the information that is unavailable and its probable significance, 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 CEO in an earnings conference call that the registrant did in fact maintain such GAAP projections. In response, the registrant explained that the CEO did not intend to indicate that the registrant currently has or utilizes 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.

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 characterized 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 there was a similar charge or gain within the prior 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 scrutinized 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) 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; (3) certain pension costs; and (4) other charges and gains that appeared normal and recurring in the registrant's operations and are to be settled in cash.
- **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 amortization of intangible assets they acquired, given that the acquisition of businesses appeared to be a critical strategy they employed to grow their business. In certain cases, the Staff also asked registrants to accurately describe how they define their "core" vis-à-vis their "non-core" activities. Registrants often employ a non-GAAP financial measure such as "core earnings" or "core revenues" to characterize 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 businesses.

- **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: adjusting non-GAAP pro rata balance sheets and income statements for the registrant's proportionate economic ownership of each asset in its portfolio that are not wholly owned by the registrant; presenting adjusted earnings and adjusted EBITDA by excluding step-up depreciation and amortization; 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; presenting Adjusted EBITDA excluding inventory revaluation; and presenting non-GAAP adjusted operating corporate costs and non-GAAP segment earnings that exclude normal, recurring, operating items such as certain pension costs, restructuring and other charges and gains.
- **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 is a non-GAAP financial measure and to consistently use titles for the financial measures that are clearly distinguishable from comparable GAAP titles. The Staff asked registrants to stop naming or labeling their non-GAAP financial measures with titles or descriptions that were the same as, or confusingly similar to, the GAAP financial measures. For example, the Staff asked registrants the following: (1) to retitle their non-GAAP financial measure "operating earnings" since it is confusingly similar to the terms "earnings from operations," "operating income," "operating earnings" and "profit from operations," which are terms used under U.S. 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 its non-GAAP financial measure "cash earnings per share" since such title could be erroneously read to imply that it is related to cash flows; and (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 U.S. GAAP. In certain instances, the Staff accepted the renaming of the non-GAAP financial measure by the simple addition of "(Non-GAAP)" in the caption or label of the financial measure in question.

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 believes that the presentation of non-GAAP financial measures provides useful information to investors regarding their 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 uses the non-GAAP financial measures, rather than just including boilerplate statements that the financial measures are 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 analyzing 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 characterization. In a number of comment letters, the Staff determined that non-GAAP financial measures characterized by registrants as performance measures were actually used by them as liquidity measures and, hence, should have been characterized 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.

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.

SEC Enforcement Division Action and Inquiries

Outside 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 fall 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.[1] 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.[2]

In addition, on September 8, 2016, the SEC charged the former chief financial officer and chief accounting officer of a publicly traded real estate investment trust for purposely inflating a key non-GAAP financial measure used by analysts and investors to assess the registrant.[3]

Effective Disclosure Controls, Audit Committee Involvement and Other Industry Initiatives

During 2016, senior members of the Staff emphasized that appropriate and effective disclosure controls and procedures on the use of non-GAAP financial measures should be considered and established by registrants.[4] Senior members of the Staff have continued to voice that same theme recently, particularly with respect to 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 American Institute of Certified Public Accountants ("AICPA") Conference in Washington, D.C., highlighted the important "critical gatekeeper" role audit committee members play in ensuring credible, reliable financial reporting, including compliance with the Updated C&DIs.[5] Mr. Bricker stated that audit committee members should seek to understand management's judgments in the design, preparation and presentation of non-GAAP financial measures and how those measures might differ from approaches followed by other registrants.[6] Mr. Bricker also highlighted that the oversight of management's activities is crucial for investor protection, that it is important for both auditors and audit committees to keep and maintain a direct and open line of communication, and that audit committees have an important role overseeing external auditors, as auditors are accountable to the board of directors through the audit committee and not to management.[7]

Similarly, the Center for Audit Quality ("CAQ"), a non-profit public policy organization affiliated with the AICPA, has issued suggested discussion questions for key stakeholder groups regarding the preparation and use of non-GAAP financial measures.[8] The CAQ identified these stakeholders as management, investors, investment analysts, securities counselors, audit committee members, internal auditors, independent auditors, regulators, accounting standard setters and academics.[9] 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 company and assessing how the non-GAAP financial measures are used by analysts and reported by the financial press to the broader public.[10] The sample discussion questions also aim to promote the transparency, consistency and comparability of non-GAAP financial measures and to assist audit committees determine whether management is complying with SEC rules and related interpretations with respect to non-GAAP financial measures.[11]

Conclusion

With the growing SEC focus on the use of non-GAAP financial measures, registrants should carefully revisit the updated SEC guidance and draw useful lessons from the recent comment letters issued by the Staff. While the use of non-GAAP financial measures can be an important tool for registrants to tell their own stories (*i.e.*, to convey information to investors that registrants believe to be relevant, meaningful and useful in understanding their financial performance, financial position or liquidity), registrants should be mindful that non-GAAP financial measures should merely supplement, and not substitute, GAAP financial measures. 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. Finally, establishing effective disclosure controls and procedures on the use of non-GAAP financial measures is essential and can be enhanced by increasing audit committee involvement and dialogue with other key stakeholders.

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Endnotes:

[1] *See SEC Enforcement Division Looking Closely at Non-GAAP Violations*, Wall Street Journal (Dec. 6, 2016), *available at*: http://blogs.wsj.com/cfo/2016/12/06/sec-enforcement-division-looking-closely-at-non-gaap-violations/ (hereinafter, "WSJ December 2016 Article"). *See also SEC Probes Whether Companies are Misusing Adjusted Earnings Metrics*, Wall Street Journal (Oct. 27, 2016), *available at*: http://www.wsj.com/articles/sec-probes-whether-companies-are-misusing-adjusted-earnings-metrics-1477577108.

[2] *Id.*

[3] *See* U.S. Securities and Exchange Commission, Press Release, *Executives Charged With Inflating Performance of Real Estate Investment Trust* (Sept. 8, 2016), *available at*: https://www.sec.gov/news/pressrelease/2016-180.html. *See also* WSJ December 2016 Article, *supra* note 1.

[4] *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. *See also* James V. Schnurr, Chief Accountant, U.S. Securities and Exchange Commission, *Remarks before the 12th Annual Life Sciences Accounting and Reporting Congress* (Mar. 22, 2016), *available at:* https://www.sec.gov/news/speech/schnurr-remarks-12th-life-sciences-accounting-congress.html.

[5] *See* Wesley R. Bricker, Chief Accountant, U.S. Securities and Exchange Commission, *Working Together to Advance High Quality Information in the Capital Markets* (Dec. 5, 2016), *available at*: https://www.sec.gov/news/speech/keynote-address-2016-aicpa-conference-working-together.html.

[6] *Id.*

[7] *Id.*

[8] *See* Center for Audit Quality, *Non-GAAP Financial Measures: Continuing the Conversation* (Dec. 5, 2016), *available at*: *http://thecaq.org/non-gaap-financial-measures-continuing-conversation* (hereinafter, "CAQ December 2016 Paper"). *See also* Center for Audit Quality, *Non-GAAP Measures: A Tool for Audit Committees* (June 28, 2016), *available at*: http://www.thecaq.org/questions-non-gaap-measures-tool-audit-committees (hereinafter, "CAQ June 2016 Paper").

[9] *See* CAQ December 2016 Paper, *supra* note 8, at 9.

[10] *See* CAQ December 2016 Paper, *supra* note 8, at 1.

[11] *See* CAQ June 2016 Paper, *supra* note 8, at 1.

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