The Tide Has Turned: The SEC’s Renewed Focus on Non-GAAP Financial Measures

For some time, the Securities and Exchange Commission, or SEC, took a noticeably hands-off approach toward the use of non-GAAP (generally accepted accounting principles) financial measures by public companies listed in the United States. However, recent developments have signaled a renewed focus on registrants’ use of non-GAAP financial measures. On May 17, 2016, the SEC released new and revised Compliance and Disclosure Interpretations clarifying guidance on the use of these financial measures. Chair Mary Jo White highlighted the SEC’s thinking on this topic in a December 2015 speech:

Another financial reporting topic of shared interest and current conversation is the use of non-GAAP measures. This area deserves close attention, both to make sure that our current rules are being followed and to ask whether they are sufficiently robust in light of current market practices. Non-GAAP measures are allowed in order to convey information to investors that the issuer believes is relevant and useful in understanding its performance. By some indications, such as analyst coverage and press commentary, non-GAAP measures are used extensively and, in some instances, may be a source of confusion.\(^1\)

These remarks, along with recent statements by Chief Accountant James Schnurr, are a warning sign to companies that the SEC will be “vigilant” in its reviews of non-GAAP financial measures.\(^2\) In fact, the use of non-GAAP financial measures has assumed a new position near the forefront of the SEC review and comment process this year, becoming the fourth-leading source of SEC staff comments in their review of annual and quarterly reports.\(^3\) As a result of these developments, companies should review their non-GAAP financial measures and related disclosure to ensure that any presentation of non-GAAP financial disclosure is compliant with the existing SEC regulatory framework and the new guidance.

What are Non-GAAP Financial Measures?

A non-GAAP financial measure, as defined by the SEC, is a numerical measure of a company’s historical or future financial performance, financial position, or cash flows that excludes amounts that are required to be included in the most directly comparable GAAP
financial measure or includes amounts that are excluded from the most directly comparable GAAP financial measure.⁴

Companies use non-GAAP financial measures to provide investors with information and views of performance and value that may not be evident on the face of GAAP financial measures. Some commonly used non-GAAP financial measures include: (i) earnings before interest and taxes, or EBIT; (ii) earnings before interest, taxes, depreciation, and amortization, or EBITDA; (iii) adjusted revenues; (iv) free cash flows; (v) core earnings; and (vi) funds from operations. When used and discussed appropriately, supplementing GAAP financial measures with non-GAAP financial measures can help companies provide a more meaningful picture of their performance and value.

What Is the Current Regulatory Framework and Environment for Non-GAAP Financial Measures?

Historically, the SEC has had varying levels of tolerance for non-GAAP financial measures. In the 1990s, technology companies benefitting from the “dot-com” boom used and relied heavily on non-GAAP financial measures. Then-Chairman Arthur Levitt’s critical commentary in 1998 on the practice of “earnings management” (which Chairman Levitt described as “earnings reports reflecting the desires of management rather than the underlying financial performance of the company”) was the first indication of the SEC’s concern about the use of these measures.⁵ In the following years, the SEC’s then-Chief Accountant warned of earnings releases that aimed at misleading investors by containing “everything but the bad stuff.”⁶ Later, in January 2002, the SEC brought its first enforcement action alleging the misleading use of non-GAAP financial information.⁷

Shortly thereafter, in 2003, the SEC adopted Regulation G and Item 10(e) of Regulation S-K as part of its directive under the Sarbanes-Oxley Act of 2002 to regulate the use of non-GAAP financial measures. Regulation G, which governs all public disclosures that contain non-GAAP financial measures, including press releases, investor presentations and conference calls, requires companies that publicly disclose non-GAAP financial measures to include:

- A presentation of the most directly comparable GAAP financial measure; and
- A quantitative reconciliation for historical and, to the extent available without unreasonable efforts, forward-looking non-GAAP financial measures presented of the differences between the non-GAAP financial measure disclosed or released with the most comparable GAAP financial measure.

In addition, Item 10(e), which governs all filings with the SEC under the Securities Act and the Exchange Act, requires that any such filing with non-GAAP financial measures must include:

- A statement disclosing the reasons why the company’s management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding its financial condition and results of operations; and
- To the extent material, a statement disclosing the additional purposes, if any, for which the company’s management uses the non-GAAP financial measure.

How Have the SEC’s New C&DIs Changed the Landscape?

In the new Compliance and Disclosure Interpretations (“C&DIs”), the SEC provides additional guidance on practices that may lead to misleading non-GAAP financial measures. Most notably, the SEC set forth specific examples of non-GAAP financial measures that are more prominent than their comparable GAAP financial measures in the SEC’s view (a violation of Item 10(e)). Some of the examples provided are considered a departure from past practices and may require companies to revise current filings.

Companies should avoid:

- Presenting a full income statement of non-GAAP financial measures;
- Presenting a non-GAAP financial measure using a style of presentation (e.g., bold, larger font) that emphasized the non-GAAP financial measure over the comparable GAAP financial measure; or
• Presenting a non-GAAP financial measure preceding the most directly comparable GAAP financial measure (including in an earnings release headline or caption).

What Can Companies Expect from the SEC's Enforcement Division?

The new focus on non-GAAP financial measures is largely and appropriately centered in the Division of Corporation Finance, or DCF. The main question to consider is at what point might focus on non-GAAP financial measures become more than a comment letter campaign and become an area of interest to the Division of Enforcement. Historically, there has been very little enforcement activity when it comes to non-GAAP financial measures. However, when the Division of Enforcement’s Financial Reporting and Audit Group was created in 2013, the use of non-GAAP financial measures was mentioned as a possible area of scrutiny. Two areas that the Division of Enforcement may consider are companies’ (i) use of misleading non-GAAP financial measures and (ii) internal controls around the calculation of non-GAAP financial measures.

The first area of interest is one that companies should expect: If they are accused of misleading investors through GAAP or non-GAAP financial measures, the SEC will be interested. In the few SEC enforcement actions involving non-GAAP financial measures, the central allegation was that the companies misled investors about what was included in their earnings. The first enforcement action alleging the misleading use of non-GAAP financial measures centered on a quarterly earnings release that was deemed materially misleading because it expressly stated that the net income figure excluded a one-time charge, which arguably implied that no other significant one-time items were included, when in fact the stated net income included an undisclosed one-time gain of $17.2 million. The first and only Regulation G action filed by the SEC arose in the context of an options backdating case and alleged that the issuer also represented that its “non-GAAP earnings results excluded certain non-recurring expenses, when, in fact, [it] had misclassified and excluded a significant amount of recurring, operating expenses from its non-GAAP earnings results, in order to meet or exceed quarterly EPS targets.”

What Should Companies Do in Light of the Recent Attention on Non-GAAP Financial Information?

• Management and audit committees should review existing non-GAAP financial measures and disclosure in consultation with outside counsel. Companies should have the appropriate processes in place to ensure that non-GAAP financial measures comply with SEC rules, provide an adequate picture of the company’s business, and provide a useful tool to investors.

• Clearly describe why the non-GAAP financial measure is being used, and how it provides investors with useful information. The SEC, through its guidance and interpretations, has made clear that boilerplate language will no longer be sufficient.

• Ensure that non-GAAP financial measures receive no greater prominence than GAAP financial measures. Companies should pay particular attention to non-GAAP financial information used in bullet points or headlines in earnings releases or discussed in detail on earnings calls.

• When providing non-GAAP financial measures on a per-share basis, ensure that the information provided relates to performance measures. The SEC does not allow non-GAAP financial liquidity measures that are presented on a per-share basis.

• Avoid inconsistencies in the presentation of non-GAAP financial measures from period to period. Any changes to non-GAAP financial measures will receive increased scrutiny from the SEC, and appropriate changes should include extensive disclosure on the purpose and utility of the change.

• Avoid the asymmetrical inclusion of revenue or gains without similarly including charges for the non-GAAP financial measure.
Four Things to Avoid

• Presenting non-GAAP liquidity measures that measure cash on a per-share basis in SEC filings;
• Non-GAAP financial measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP;
• An earnings release headline including a non-GAAP financial measure but excluding its comparable GAAP financial measure; and
• Stating a charge or gain is nonrecurring, infrequent, or unusual unless it meets the specified criteria.

Endnotes

4 Regulation G, Rule 101(a).
6 See Lynn E. Turner, Remarks to the 39th Annual Corporate Counsel Institute (October 12, 2000).
9 See Mary Jo White, Keynote Address at the 2015 AICPA National Conference: “Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility” (Dec. 9, 2015) (“Are your explanations of how you are using the non-GAAP measures—and why they are useful for your investors—accurate and complete, drafted without boilerplate? Are there appropriate controls over the calculation of non-GAAP measures?”).
13 See “SEC Charges Company and Executives for Faulty Evaluations of Internal Controls” (Mar. 10, 2016) (internal controls over financial reporting); “SEC Announces Financial Fraud Cases” (Apr. 19, 2016) (announcing two settled matters involving alleged controls failures).