No. 2016-23
10 October 2016

Technical Line

A closer look at the SEC staff's scrutiny of non-GAAP financial measures

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What you need to know

- The SEC staff is continuing to focus on whether companies' use of non-GAAP financial measures in earnings releases complies with the more explicit guidance the staff issued in May 2016.
- The SEC staff is currently reviewing and commenting on companies' use of non-GAAP measures in second-quarter earnings releases, which should provide more information about how the staff will apply the interpretations.
- Companies should challenge their disclosures of non-GAAP measures and monitor developments in SEC staff views and comments.
- Companies should involve the audit committee in discussions about their non-GAAP measures and strengthening disclosure controls and procedures related to those disclosures.

Overview

In the nearly six months since the Securities and Exchange Commission (SEC) staff updated its Compliance and Disclosure Interpretations (C&DIs) on non-GAAP financial measures, the staff has focused on compliance with that guidance in its reviews of earnings releases and SEC filings. The staff is currently performing reviews of second-quarter earnings releases, and the related SEC staff comment letters should provide more information about how the staff will apply the updated C&DIs.

In some cases, the staff is looking at earnings releases of companies that it had already reviewed this year and is challenging measures and presentations that it didn't previously question.

Building a better working world

As we previously reported,[1] the updated C&DIs describe in detail non-GAAP financial measures that the staff believes would be misleading and would therefore violate applicable SEC rules. The clear message is that companies need to reevaluate their use and presentation of non-GAAP financial measures. In response to the updated C&DIs and comments from SEC officials, many companies changed the format of their earnings releases and filings in the second quarter to present GAAP figures more prominently than non-GAAP measures, and a number of them began developing and implementing more robust disclosure controls and procedures.

The Financial Accounting Standards Advisory Council, which advises the Financial Accounting Standards Board, and the Standing Advisory Group, which advises the Public Company Accounting Oversight Board, have also been discussing whether additional standard setting and auditor involvement is needed with respect to non-GAAP measures.

This publication discusses the SEC staff's main areas of focus in comment letters seeking compliance with the updated C&DIs, changes companies have made to their disclosures and challenges companies are encountering with their non-GAAP disclosures.

Staff focus areas and changes companies are making

Prominence of non-GAAP measures

The SEC staff's views on prominence were clarified in the C&DIs. As a result, many companies revised their non-GAAP disclosures in recent earnings releases and SEC filings to comply with the C&DIs. Based on our review, the most common request from the staff has been that companies reorganize their disclosures so that non-GAAP measures are not shown with greater prominence than the corresponding GAAP measures.

Example comment: Prominence
We note that you present non-GAAP measures in the headline of your press release without also presenting GAAP with equal or greater prominence, as required by Item 10(e)(1)(i)(A) of Regulation S-K. Your presentations appear to give greater prominence to the non-GAAP measures than to the comparable GAAP measures, which is inconsistent with the updated Compliance and Disclosure Interpretations. Please review this guidance when preparing your next earnings release.

While this may seem like a straightforward rule to follow, some companies with extensive non-GAAP disclosures have struggled to comply. For example, in addition to presenting non-GAAP measures in bulleted highlights in earnings releases, those companies often disclosed non-GAAP measures before GAAP measures, used a bold font for non-GAAP measures and put more emphasis on non-GAAP measures throughout the release. These practices have required some companies to substantially overhaul their earnings releases to comply with the updated C&DIs. In some cases, companies have chosen to discontinue disclosure of some non-GAAP measures.

Some companies also struggled with the requirement to reconcile any forward-looking non-GAAP disclosures with GAAP measures. While the reconciliation of forecasted guidance is clearly required by Item 10(e) of Regulation S-K, the rule provides an exception that allows companies to omit a reconciliation if it would require "unreasonable efforts" to prepare. The C&DIs challenge how frequently companies can rely on that exception, which applies in limited cases such as when a significant reconciling item is difficult to predict. One example might be the change in the fair value of a derivative that is not a designated hedge. If a company does not provide the reconciliation in reliance on the exception, it must disclose that fact and explain what information is unavailable and how it might affect the GAAP measure.

Example comment: Non-GAAP forecasts
In future filings, when presenting a forecasted non-GAAP financial measure, please provide a reconciliation of that measure to the most directly comparable GAAP financial measure. If you omit the information due to unreasonable efforts, please provide the required disclosures.

Appropriateness of adjustments and disclosures

The updated C&DIs also provide guidance on measures the staff would consider misleading or inappropriate under Regulation G. These include applying "individually tailored" accounting principles or adjusting performance measures to remove normal cash operating expenses.

Example comments: Tailored accounting principles
It appears you adjust a GAAP measure to accelerate the recognition of revenue in your presentation of gross operating margin, which may be inconsistent with the updated non-GAAP Compliance and Disclosure Interpretations. Please review this guidance and explain to us whether and how it will impact your disclosures in future filings.

The updated C&DIs clearly state that non-GAAP performance measures that accelerate revenue recognition are unacceptable, and many companies changed their measures to comply. However, the C&DIs don't explain what other types of adjustments the staff would consider to be "tailored" accounting principles.

The reconciliation of forecasted guidance is clearly required by Item 10(e) of Regulation S-K.

The SEC staff recently said that it will object to non-GAAP measures calculated based on proportionate consolidation when those measures don't follow the applicable GAAP consolidation principles. The staff has objected to non-GAAP measures that combine unconsolidated and consolidated interests (or removing the non-controlling interest holders' share of consolidated amounts) on the basis that such presentations can be misleading. Such measures are common in the real estate industry, among others.

The SEC staff has said it will not object to companies disclosing the various components of measures that otherwise are prohibited because they use tailored accounting principles. That is, a company could disclose the components of such measures as key performance indicators (i.e., operating statistics) or GAAP financial measures. For example, to help investors calculate a revenue metric that removes the effect of deferred revenue and rebates, a company could provide information about bookings and disclose components of GAAP revenue such as rebates, discounts and the change in deferred revenue, among others.

The SEC staff has said that it would not object if companies that have been presenting non-GAAP measures calculated using proportionate consolidation separately present financial statement line item information applicable to each type of interest (i.e., controlling and non-controlling). Analysts could then calculate alternative measures that are relevant to them (e.g., deduct the non-controlling interest share from the consolidated balances and add the proportionate share of any unconsolidated interests).

Excluding normal recurring cash operating expenses

The staff is issuing more comments on non-GAAP performance measures that exclude recurring cash operating expenses (e.g., those that add back restructuring charges, acquisition costs, litigation expenses, store opening expenses and elements of pension costs). The updated C&DIs state that excluding recurring expenses could be considered misleading because these items are routine and related to activities that drive profitability. Companies should consider why they are making such adjustments to their non-GAAP performance measures and whether those measures reflect the company's operating performance. To date, we have not seen the SEC staff challenge adjustments to non-GAAP performance measures that eliminate stock-based compensation, because such amounts are noncash.

Example comment: Excluding recurring cash operating expenses
You disclosed a non-GAAP financial measure, Adjusted Operating Income, which excludes various compensation, restructuring and acquisition charges from net income. Please explain, in greater detail, the nature of the excluded charges in the calculation of the non-GAAP financial measure and tell us whether these charges are recurring and/or cash expenses and how they are in line with the updated Compliance and Disclosure Interpretations.

Other considerations

Strengthening disclosure controls and procedures

SEC Chair Mary Jo White has said that companies should implement controls over their preparation and disclosure of non-GAAP measures. When disclosed in SEC filings, non-GAAP measures and the related reconciliations and disclosures fall under a company's disclosure controls and procedures that require certification by the Chief Executive Officer and Chief Financial Officer. Common types of disclosure controls implemented by companies include establishing policies that clearly describe the adjustments made to calculate a non-GAAP measure, establishing a process for changing how a non-GAAP financial measure is calculated (including reviewing non-GAAP adjustments for compliance with the SEC rules and staff interpretations) and enhancing audit committee oversight of the company's disclosure of non-GAAP financial measures.

Applying the non-GAAP rules and regulations

One of the common challenges companies encounter involves which rules apply to which forms of communication (i.e., earnings releases, filings required by the Securities Act or the Securities Exchange Act, earnings calls, investor presentations and other forms of communication with investors).

For example, the rules on the prominence of non-GAAP measures appear in Item 10(e) of Regulation S-K, which applies to all documents filed with the SEC and earnings releases furnished under Item 2.02 of Form 8-K (including supplemental information included or incorporated into such filings). The prominence rules do not apply to other communications such as investor presentations or information a company posts on its website or presents in an earnings call. Therefore, the prominence rules technically do not apply to these other forms of communication. Nevertheless, companies should still consider whether the nature of non-GAAP measures, or the manner of their presentation, is misleading. We encourage companies to consult with their securities counsel on such questions.

Regulation G prohibits misleading uses of non-GAAP measures in all communications by registrants. Regulation G also requires a reconciliation to the most comparable GAAP measure for non-GAAP measures used in all communications.

Presenting changes to non-GAAP disclosures

The SEC staff has said that changing a non-GAAP measure from period to period could be misleading. Companies that are changing their measures to comply with the updated staff interpretations should provide clear and transparent communication to explain the change, why it was made and how the new measure provides useful information. For example, a company might reconcile a revised measure to the one it previously presented in addition to recasting the previously presented measure to reflect the new calculation.

If a company changes how it calculates a non-GAAP measure to comply with the staff guidance, the staff has said it won't object if the company presents the inappropriate measure for one additional period to explain the change to investors.

What's next?

In the coming months, we expect the SEC staff to continue its focus on non-GAAP disclosures through its comment letter process. We also expect senior officials to continue to discuss the topic. Chair White said in a recent speech that enforcement actions and rulemaking were also possible.[2]

Endnotes:

[1] Our publication To the Point, *SEC staff updates guidance on non-GAAP financial measures* discusses the staff's updated interpretations issued in May 2016. For additional information on non-GAAP rules also refer to our Technical Line, *Spotlight on non-GAAP financial measures*.

[2] Keynote Address, International Corporate Governance Network Annual Conference: Focusing the Lens of Disclosure to Set the Path Forward on Board Diversity, Non-GAAP, and Sustainability https://www.sec.gov/news/speech/chair-white-icgn-speech.html.