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Heads Up

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A Chance to Self-Correct

SEC Urges Companies to Take a Fresh Look at Their Non-GAAP Measures

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Background

Last week, the SEC updated its C&DIs[1] on non-GAAP measures in response to its increasing concerns that such measures may be misleading, more prominent than comparable GAAP measures, or inconsistently presented from period to period. The C&DIs do not prohibit companies from using non-GAAP measures that comply with the SEC's existing rules.[2] However, the SEC staff's tone in the C&DIs is intentionally forceful in an effort to "send a message," as stated by Chief Accountant Mark Kronforst in the SEC's Division of Corporation Finance (the "Division") at the May 18 meeting of the PCAOB's Standing Advisory Group (SAG). In his discussion of the SEC's concerns about non-GAAP measures, Mr. Kronforst announced that "this next quarter will be a great opportunity for companies to self-correct."

The months leading up to the updated C&DIs' release have been marked by an explosion of press coverage and SEC scrutiny of non-GAAP measures in reaction to the increased use of these measures as well as the progressively larger difference between the amounts reported for GAAP and non-GAAP measures. For example, a study published by FactSet determined that for 2015, 67 percent of the companies in the Dow Jones Industrial Average reported non-GAAP earnings per share and, on average, that the difference between the GAAP and non-GAAP earnings per share for these companies was approximately 30 percent, representing a significant increase from approximately 12 percent in 2014.

SEC officials have commented on the sharp rise in the use of non-GAAP measures. In a speech delivered in March of this year, SEC Chief Accountant James Schnurr noted that the "SEC staff has observed a significant and, in some respects, troubling increase . . . in the use of, and nature of adjustments within, non-GAAP measures" as well as their prominence. He further noted that non-GAAP measures are intended to "supplement . . . not supplant" the information in the financial statements. In April and May, Mr. Kronforst and Wesley Bricker, a deputy chief accountant in the SEC's Office of the Chief Accountant, highlighted additional concerns about non-GAAP measures.[3] Their comments focused

[1] Compliance and Disclosure Interpretations (C&DIs) are not rules, regulations, or statements of the SEC; instead, they provide general guidance on the views of the SEC staff on a variety of issues. The C&DIs are available on the SEC's Web site.

[2] See Regulation G and Regulation S-K, Item 10(e). For a summary of the disclosure requirements and rule prohibitions related to non-GAAP measures, see Appendix B of this *Heads Up*.

[3] See the transcript of Mr. Bricker's remarks at the 2016 Baruch College Financial Reporting Conference on May 5, 2016. His comments were consistent with those of Mr. Kronforst at the Baruch College conference and the Garrett Corporate and Securities Law Institute held at Northwestern University's Pritzker School of Law on April 28, 2016.

primarily on the use of individually tailored accounting principles to calculate non-GAAP earnings, such as those used in certain adjusted revenue measures; non-GAAP per-share performance measures that appear to be liquidity measures; and the tax treatment of non-GAAP adjustments.

As reflected in its reviews and comment letters, speeches, and updated C&DIs, the SEC is urging companies to take a fresh look at their use of non-GAAP measures in earnings releases and periodic reports.

Current Areas of Focus and Concern

The C&DIs provide guidance on the following questions related to non-GAAP measures:

- What is misleading or prohibited?
    - *Misleading adjustments* — Several new C&DIs[4] provide examples of non-GAAP measures that could mislead investors, including those that:
        - Exclude normal, recurring cash operating expenses necessary for business operation.
        - Adjust an item in the current reporting period but do not adjust for a similar item in the prior period, without appropriate disclosure about the change and an explanation for the reasons for the change.
        - Exclude certain nonrecurring charges but do not exclude nonrecurring gains (i.e., "cherry-picking" non-GAAP adjustments in a non-GAAP measure to achieve the most positive measure).
        - Are based on individually tailored accounting principles, including certain adjusted revenue measures.

      In C&DI 100.04, the SEC staff provides an example of a prohibited non-GAAP performance measure that reflects revenue that is recognized over the service period under GAAP on an accelerated basis as if the registrant earned revenue when it billed its customers. The measure is prohibited because it is an individually tailored accounting principle and does not reflect the registrant's required GAAP measurement method. While the example is about revenue recognition, the C&DI indicates that individually tailored accounting principles applied to other financial statement line items to create a non-GAAP measure may also be prohibited.

      Editor's Note: Under ASC 280,[5] a company may present segment measures, including segment-adjusted revenues or segment profit, on a basis that is consistent with the manner in which the company is managed but different from the basis presented in its consolidated financial statements prepared in accordance with GAAP. While such segment measures are not considered non-GAAP financial measures if they are presented in accordance with ASC 280,[6] the SEC staff may object to their presentation or discussion on a **consolidated** basis when they are based on individually tailored accounting principles.

    - *Per-share non-GAAP measures* — Registrants must assess whether a non-GAAP measure is (1) a performance measure that is different from and reconciled to net income or loss or (2) a measure of liquidity that is different from and reconciled to cash flow from operations. This determination is important because cash-flow or liquidity per-share measures are prohibited. Historically, the SEC staff has generally accepted management's determination of whether a measure is a performance measure or liquidity measure. However, as indicated in C&DI 102.05, as revised, the SEC staff may challenge measures designated as performance measures that appear to be more like liquidity measures. If they are ultimately determined to be liquidity measures, the SEC would prohibit per-share

[4] See C&DIs 100.01 through 100.04.

[5] FASB Accounting Standards Codification Topic 280, *Segment Reporting*.

[6] See C&DI 104.01.

amounts (e.g., free cash flow is a liquidity measure and therefore per share presentation is expressly prohibited).[7] In addition, C&DI 103.02 notes that EBIT[8] or EBITDA[9] should not be presented on a per-share basis.

- When is the disclosure of a non-GAAP measure more prominent than that of a GAAP measure?

  A registrant that presents a non-GAAP measure is required to present the most directly comparable GAAP measure with equal or greater prominence. C&DI 102.10 provides examples illustrating when the presentation of non-GAAP measures may not meet this requirement and thus might be subject to SEC scrutiny. It states, in part:

  > Although whether a non-GAAP measure is more prominent than the comparable GAAP measure generally depends on the facts and circumstances in which the disclosure is made, the staff would consider the following examples of disclosure of non-GAAP measures as more prominent:
  >
  > - Presenting a full income statement of non-GAAP measures or presenting a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures;
  > - Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures;
  > - Presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure;
  > - A non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption);
  > - Describing a non-GAAP measure as, for example, "record performance" or "exceptional" without at least an equally prominent descriptive characterization of the comparable GAAP measure;
  > - Providing tabular disclosure of non-GAAP financial measures without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table;
  > - Excluding a quantitative reconciliation with respect to a forward-looking non-GAAP measure in reliance on the "unreasonable efforts" exception in Item 10(e)(1)(i)(B) without disclosing that fact and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence; and
  > - Providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence.

- How should a registrant present income tax effects for a non-GAAP measure?

  When calculating a non-GAAP measure, a registrant should be mindful of the impact that adjustments made to a GAAP measure have on income tax expense. Adjusting revenue or income before tax could affect the tax expense or benefits assumed in the calculation of the tax provision. C&DI 102.11 provides new guidance on the consideration of the tax impact of the adjustment. If a non-GAAP measure is a liquidity measure, it may be acceptable to adjust the GAAP tax amount to present taxes paid in cash. If the measure is a performance measure, registrants "should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability" and should not present adjustments net of tax. They should present an adjustment for income taxes separately and disclose how the adjustment was determined.

- What about funds from operations (FFO)?

  FFO is a non-GAAP measure commonly used in the real estate industry. C&DIs 102.01 and 102.02 indicate that FFO, as defined by the National Association of Real Estate Investment Trusts (NAREIT) and in effect as of May 17, 2016, as well as FFO per share will continue to be accepted as performance measures. If a registrant makes adjustments to FFO to arrive at a measure of adjusted FFO, such adjustments must comply with the non-GAAP requirements

[7] See also C&DI 102.07.
[8] Earnings before interest and taxes.
[9] Earnings before interest, taxes, depreciation, and amortization.

for a performance measure or a liquidity measure. If adjusted FFO is, in substance, a liquidity measure, presentation on a per-share basis is prohibited.

Looking Forward

The FASB, IASB, and PCAOB are also taking a hard look at non-GAAP measures. In an April 7, 2016, video interview at REITWise 2016,[10] FASB Chairman Russell Golden spoke about the Board's research efforts related to the increase in non-GAAP reporting. He indicated that the research is expected to result in the FASB's issuance this summer of an agenda consultation paper that will discuss potential improvements to, and may involve new types of metrics in, the statements of income and cash flow.[11] On May 11, 2016, IASB Chairman Hans Hoogervorst spoke about non-GAAP measures and performance reporting at the Annual Conference of the European Accounting Association. He noted that the popularity of non-GAAP measures may be due in part to a lack of guidance that explicitly defines subtotals in the income statement and common measures such as EBIT and that opportunities therefore exist for the IASB to provide additional guidance. Further, the SAG discussed the auditor's role regarding non-GAAP measures at its May 18–19, 2016, meeting.[12]

The SEC will continue its vigilance in monitoring non-GAAP measures, with particular emphasis on misleading measures and prominence. The number of comments issued by the Division on these measures is expected to increase,[13] and new comments should be posted to the SEC's EDGAR database soon.[14]

Additional SEC comments are also expected on the usefulness of measures. If a company cannot justify why a non-GAAP measure is an appropriate way to measure a company's performance and how it is useful to investors, the SEC may object to the measure. A non-GAAP measure's usefulness to analysts cannot be the only support for presenting the measure, and justification for the measure must be substantive and specific to the company.

Given the SEC staff's remarks urging registrants to self-correct in the next quarter, now is the time for companies to take a fresh look at their use of non-GAAP measures. While the plea for registrants to self-correct may be an effort by the SEC to forestall time-consuming rulemaking in light of its other high priorities, the Commission may consider whether rulemaking is necessary if such self-correction does not occur.

As companies prepare earnings releases and periodic filings for the next quarter of 2016 and future reporting periods, they should consider the questions in Appendix A, as well as the summary of the disclosure requirements and rule prohibitions related to non-GAAP measures in Appendix B, to ensure that their non-GAAP measures reflect the guidance in the C&DIs and recent SEC remarks.

A new Deloitte Roadmap publication on non-GAAP financial measures is currently in development and is expected to be issued in the summer of 2016.

[10] NAREIT's Law, Accounting & Finance Conference.

[11] The agenda consultation paper is expected to include discussions of several topics, including financial performance, which will explore income statement format, cash flow, and non-GAAP measures.

[12] Watch for Deloitte's upcoming coverage of the SAG meeting.

[13] See Deloitte's *SEC Comment Letters — Including Industry Insights: What "Edgar" Told Us* for a more detailed discussion of trends identified in the SEC staff's comment letters on non-GAAP measures.

[14] The SEC's EDGAR database provides free public access to company filings, including the Commission's comment letters and responses from registrants.

Appendix A — Non-GAAP Measures: What to Ask

As a company prepares earnings releases and periodic filings, it should consider the following questions about using a non-GAAP measure:

1. Is the measure neither misleading nor prohibited?
2. Is the measure presented with the most directly comparable GAAP measure and with no greater prominence than the GAAP measure?
3. Is the measure appropriately defined and described, and clearly labeled as non-GAAP?
4. Does the reconciliation between the GAAP and non-GAAP measure clearly label and describe the nature of each adjustment, and is each adjustment appropriate?
5. Is there transparent and company-specific disclosure of the substantive reason(s) why management believes that the measure is useful for investors and the purpose for which management uses the measure?
6. Is the measure consistently prepared from period to period in accordance with a defined policy, and is it comparable to that of the company's peers?
7. Is the measure balanced (i.e., it adjusts not only for nonrecurring expenses but also for nonrecurring gains)?
8. Does the measure appropriately focus on material adjustments and not include immaterial adjustments that would not seem to be a focus of management?
9. Do the disclosure controls and procedures address non-GAAP measures?
10. Is the audit committee involved in the oversight of the preparation and use of non-GAAP measures?

Appendix B — Non-GAAP Measures: Summary of Disclosure Requirements and Prohibitions Applicable to Domestic[15] Registrants

Disclosure Requirements/Prohibitions	All Disclosure of Non-GAAP Financial Measures (Regulation G[16,17])	SEC Filings (Regulation S-K, Item 10[18,19])	Press Releases Furnished to the SEC (Form 8-K, Item 2.02[20])
Presentation requirements:			
• Presentation of the most directly comparable GAAP financial measure	X		
• Presentation, **with equal or greater prominence**, of the most directly comparable GAAP financial measure		X	X
• Quantitative reconciliation of the non-GAAP financial measure to the most directly comparable GAAP financial measure	X	X	X
• Statement disclosing the reasons why management believes the non-GAAP financial measure provides useful information to investors		X	X
• To the extent material, a statement disclosing the additional purposes for which management uses the non-GAAP financial measure		X	X
Prohibitions on certain presentations of non-GAAP financial measures:[21]			
• Material misstatements or omissions that would make the presentation of the non-GAAP financial measure misleading[22]	X	X	X
• Presenting per-share measures of liquidity[23]		X	X
• Excluding charges or liabilities that require, or will require, cash settlement, or would have required cash settlement in the absence of an ability to settle in another manner, from non-GAAP liquidity measures (other than EBIT and EBITDA)		X	
• Adjusting a non-GAAP performance measure to 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 prior two years (prohibition is based on the description of the charge or gain that is being adjusted)		X	
• Presenting non-GAAP financial measures on the face of the GAAP financial statements or in the accompanying notes		X	
• Presenting non-GAAP financial measures on the face of any pro forma financial statements required to be disclosed by Regulation S- X, Article 11		X	
• Using 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		X	

15 For guidance applicable to foreign private issuers, see Regulation G; Regulation S-K, Item 10(e); Section 106 of the C&DIs; and Section 8140 of the Division's Financial Reporting Manual.

16 Regulation G applies whenever a registrant, or person acting on its behalf, publicly discloses or releases material information that includes a non-GAAP financial measure, whether that information is furnished to, or filed with, the SEC.

17 In certain situations, the requirements of Regulation G and Regulation S-K, Item 10(e), do not apply. For example, these rules do not apply to non-GAAP measures related to a proposed business combination or measures required to be disclosed by a governmental authority. See Regulation G and Item 10(e) for additional information.

18 Regulation S-K, Item 10, applies to all SEC filings that include non-GAAP financial measures.

19 See footnote 17.

20 Form 8-K, Item 2.02, requires registrants to furnish to the SEC all releases or announcements disclosing material nonpublic financial information about completed annual or quarterly fiscal periods, regardless of whether the release or announcement includes disclosure of a non-GAAP financial measure. If a registrant elects to file the release or announcement with the SEC, such disclosure is subject to the requirements of Regulation S-K, Item 10.

21 Although Form 8-K, Item 2.02, does not refer to the prohibitions in Regulation S-K, Item 10(e)(1)(ii), registrants should consider the concepts in these prohibitions when using non-GAAP measures in a furnished press release.

22 See Regulation G, Rule 100(b), and Section 100 of the C&DIs.

23 Footnote 11 of SEC Rule Release 33-8176, *Conditions for the Use of non-GAAP Measures*, notes that certain non-GAAP per-share measures are prohibited under GAAP and SEC rules.

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