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Heads Up

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Top 10 Questions to Ask When Using a Non-GAAP Measure

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Background

Recently, press coverage and SEC scrutiny of non-GAAP measures have exploded. The intense focus on these measures results from their increased use and prominence, the nature of the adjustments, and the progressively large 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 this sharp rise in the use of non-GAAP measures. In a recent speech, 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. His remarks build on recent comments by SEC Chair Mary Jo White at the U.S. Chamber of Commerce 2016 Capital Markets Summit, where she indicated that the use of non-GAAP measures is "something we are really looking at — whether we need to actually rein that in a bit even by regulation."

The rise in the number of comments issued to companies as part of the review process by the SEC's Division of Corporation Finance (the "Division") corresponds to the increase in the use of non-GAAP measures. The Division's recent comment letters have particularly focused on the use of non-GAAP measures in press releases. In many instances, the Division has asked companies to make sure that non-GAAP measures are not more prominent than GAAP measures. 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.

Although non-GAAP measures can be meaningful and provide valuable information about what is important to management, the SEC is concerned that the measures may be confusing to investors and analysts. By studying information it obtains from the Division's review process, the SEC may be trying to ascertain whether companies have gone overboard in their use of non-GAAP measures and whether more regulation in this area may be necessary. Although additional rulemaking may not be imminent given the SEC's other priorities, companies can expect the Division to continue to vigorously comment and focus on non-GAAP measures.

For a summary of the disclosure requirements and rule prohibitions related to non-GAAP measures, see the appendix of this *Heads Up*.

What to Ask

As companies prepare earnings releases and periodic filings for first-quarter 2016 and future reporting periods, management should consider the following questions when using a non-GAAP measure:

1. Is the measure misleading or prohibited?

> **Editor's Note:** While such instances have been infrequent, the SEC has objected to the use of non-GAAP measures when they are potentially misleading. For example, in one comment letter, the SEC objected to a non-GAAP measure that excluded certain marketing expenses that were considered normal recurring operating cash expenditures.

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?

> **Editor's Note:** Mr. Schnurr indicated in his speech that companies should question "why, in contrast to the GAAP measure, the non-GAAP measure is an appropriate way to measure the company's performance and is useful to investors."

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?

> 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.

Appendix — Non-GAAP Measures: Summary of Disclosure Requirements and Prohibitions Applicable to Domestic[1] Registrants

Disclosure Requirements/Prohibitions	All Disclosure of Non-GAAP Financial Measures (Regulation G[2,3])	SEC Filings (Regulation S-K, Item 10[4,5])	Press Releases Furnished to the SEC (Form 8-K, Item 2.02[6])
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
No material misstatements or omissions that would make the presentation of the non-GAAP financial measure misleading	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:[7]			
• Presenting per-share measures of liquidity		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[8] and EBITDA[9])		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 Article 11 of Regulation S- X		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	

1 For guidance applicable to foreign private issuers, see Regulation G; Regulation S-K, Item 10(e); Section 106 of the Compliance and Disclosure Interpretations; and Section 8140 of the Division's Financial Reporting Manual.
2 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.
3 In certain situations, the requirements of Regulation G and 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.
4 Regulation S-K, Item 10, applies to all SEC filings that include non-GAAP financial measures.
5 See footnote 3.
6 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.
7 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.
8 Earnings before interest and taxes.
9 Earnings before interest, taxes, depreciation, and amortization.

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