CONTRIBUTED CONTENT & PRESENTATIONS

Re-evaluating Your Company's Use and Presentation of Non-GAAP Financial Measures

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At a Glance:

In May, the Securities and Exchange Commission (the "SEC") added twelve new Compliance and Disclosure Interpretations ("C&DIs") on the use of non-GAAP ("Generally Accepted Accounting Principles") financial measures to its existing body of guidance. This guidance follows recent concern from the SEC that companies may be abusing non-GAAP financial measures. The SEC fears that aggressive use of non-GAAP financial measures misleads and confuses investors. In particular, the guidance focuses on companies putting emphasis on and giving more prominence to non-GAAP figures without giving the same emphasis and prominence to the accompanying disclosure of GAAP figures required by the existing non-GAAP disclosure rules.

Our Take:

What does this mean for your company?The SEC will focus its attention on the use of non-GAAP financial measures and target use that it considers improper under the new guidance. We encourage companies to re-evaluate their use and presentation of non-GAAP financial measures in their filed documents, in their press releases, on their websites, and in any other public disclosure of financial information.

Background:

The SEC's current non-GAAP disclosure rules-Regulation G and Item 10(e) of Regulation S-K-require companies using non-GAAP measures to disclose that the measure is non-GAAP, to provide the most directly comparable GAAP measure, and to reconcile the non-GAAP measure with the comparable GAAP measure. The twelve new C&DIs interpret these two regulations and provide greater clarity about what the SEC considers permissible use of non-GAAP measures. For all of the C&DIs on non-GAAP financial measures, including those summarized in this update, see the SEC's website.

What's New?

The new guidance focuses on:

- Prominence of/emphasis on non-GAAP measures
- Misleading non-GAAP financial measures
- Improper inclusion of revenue in non-GAAP financial measures

- Exclusion of charges/expenses in non-GAAP financial measures
- Use of non-GAAP per share performance measures
- Measure of “free cash flow”
- Income tax effects on non-GAAP measures
- Reconciliation of reported Earnings Before Interest, Taxes, Depreciation and Amortization (“EBITDA”)

EXAMPLES OF IMPROPER USE OF NON-GAAP MEASURES

Companies must be sure to assess whether their disclosures give greater prominence to non-GAAP measures. The current non-GAAP disclosure rules require a company to present a GAAP measure with prominence equal to or greater than the prominence of the non-GAAP measure. In other words, a non-GAAP measure should not be given more significance or greater emphasis than a GAAP measure in disclosures. When is a non-GAAP measure more prominent? The SEC stated generally that whether the non-GAAP measure is more prominent than the GAAP measure will depend on the facts and circumstances in which the disclosure is made. Helpfully, the staff followed this broad statement with specific examples of undue prominence in the use of non-GAAP measures. Examples of when a non-GAAP measure is more prominent than a GAAP measure include:

- using a non-GAAP measure in an earnings release headline or caption but omitting the comparable GAAP measure;
- presenting the non-GAAP measure in a style (i.e., bold, larger font) that emphasizes the non-GAAP measure over the GAAP measure;
- placing the non-GAAP measure before the most directly comparable GAAP measure;
- describing a non-GAAP measure as “record performance” or “exceptional” without an equally prominent description of the comparable GAAP measurement;
- providing a tabular disclosure (i.e. a chart) of non-GAAP financial measures without providing an equally prominent tabular disclosure of GAAP measures before it or including the comparable GAAP measures in the same table; and
- providing discussion and analysis of a non-GAAP measure without similar discussion and analysis of the comparable GAAP measure in a location with greater or equal prominence.

NON-GAAP MEASURES CONSIDERED TO BE MISLEADING

Even if an adjustment is not explicitly prohibited, the SEC may still consider the non-GAAP measure misleading. The C&DIs include various situations in which the SEC would consider non-GAAP measures misleading. These circumstances include:

- presenting a performance measure that excludes normal, recurring cash operating expenses necessary to operate the business;

- presenting a non-GAAP measure inconsistently between periods;
- presenting a non-GAAP measure that uses revenue recognition and measurement methods that are not in accordance with GAAP, such as accelerating revenue; and
- excluding charges, but not gains, from a non-GAAP measure.

MISUSE OF NON-GAAP PER SHARE PERFORMANCE MEASURES

In the C&DIs, the SEC acknowledges that certain non-GAAP per share performance measures may be meaningful to a company from an operating standpoint. Accordingly, a non-GAAP per share performance measure can be presented as long as it is reconciled with GAAP earnings per share. However, in documents furnished or filed with the SEC, a company may not present non-GAAP liquidity measures that measure cash generated. Whether the SEC prohibits the per share data depends on whether the non-GAAP measure can be used as a liquidity measure, regardless of the management's characterization of the per share measure as solely a performance measure. The SEC stated that is will focus on the substance of the measure, not on the management's characterization.

USE OF A FREE CASH FLOW METRIC

Some companies present a "free cash flow" measure. Typically, the company calculates free cash flow by subtracting capital expenditures from operating activities as presented in the statement of cash flows under GAAP. According to the SEC, companies that present a free cash flow measure that deducts the capital expenditures do not violate the rules. On the other hand, if a company chooses to present a free cash flow measure, it must include a clear description of how that measure is calculated and the necessary reconciliation of that measure. The description is necessary because free cash flow does not have a uniform definition, therefore, the term itself does not explain how it is calculated.

ADJUSTMENTS FOR INCOME TAX

In the C&DIs, the SEC clarifies that adjustments to reflect income tax effects on a non-GAAP measure should depend on the nature of the measures. For a liquidity measure, it might be acceptable to adjust GAAP taxes to show taxes paid in cash. For a performance measure, the company should include current and deferred income taxes. Additionally, companies should show income tax adjustments separately with a clear explanation rather than simply present adjustments labeled as "net of tax."

EBITDA

When a company presents EBITDA as a performance measure, it must reconcile such measure to net income rather than operating income. These measures should not be presented on a per share basis.

If you have any questions on this topic please contact a member of Benesch's Corporate & Securities Practice Group.