

New compliance guidance by SEC staff signals increased scrutiny of non-GAAP financial measures

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Abstract

Purpose – This article examines compliance and disclosure interpretations issued by the staff of the Securities and Exchange Commission in May 2016 that provide guidance to SEC-reporting companies on how they can use financial measures not prepared in accordance with generally accepted accounting principles in a manner that complies with SEC rules governing the presentation of non-GAAP measures in SEC filings and other public communications.

Design/methodology/approach – This article provides an in-depth analysis of the new interpretive guidance in the context of the increasing use of non-GAAP financial measures by SEC-reporting companies and the SEC's concern that some companies have been using non-GAAP measures inappropriately to present a materially different picture of their operating performance than investors can discern from financial measures prepared in accordance with GAAP.

Findings – Although the appropriate use of non-GAAP financial measures can enhance investor understanding of a company's business and operating results, a relatively permissive SEC attitude towards the use of non-GAAP measures in recent years has emboldened some companies to increase their reliance on non-GAAP measures in a manner the SEC views as inconsistent with its rules. The SEC staff's new guidance signals a renewed focus by the SEC on compliance with its requirements concerning the nature of permissible non-GAAP measures and the ways in which companies should present those measures.

Originality/value – This article provides expert guidance on a major new SEC disclosure requirement from experienced securities lawyers.

Keywords United States of America, Securities regulation, Non-GAAP financial measures, SEC disclosure

Paper type Technical paper

On May 17, 2016, the Division of Corporation Finance of the US Securities and Exchange Commission (SEC) issued interpretive guidance on the use by public companies of financial measures, referred to “non-GAAP financial measures”, that are not calculated in accordance with accounting principles generally accepted in the United States (GAAP). The SEC staff issued the guidance in the form of new and revised compliance and disclosure interpretations (C&DIs) relating to the SEC's rules governing the use of non-GAAP financial measures (U.S. Securities and Exchange Commission, 2016). The interpretations signal a renewed focus by the SEC on compliance with its requirements concerning the nature of permissible non-GAAP financial measures and the ways in which companies should present those measures.

Over the past decade, the use of non-GAAP financial measures by reporting companies to supplement the presentation of their financial results on a GAAP basis has become increasingly widespread. Companies use non-GAAP financial measures primarily to exclude non-recurring, non-cash and other amounts from their GAAP results to present what they believe is a clearer picture of their fundamental operating performance. In some cases, non-GAAP financial measures have crowded out unadjusted GAAP results in the

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headlines of earnings releases as the preferred indicator of a company's financial performance, financial position or liquidity.

The new guidance reflects in part SEC concern that some companies are using non-GAAP financial measures less to clarify their operating results than to mask their performance as measured by GAAP with an array of customized financial metrics. Recent statements by SEC Commissioners and the SEC staff have expressed alarm over some common non-GAAP disclosure practices they view as inconsistent with the agency's rules. In speeches delivered in December 2015 and March 2016, SEC Chair Mary Jo White said that CEOs "love the non-GAAP measures because they tell a 'better' story" than GAAP results (Hiltzik, 2016), and announced that the use of non-GAAP measures "deserves close attention" to ensure that the SEC's rules are being followed and that those rules are "sufficiently robust in light of current market practices" (White, 2015). The Chief Accountant of the Division of Corporation Finance subsequently warned that the SEC intends to "crack down" on the use of non-GAAP financial measures (Katz, 2016).

Public companies have been attentive to shifts in the regulatory attitude towards the use of non-GAAP financial measures. Periods of intensive SEC scrutiny have been followed by periods characterized by a more permissive regulatory stance, which has emboldened some companies to increase their reliance on non-GAAP presentations. In his remarks noted above, the Chief Accountant of the Division of Corporation Finance pointedly observed that "the pendulum has swung" (Katz, 2016) from the generally more deferential approach to non-GAAP financial measures observed by the SEC staff since 2010, when it last issued guidance on the use of such measures. The recent remarks by the SEC staff and the latest C&DIs reflect the staff's intention to keep close tabs on the use of non-GAAP financial measures and to hold companies accountable for presentations the staff considers to be misleading.

Background

Public companies have long used non-GAAP financial measures in their SEC filings and other public disclosures to enhance investor understanding of their business and operating results. The principal advantage of non-GAAP measures, according to companies and members of the investment community, is that the exclusion from GAAP results of non-recurring or infrequent charges and other commonly adjusted financial statement amounts, including non-cash charges, clarifies underlying business trends and the company's "core" performance.

Over the years, the SEC and its staff have sounded warnings about the publication of misleading non-GAAP financial measures and reminded companies that the disclosure of non-GAAP financial measures is subject to the anti-fraud provisions of the federal securities laws^[1]. In 2000, a senior SEC accountant noted that the SEC was increasingly "seeing earnings releases published that convey an incomplete or inaccurate picture to investors", and characterized those communications relying on non-GAAP financial measures as "Everything but Bad Stuff" releases (Turner, 2000). The staff has cautioned companies that the use of non-GAAP financial measures could mislead investors, particularly when companies do not clearly disclose the adjustments made to GAAP financial measures or when non-GAAP measures present a materially different picture of the company's performance than GAAP measures.

The SEC reinforced these warnings in January 2002 when it brought its first enforcement action based on misleading *pro forma* financial information, as non-GAAP financial measures were often called at the time. The SEC charged Trump Hotels & Casino Resorts, Inc. for fraudulently citing non-GAAP measures to "tout purportedly positive results of operations but fail[ing] to disclose that those results were primarily attributable to an unusual one-time gain rather than to operations"^[2].

Until 2003, there were no SEC rules or other agency guidelines regulating the use of non-GAAP financial measures. Effective on March 28, 2003, as required by the Sarbanes-Oxley Act of 2002, the SEC adopted Regulation G^[3] under the Securities Exchange Act of 1934 and Item 10(e) of Regulation S-K^[4] to implement the statutory mandate that publicly disclosed non-GAAP financial measures be presented in a manner that is:

- not materially misleading; and
- reconciled with the most directly comparable GAAP financial measures.

Following the issuance of the rules, the staff published interpretive guidance on their application in the form of the “frequently asked questions” (FAQs). In that guidance and in comments on disclosures filed with the SEC over the next seven years, the staff adopted a restrictive approach to the application of the new requirements that, in the view of many experienced securities practitioners, went beyond the words of the rules.

In January 2010, the SEC staff published C&DIs that signaled its adoption of a more flexible approach to the non-GAAP requirements. The new approach was prompted in part by a view within the agency that the staff’s early, less accommodating position had discouraged some companies from including in their SEC filings the non-GAAP financial measures they were presenting in their press releases, investor presentations and other corporate disclosures. This had contributed to a divergence between disclosures of non-GAAP measures in the filings, which are subject to regular staff review, and disclosures of such measures in unfiled communications.

The most significant change in approach reflected in the 2010 C&DIs was to permit companies in their SEC filings to exclude recurring items, such as stock-based compensation, from GAAP financial measures so long as the companies did not improperly identify the items as non-recurring. When it adopted Regulation G and Item 10(e), the SEC had expressed concern about the increasing use of non-GAAP financial measures in public company disclosures that could confuse investors about a company’s actual performance or liquidity position and, in some cases, could be used inappropriately to “smooth” or “normalize” a company’s financial results. The SEC addressed this concern in Item 10(e) by prohibiting adjustment of “a non-GAAP performance measure to eliminate or smooth items *identified* as non-recurring, 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”. (Emphasis supplied) This prohibition in particular had raised questions about the kind of adjustments a company may make in non-GAAP financial measures, including whether a company is prohibited from making any adjustment relating to a charge or gain unless the item is “non-recurring”, or, instead, whether the company may make the adjustment and is prohibited only from identifying the item as “non-recurring” if it is not, in fact, non-recurring under the two-year test.

Until it issued its revised interpretations in 2010, the staff had said that companies seeking to exclude a recurring item in a non-GAAP measure contained in an SEC filing would need to “meet the burden of demonstrating the usefulness” of that measure. This hurdle effectively precluded the exclusion of many recurring items in non-GAAP measures presented in SEC filings, although not in unfiled disclosures (which are not subject to the prohibition of Item 10(e)). The C&DIs in 2010 omitted this language and acknowledged that, as Item 10(e) itself indicates, exclusion of a recurring item would be compliant if, in accordance with the requirement of the rule, the company did not label an item as “non-recurring, infrequent or unusual” if it had occurred in the preceding two years or was reasonably likely to occur in the next two years. This change in interpretive approach and other accommodations in the 2010 guidance had the effect of encouraging companies to include substantially the same non-GAAP financial measures in their SEC filings as in their other public communications.

Following the publication of its 2010 guidance, the staff principally relied on the comment letter process to convey its interpretive position on the application of Regulation G and Item 10(e). In contrast to its more aggressive posture before issuance of that guidance, the staff largely limited its comments to ensuring compliance with the express requirements of the rules. The staff did not hesitate to object to non-GAAP presentations that it considered to be misleading. In one widely publicized instance, it required a technology company conducting an initial public offering to recast a non-GAAP profitability measure the staff labeled as misleading because the measure excluded normal, recurring cash operating expenses[5].

In the years before the issuance of the C&DIs in May 2016, the number of public companies making regular use of non-GAAP financial measures continued to climb. According to one study, the number of companies in the S&P 500 index that reported their results solely on a GAAP basis fell from 119 in 2006 to 29 in 2015-2016. Over this period, the number of S&P 500 companies using some non-GAAP financial measures rose from 351 in 2006 to 482 in 2015-2016 (Shumsky and Francis, 2016).

Many members of the investment community welcome the use of non-GAAP financial measures (and, in the view of some companies, consider the measures to be an indispensable feature of the financial reporting process). Critics of non-GAAP presentations, however, have been troubled by the types of differences between GAAP and non-GAAP results highlighted by SEC Chair White. According to a study that considered adjustments to GAAP net income disclosed in earnings releases of 816 companies for their 2015 fiscal year, the companies reported non-GAAP net income that was \$164.1 billion higher in total than the net income they reported on a GAAP basis[6]. Another study found that although GAAP earnings of S&P 500 companies in 2015 compared with 2012 were “virtually unchanged”, non-GAAP earnings rose almost 14 per cent during this period (Rapoport and Michaels, 2016).

Regulation G and Item 10(e) raise a number of important interpretive questions that were not answered in the 2010 guidance. Although the SEC staff communicated its views on some of the questions in the comment letter process, the lack of more authoritative, generally applicable guidance resulted in different approaches to compliance before the staff moved in May 2016 to address some areas of uncertainty under its rules.

Regulation G and Item 10(e)

Rule 101(a)(1) of Regulation G and Item 10(e)(2) define a “non-GAAP financial measure” as a numerical measure of a company’s historical or future financial performance, financial position or cash flows that:

- excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the company; or
- includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable GAAP measure so calculated and presented.

The nature of non-GAAP adjustments, which typically are in the nature of exclusions from GAAP financial measures, may vary among different industry sectors and in response to economic factors. According to one study, for example, the most common categories of adjustments to net income in fiscal year 2015 among a sample of 816 public companies related to acquisition costs, restructuring charges and compensation expenses. In dollar terms, among the companies surveyed, those items accounted for approximately 95 per cent of non-GAAP adjustments. The most common adjustment among technology companies, which rely heavily on equity-based awards for compensation, was to exclude the effect of stock-based compensation expense from net income. Energy companies

surveyed, which operated in a sector that had undergone significant restructuring activity because of falling oil prices, emphasized the exclusion of restructuring charges[7].

The application of Regulation G and Item 10(e) varies with the nature of the public disclosure in which a company presents non-GAAP financial measures. A company must consider the application of three progressively more comprehensive compliance requirements:

- Regulation G (all public disclosures): Regulation G applies whenever a company, or a person acting on its behalf, publicly discloses material information, whether orally or in written or electronic form, that includes a non-GAAP financial measure. Accordingly, Regulation G applies not only to SEC filings and earnings releases furnished in a current report on Form 8-K, but also to investor presentations and other documents publicly disclosed by a company. Under the two key mandates of Regulation G, the company must present (1) each non-GAAP financial measure in a way that is not false or misleading to investors (Rule 100(b)) and (2) the most directly comparable GAAP financial measure, together with a clearly understandable quantitative reconciliation of the non-GAAP measure to the most directly comparable GAAP financial measure (Rule 100(a)).
- Item 10(e)(1)(i) of Regulation S-K (furnished earnings releases): Non-GAAP disclosure contained in earnings releases “furnished” (rather than “filed”) under Item 2.02 of a Form 8-K report must comply with the requirements of paragraph (1)(i) of Item 10(e) in addition to Regulation G. Under the requirements of this provision of Item 10(e), the company must disclose:
 1. a presentation, with “equal or greater prominence”, of the most directly comparable GAAP financial measure or measures; and
 2. a statement that discloses the reasons why management believes the non-GAAP presentation provides useful information to investors and to the extent material, any additional purposes for which management uses the non-GAAP measures.
- Item 10(e) of Regulation S-K (SEC filings): With limited exceptions, the full requirements of Item 10(e) apply to non-GAAP disclosures contained in reports, registration statements and other information filed with the SEC. In addition to the affirmative disclosure requirements of paragraph (1)(i) discussed above, Item 10(e) specifically prohibits specified adjustments to GAAP measures and other presentation practices that historically were considered to be misleading.

New and revised C&DIs

The 12 C&DIs issued by the SEC staff on May 17 provide insight into the types of non-GAAP financial measures the staff considers to be potentially misleading. The staff also summarizes its views on the application of the “equal or greater prominence” requirement of Item 10(e)(1)(i), the use of non-GAAP per share measures, the disclosure of funds from operations, and the calculation and presentation of income tax effects related to adjustments[8].

The new guidance largely represents a summary of positions expressed over the years in comment letters issued by the SEC staff in connection with its review of non-GAAP financial measures disclosed in filed documents and earnings releases. Like the staff comment letters, the C&DIs consist of conclusory observations that provide little in the way of reasoned elaboration or any sustained engagement with the central concepts underpinning the guidance.

New guidance on non-GAAP financial measures that could be misleading

The SEC staff identifies in four new C&DIs a number of non-GAAP financial measures that in its view “could” be misleading and therefore “could” or “may” violate Rule 100(b)

of Regulation G. Rule 100(b) states that a company may not present a non-GAAP financial measure “that, taken together with the information accompanying that measure and any other accompanying discussion of that measure, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading”. This provision requires consideration of a non-GAAP financial measure in the context in which it was disclosed and in light of the circumstances in which it was made. Recognizing the facts-and-circumstances evaluation required in each case, the staff stops short of concluding that the non-GAAP financial measures highlighted in its guidance necessarily are misleading. It appears, however, that any company departing from this guidance could bear a significant burden in convincing the staff that its presentation is not misleading within the meaning of Rule 100(b).

The staff highlights in the C&DIs the following non-GAAP financial measures that it believes could be misleading.

Certain adjustments, even if not explicitly prohibited. The staff indicates that “certain” adjustments to GAAP measures, even though not explicitly prohibited by Regulation G, may violate Rule 100(b) “because they cause the presentation of the non-GAAP measure to be misleading”. The staff cites, as one example of a problematic adjustment, the presentation of a performance measure that excludes normal, recurring cash operating expenses necessary to operate a company’s business. (Question 100.01) This interpretive gloss on Rule 100(b) may have been added in response to situations like that involving the IPO issuer referred to earlier^[9], in which a company seeks to exclude from operating results measures regular operating costs that require cash outlays.

The staff added a cross-reference to this new guidance in a C&DI issued in January 2010, in which the staff reaffirms that, subject to Regulation G and applicable requirements of Item 10(e), a company is not precluded from adjusting a GAAP measure for a charge or gain by the fact that the company cannot describe the charge or gain as non-recurring, infrequent or unusual. (Question 102.03) Accordingly, subject to the prohibition on excluding cash operating expenses of the type referred to in the new interpretation, a company still may exclude a recurring charge from a performance measure, so long as it does not identify the charge as “non-recurring, infrequent or unusual”, if the charge has occurred in the preceding two years or is reasonably likely to occur in the next two years.

Non-GAAP adjustments presented inconsistently between periods. Companies using non-GAAP financial measures sometimes expand the number and type of adjustments over time as new events occur that they believe warrant an adjustment to provide investors with a more meaningful picture of the company’s operating performance. The staff cautions that a company could be providing misleading disclosure if a non-GAAP measure is presented inconsistently between periods, such as where a non-GAAP measure adjusts a particular charge or gain in the current period but does not also adjust other, similar charges or gains in prior periods. The staff, however, does not go so far as to say that a company may not revise a particular non-GAAP measure for presentation in a subsequent period. Rather it indicates that the company can address the potentially misleading nature of an inconsistent presentation by disclosing the change between periods and explaining the reasons for the change. The staff adds, that, “depending on the significance of the change, it may be necessary to recast prior measures to conform to the current presentation and place the disclosure in the appropriate context”. (Question 100.02) As a result of this guidance, companies deciding to make a non-GAAP adjustment for a particular period should consider whether they intend to make similar adjustments for future periods.

Exclusion of charges without exclusion of gains. The staff warns that a non-GAAP measure could be misleading if it excludes charges, but does not exclude any gains. The staff

indicates that a non-GAAP measure could violate Rule 100(b) of Regulation G if it is adjusted only for non-recurring charges when there were non-recurring gains that occurred during the same period. (Question 100.03) An adjustment of this type subjected Trump Hotels in 2002 to the SEC enforcement action mentioned above^[10] In that case, the company issued a quarterly earnings release in which it excluded a one-time charge from its GAAP net income without also excluding a one-time gain, which the company did not disclose. The SEC alleged that the company's failure to exclude the gain as well as the charge created a misleading impression that the increase in net income announced in the release had resulted from improved operating performance rather than from the undisclosed gain.

Presentation of individually tailored recognition and measurement methods. Companies often adjust the recognition and measurement principles of GAAP financial measures to derive non-GAAP measures. In a new interpretation, the staff identifies as potentially misleading any non-GAAP measure that substitutes "individually tailored revenue recognition and measurement methods" for those of GAAP. The staff specifically finds troublesome a non-GAAP performance measure that is adjusted to accelerate revenue recognized ratably over time in accordance with GAAP as though the company earned revenue when its customers are billed. The staff emphasizes that a company could violate Rule 100(b) of Regulation G by using individually tailored recognition and measurement methods for financial statement line items other than revenue. (Question 100.04) Based on this interpretation, companies should carefully consider the advisability of any adjustments that have the effect of accelerating revenue for purposes of their non-GAAP measures. The interpretation could have far-reaching implications if the staff extends it to other types of revenue recognition adjustments.

New guidance on presentation of GAAP measures with "equal or greater prominence"

Paragraph (1)(i) of Item 10(e) requires companies disclosing non-GAAP financial measures in SEC filings and in earnings releases furnished in a Form 8-K report to present the most directly comparable GAAP financial measure "with equal or greater prominence". In the absence of published guidance on the types of presentations that would comply with this requirement, market practice has evolved to encompass a wide variety of approaches, particularly in the context of the placement of non-GAAP results in the headlines or captions of earnings releases. The SEC staff has questioned some of those approaches in the comment letter process. Now, in a new C&DI, the staff has assembled a list of the presentations that it considers non-compliant. Adherence to the new guidance will require many companies to modify their prior presentation practice, particularly in earnings releases, in which companies increasingly have emblazoned non-GAAP measures in a manner designed to attract maximum investor attention.

The staff prefaces its guidance on this presentation issue with the statement that 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 then indicates that, notwithstanding this facts-and-circumstances analysis, it "would consider the following examples of disclosure of non-GAAP measures as more prominent" than the comparable GAAP measures and therefore as failing to comply with the "equal or greater prominence" requirement:

- 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 text or a 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 that disclosure with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table; and
- providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location of equal or greater prominence. (Question 102.10)

The SEC staff also identifies as non-compliant a presentation that excludes a reconciliation of a forward-looking non-GAAP measure in reliance on the “unreasonable efforts” exception in Item 10(e)(1)(i)(B) without disclosing the exclusion and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence. This aspect of the C&DI refers to the provision in Item 10(e), which is also found in Rule 100(a) of Regulation G, that permits a company to present a forward-looking non-GAAP measure without providing a reconciliation to the most directly comparable forward-looking GAAP measure if reconciling information is not available without “unreasonable efforts”. The guidance refers to the SEC’s statement in its 2003 release adopting Regulation G and Item 10(e)[11] that a company relying on the exception must identify the reconciling information that is unavailable and disclose the probable significance of that information. Many companies that use forward-looking non-GAAP measures historically have not provided reconciliations to the comparable forward-looking GAAP measures and have included only limited references to the unavailability of reconciling information. Although this C&DI focuses companies on where to disclose such information, it also provides a reminder of the nature of the disclosure required to rely on the “unreasonable efforts” exception, particularly with respect to the probable significance of the unavailable information.

Other guidance

The SEC staff also issued interpretations relating to a number of other common compliance issues

Non-GAAP per share measures. The staff has updated its guidance concerning the circumstances in which a company may use non-GAAP per share numbers in documents filed or furnished with the SEC. The staff confirms, consistent with its prior guidance, that although companies may use non-GAAP per share performance measures, such as adjusted earnings per share, they may not present non-GAAP liquidity measures (characterized in the updated guidance as numbers that “measure cash generated”) on a per share basis, because such per share measures are specifically prohibited in financial statements under GAAP. The staff clarifies that whether per share data are prohibited depends on whether the non-GAAP measure “can be used as a liquidity measure” even if management presents the measure solely as a performance measure. The staff indicates that, in evaluating use of a non-GAAP per share measure, it will not defer to management’s characterization, but instead will focus its review on the substance of the measure and whether the measure can be used as a liquidity measure. (Question 102.05)

Consistent with positions it has expressed in comment letters, the SEC staff also has updated its guidance to confirm that, for purposes of the prohibition on per share measures, it views free cash flow, earnings before interest and taxes (EBIT) and earnings before interest, taxes, depreciation and amortization (EBITDA) as liquidity measures that must not be presented on a per share basis. (Questions 102.07, 103.02) This position does not preclude the use of EBIT or EBITDA as a performance measure that should be reconciled to net income.

Funds from operations (FFO). The adopting release for Regulation G and Item 10(e) provides that companies may use the non-GAAP financial measure styled as “funds from operations” (FFO), a measure commonly used by real estate investment trusts, on a per share basis. The SEC has updated its guidance on this measure to note that it accepts the National Association of Real Estate Investment Trusts (NAREIT) definition of FFO in effect as of May 17, 2016 as a performance measure and does not object to the presentation of FFO on a per share basis. (Question 102.01)

The staff also clarifies the limits to presentation of FFO on a basis other than that defined by NAREIT as of May 17, 2016. Any adjustments to FFO as so defined by NAREIT must comply with the requirements of Item 10(e) for a performance measure or a liquidity measure (depending on the nature of the adjustments), and the resulting non-GAAP measure must not be misleading in violation of Rule 100(b) of Regulation G. Referring to its revised guidance on the prohibition of non-GAAP per share measures that can be used as liquidity measures, the staff indicates that some of the adjustments may trigger a prohibition on presenting the adjusted FFO measure on a per share basis. (Question 102.02)

Income tax effects related to adjustments. The SEC staff has withdrawn a prior C&DI stating that companies may present an adjustment “net of tax” when reconciling a non-GAAP performance measure to the most directly comparable GAAP measure so long as they also disclose how they calculated the tax effect. A new C&DI states that companies should not present as “net of tax” adjustments made to arrive at a non-GAAP measure, but instead should show income taxes as a separate adjustment and clearly explain the adjustment. The staff thus wants companies to present their non-GAAP tax adjustment as a single line rather than within each individual adjustment line. The staff also indicates that a company “should provide income tax effects on its non-GAAP measures depending on the nature of the measures”. The staff explains that, if a measure is a liquidity measure that includes income taxes, it “might be acceptable” to adjust GAAP taxes to show taxes paid in cash. If a measure is a performance measure, the company should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. The interpretation thus indicates that, for adjustments that are tax-based, companies may use cash taxes for liquidity measures, but should not do so for performance measures. (Question 102.11)

Looking ahead

The SEC staff has made clear its intention to monitor with renewed vigilance the use of non-GAAP financial measures. The Chief Accountant of the Division of Corporation Finance stated at a meeting of the Public Company Accounting Oversight Board’s standing advisory group on May 18, 2016 that the SEC staff believes it will issue an increased number of comments objecting to the nature or presentation of non-GAAP measures in the coming months ([Rapoport and Michaels, 2016](#)). Although the SEC official indicated that this ramp-up will not take place overnight, companies nevertheless should begin now to evaluate their approach to compliance with the requirements of Regulation G and Item 10(e) in light of the staff’s updated guidance. The Chief Accountant observed that the first quarter ending after issuance of the guidance “will be a great opportunity for companies to self-correct” the presentation of non-GAAP measures in their public disclosures ([Rapoport and Michaels, 2016](#)).

It appears that many companies are heeding the SEC staff's admonition to review and, if necessary, revise their non-GAAP presentations in light of the guidance. One review of earnings releases issued by companies in the S&P 500 index for the fiscal quarter that ended after publication of the C&DIs reported that 81 per cent of those companies presented GAAP financial measures more prominently than non-GAAP measures, compared to 52 per cent of the companies in the preceding fiscal quarter (Shumsky, 2016).

The prompt shift to compliance with the SEC's view on the "equal or prominence requirement" is unsurprising in light of the clear guidelines articulated by the staff on this aspect of the rules. Companies will face greater compliance challenges in seeking to bring other features of their non-GAAP presentations into line with the staff's expectations. For many companies, this inquiry will require renewed consideration of why investors consider their non-GAAP financial measures to be useful and whether, if the non-GAAP presentation is modified, investors will find the same value in the measures. The SEC staff promises to prod companies to engage in this type of reflection. Senior officials have indicated that they are "very concerned" about "usefulness disclosures", and that they will issue comments requiring more compelling justifications for the use of non-GAAP measures (Katz, 2016).

With thoughtful application of the new guidance, companies should continue to be able to present non-GAAP financial measures that are important to their investors in a manner that satisfies what promises to be a new period of more demanding regulatory oversight.

Notes

1. Examples of SEC statements are on the topic collected in note 9 of the SEC's adopting release for Regulation G. See Conditions for Use of Non-GAAP Financial Measures, Release No. 33-8176, Release No. 34-47226, 68 Fed. Reg. 4820 (Jan. 30, 2003).
2. *In the Matter of SEC v. Trump Hotels & Casino Resorts, Inc.*, Release No. 34-45287, available at: www.sec.gov/litigation/admin/adminarchive/adminarc2002.shtml (last accessed 2 September 2016).
3. 17 C.F.R. § 244.100-102 (2016).
4. 17 C.F.R. § 229.10 (2016).
5. Groupon, Inc., Registration Statement on Form S-1 (Registration No. 333-174661) (initially filed on June 29, 2011). In reviewing the company's registration statement, the SEC staff objected to use of a non-GAAP financial measure called "Adjusted Consolidated Segment Operating Income" that excluded online marketing expenses of the registrant, which describes itself as "a local e-commerce marketplace that connects merchants to consumers". The staff said in its letter of comments on the filing that the exclusion of this "normal, recurring operating cash expenditure" from the company's operating results was "potentially misleading". The staff insisted that the company remove online marketing expenses from its non-GAAP measure.
6. *Measuring Non-GAAP Metrics: A Look at Adjusted Net Income*, Calcbench & Radical Compliance (June 2016), available at: www.calcbench.com/nongaap.
7. See the study cited at note 6 *supra*.
8. The C&DIs are presented in a Q&A format. In the following discussion, each C&DI is identified by the "Question" number assigned to it in the guidance.
9. See note 5 *supra*.
10. See note 2 *supra* and accompanying text.
11. See note 1 *supra*.

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