

Capital Markets | May 23, 2016

SEC Staff Updates Guidance on Use of Non-GAAP Financial Measures

On Tuesday May 17, 2016, the staff of the SEC's Division of Corporation Finance issued new C&DIs relating to Regulation G (which governs use of non-GAAP financial measures in public disclosures generally) and Item 10(e) of Regulation S-K (which governs use of non-GAAP financial measures in filings with the SEC and, in part, earnings releases).

These interpretations are the latest development in a recent resurgence of concern about the misuse of non-GAAP financial measures reflected in statements by SEC Chair Mary Jo White and members of the SEC staff as well as in prominent press articles. Companies should expect an environment of additional scrutiny around non-GAAP measures, the potential for an increase in SEC comments in this area and the possibility of future rulemaking. Given the current climate, companies and audit committees should quickly familiarize themselves with the new guidance and engage in a thorough review of their practices relating to use of non-GAAP measures.

New Guidance for Non-GAAP Measures in all Public Disclosures

This guidance applies to Regulation G.¹ The new guidance under Regulation G includes the following interpretations:

- **Some adjustments, while not expressly prohibited, may be misleading and violate Rule 100(b) of Regulation G.**² The interpretation cites as an example presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate the business.
- **Non-GAAP measures may violate Rule 100(b) if presented inconsistently between periods.** The interpretation indicates that adjusting a charge or gain in the current period but not adjusting for similar charges or gains in prior periods may be misleading unless the change is disclosed and the reasons for it explained.

¹ Any company that has a class of securities registered under Section 12 of the Securities Exchange Act of 1934 or is required to file reports under Section 15(d) of the Act must comply with Regulation G. Foreign private issuers are not excluded from the scope of Regulation G. By interpretation, the Staff has also expressed an expectation that voluntary filers (such as debt-only issuers that continue to report due to covenant obligations after their 15(d) obligations are suspended) should also comply.

² Rule 100(b) states that "[a] registrant, or a person acting on its behalf, shall not make public 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.

Depending on the significance of the change, prior period measures may need to be conformed to the current presentation.

- **Non-GAAP measures may violate Rule 100(b) if they exclude charges but not gains.** The interpretation cites as an example adjusting only for non-recurring charges when there were also non-recurring gains that occurred during the same period.
- **Non-GAAP measures that substitute tailored revenue recognition and measurement methods may violate Rule 100(b).** The interpretation specifically rejects using a non-GAAP performance measure that is adjusted to accelerate revenue recognized ratably over time under GAAP as though it was earned when customers are billed. The interpretation also indicates that using non-GAAP measures that involve tailored recognition and measurement methods for line items other than revenue may violate the Rule.

Reliance on Rule 100(b) as the basis for the Regulation G interpretations suggests a movement to a principles-based analysis that may be difficult for companies to navigate and may force a more conservative approach to some non-GAAP measures.

New Guidance for Non-GAAP Measures in SEC Filings and Earnings Press Releases

This guidance applies to Item 10(e)(1)(i) of Regulation S-K.³ The new guidance includes the following:

- **Equal Prominence Requirement.** The interpretation most likely to require companies to reevaluate their disclosure practices is the specific guidance given on the “equal prominence” requirement.⁴ The interpretation provides the following examples where the Staff would consider the disclosure of a non-GAAP measure to be more prominent (and therefore in violation of the rule):
 - Presenting a full income statement of non-GAAP measures or 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 that emphasizes the non-GAAP measure over the GAAP measure (bold text or a larger font)
 - A non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline)

³ While most earnings releases are “furnished” rather than “filed” with the SEC, instruction 2 to Item 2.02 of Form 8-K makes Regulation S-K Item 10(e)(1)(i) applicable to such earnings releases. Item 10(e)(1)(i) includes the equal prominence requirement, the requirement to present a quantitative reconciliation to the most directly comparable GAAP measure, the requirement to disclose the reasons management thinks the non-GAAP measure provides useful information for investors, and the requirement to disclose the other purposes, if any, for which management uses the non-GAAP measure.

⁴ Regulation S-K Item 10(e)(1)(i)(A) requires a presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with GAAP.

- 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 a table of non-GAAP measures without preceding it with an equally prominent table of comparable GAAP measures or including them in the same table
- Excluding a reconciliation with respect to a forward-looking non-GAAP measure in reliance on the “unreasonable efforts” exception without identifying the information that is unavailable and its probable significance in a location of equal or greater prominence
- 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

New Guidance for Non-GAAP Financial Measures in SEC Filings

This guidance applies to Item 10(e) of Regulation S-K. The new guidance includes the following interpretations:

- ***Non-GAAP liquidity measures (even ones management presents solely as performance measures) cannot be presented on a per share basis.*** Non-GAAP per share performance measures are permitted as they may be meaningful from an operating standpoint. However, non-GAAP liquidity measures that measure cash generated must not be presented on a per share basis in documents filed with or furnished to the SEC. Whether per share data is prohibited depends on whether the non-GAAP measure can be used as a liquidity measure, even if management presents it solely as a performance measure. The interpretations cite free cash flow, EBIT and EBITDA as examples of non-GAAP measures that may not be presented on a per share basis.
- ***Income tax effects on non-GAAP measures should be provided depending on the nature of the measures.*** For a liquidity measure that includes income taxes, it might be acceptable to adjust GAAP taxes to show taxes paid in cash. For a performance measure, current and deferred income tax expense should be included commensurate with the non-GAAP measure of profitability. Adjustments to arrive at a non-GAAP measure should not be presented “net of tax” but instead should be shown as a separate adjustment and clearly explained.

Next Steps for Companies

SEC registrants and voluntary filers should take note of the increasing scrutiny and public concern over non-GAAP financial measures and take the following steps in light of the new SEC staff guidance:

- Evaluate the non-GAAP measures the company uses in light of the Staff’s focus on Rule 100(b). Could any of the measures presented be considered misleading based on the new Regulation G interpretations or by analogy?
- Review past practices with respect to the equal prominence rule, particularly in earnings releases, and consider whether those practices are consistent with the specific examples in the new interpretation.
- Review the new guidance with the disclosure committee. Review conclusions as to the company’s practices relating to non-GAAP measures with the Audit Committee.
- Review disclosure controls and procedures to ensure they adequately address the use and presentation of non-GAAP financial measures.

For additional information, please contact one of the Shearman & Sterling attorneys below.

CONTACTS

Richard B. Alsop

New York
+1.212.848.7333
Richard.alsop@shearman.com

Jonathan M. DeSantis

New York
+1.212.848.5085
jonathan.desantis@shearman.com

Robert Ellison

São Paulo
+55.11.3702.2220
Robert.ellison@shearman.com

Robert Evans III

New York
+1.212.848.8830
revans@shearman.com

Stuart K. Fleischmann

New York
+1.212.848.7527
sfleischmann@shearman.com

Lisa L. Jacobs

New York
+1.212.848.7678
ljacobs@shearman.com

Merritt S. Johnson

New York
+1.212.848.7522
merritt.johnson@shearman.com

Jason R. Lehner

Toronto
+1.416.360.2974
jlehner@shearman.com

Ilijar Mujalovic

New York
+1.212.848.5313
ilijar.mujalovic@shearman.com

Manuel A. Orillac

New York
+1.212.848.5351
morillac@shearman.com

Alan Seem

Menlo Park
+1.650.838.3753
alan.seem@shearman.com

Antonia E. Stolper

New York
+1.212.848.5009
astolper@shearman.com

Robert C. Treuhold

New York
+1.212.848.7895
rtreuhold@shearman.com

Harald Halbhuber

New York
+1.212.848.7150
herald.halbhuber@shearman.com

Apostolos Gkoutzinis

London
+44.20.7655.5532
apostolos.gkoutzinis@shearman.com

David Dixter

London
+44.20.7655.5633
david.dixter@shearman.com

Richard J.B. Price

London
+44.20.7655.5097
rprice@shearman.com

Jacques B. McChesney

London
+44.20.7655.5791
Jacques.mcchesney@shearman.com

Trevor Ingram

London
+44.20.7655.5630
trevor.ingram@shearman.com

Marwa M. Elborai

London
+44.20.7655.5524
marwa.elborai@shearman.com

Pawel J. Szaja

London
+44.20.7655.5013
pawel.szaja@shearman.com

Mehran Massih

London
+44.20.7655.5603
mmassih@shearman.com

Jonathan Handyside

London
+44.20.7655.5021
johnathan.handyside@shearman.com

Andreas Löhdefink

Frankfurt
+49.69.9711.1622
andreas.loehdefink@shearman.com

Domenico Fanuele

Rome
+39.06.697.679.210
dfanuele@shearman.com

Tobia Croff

Milan
+39.02.0064.1509
tobia.croff@shearman.com

Emanuele Trucco

Milan
+39.02.0064.1527
emanuele.trucco@shearman.com

Tommaso Tosi

Milan
+39.02.0064.1520
tommaso.tosi@shearman.com

Sami L. Toutounji

Paris
+33.1.53.89.70.62
stoutounji@shearman.com

Hervé LetrégUILly

Paris
+33.1.53.89.71.30
hietreguilly@shearman.com

Colin Law

Hong Kong
+852.2978.8090
colin.law@shearman.com

Kyungwon (Won) Lee

Hong Kong
+852.2978.8078
kyungwon.lee@shearman.com

Andrew R. Schleider

Singapore
+65.6230.3882
aschleider@shearman.com

Masahisa Ikeda

Tokyo
+03.5251.1601
mikeda@shearman.com

Peter Chen

Hong Kong
+852.2978.8012
peter.chen@shearman.com

Matthew Bersani

Hong Kong
+852.2978.8096
matthew.bersani@shearman.com

ABU DHABI | BEIJING | BRUSSELS | DUBAI | FRANKFURT | HONG KONG | LONDON | MENLO PARK | MILAN | NEW YORK
PARIS | ROME | SAN FRANCISCO | SÃO PAULO | SAUDI ARABIA* | SHANGHAI | SINGAPORE | TOKYO | TORONTO | WASHINGTON, DC

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069

Copyright © 2016 Shearman & Sterling LLP. Shearman & Sterling LLP is a limited liability partnership organized under the laws of the State of Delaware, with an affiliated limited liability partnership organized for the practice of law in the United Kingdom and Italy and an affiliated partnership organized for the practice of law in Hong Kong.

*Dr. Sultan Almasoud & Partners in association with Shearman & Sterling LLP