SEC Issues Guidance on Non-GAAP Metrics

Background

In recent months, several high-ranking Securities and Exchange Commission ("SEC") personnel[1] publicly commented on the SEC's increasing concern over the use of non-GAAP financial measures. These officials identified certain non-GAAP practices the SEC staff find troubling and suggested that additional SEC rulemaking or even enforcement action against the misleading use of non-GAAP financial metrics could follow.

On May 17, 2016, the staff of the SEC **issued important new guidance** on the use of non-GAAP financial metrics. The guidance follows the same themes that SEC personnel addressed in their public comments. The guidance, which is immediately effective, gives insight into how a company may avoid running afoul of the SEC's non-GAAP rules.

Using Specific Non-GAAP Metrics

The SEC's guidance specifically addresses the use of EBIT or EBITDA, free cash flow and per share performance metrics:

- A company that presents EBIT or EBITDA as a performance measure should reconcile these measures to net income as presented in the statement of operations under GAAP. The SEC does not view operating income as the most directly comparable GAAP financial measure because EBIT and EBITDA make adjustments for items that are not included in operating income. In addition, these measures cannot be presented on a per share basis.

- "Free cash flow" is a permissible non-GAAP financial measure, provided that a clear description of how this measure is calculated, as well as the necessary reconciliation, accompanies the measure when it is used. Companies should also avoid inappropriate or potentially misleading inferences about its usefulness. For example, "free cash flow" should not be used in a manner that inappropriately implies that the measure represents the residual cash flow available for discretionary expenditures, since many companies have mandatory debt service requirements or other non-discretionary expenditures that are not deducted from the measure. Also, free cash flow is a liquidity measure that cannot be presented on a per share basis.

- Certain non-GAAP per share performance measures may be meaningful from an operating standpoint and are permissible, if reconciled to GAAP earnings per share. On the other hand, non-GAAP liquidity measures that measure cash generated must not be presented on a per share basis in earnings releases, annual or quarterly reports or registration statements.

Adjustments from GAAP to Non-GAAP Metrics

The SEC's guidance also addresses what adjustments between non-GAAP metrics and GAAP metrics may be misleading:

- A company may not state that a charge or gain is "non-recurring," "infrequent," "one-time" or "unusual" in a non-GAAP disclosure if the charge or gain is reasonably likely to recur within two years or when there was a similar charge or gain within the prior two years.

- Non-GAAP measures can be misleading if presented inconsistently between periods.

  - For example, a non-GAAP measure that adjusts a particular charge or gain in the current period and for which other, similar charges or gains were not also adjusted in prior periods could be misleading unless the change between periods is disclosed and the reasons for the change is explained.

  - In addition, 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.

- A non-GAAP measure could be misleading if the measure excludes charges, but does not exclude any gains.

  - For example, a non-GAAP measure that is adjusted only for non-recurring charges when there were non-recurring gains that occurred during the same period could be misleading.

- Certain adjustments, although not explicitly prohibited, can result in a non-GAAP measure that is misleading.

  - For example, presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a company's business could be misleading.

- A company may not use a non-GAAP performance measure that is adjusted to accelerate revenue recognized ratably over time in accordance with GAAP as though it earned revenue when customers are billed or that otherwise substitute individually tailored revenue recognition and measurement methods for those of GAAP.

  - Other measures that use individually tailored recognition and measurement methods for financial statement line items other than revenue may also be misleading.

- A company that excludes income tax adjustments to arrive at a non-GAAP measure should be mindful of the following guidance. A company should provide income tax effects on its non-GAAP measures depending on the nature of the measures. 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. In addition, adjustments to arrive at a non-

GAAP measure should not be presented "net of tax." Rather, income taxes should be shown as a separate adjustment and clearly explained.

Prominence of Non-GAAP Metrics

The SEC’s guidance also provides examples of presenting a non-GAAP measure with more prominence than the comparable GAAP measure, which is impermissible in earnings releases, annual or quarterly reports or registration statements:

- 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 the SEC's non-GAAP rules without disclosing that fact and 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 with equal or greater prominence.

What You Should Do Now

- Educate your colleagues in the accounting and finance, investor relations and legal departments of the new guidance: everyone on the team should know that this is an area of SEC focus.
- Review your company’s current use of non-GAAP metrics in existing investor presentations, earnings releases and scripts, and annual and quarterly reports to determine whether updates or changes are necessary in light of the new guidance.

- Review your company’s explanations of how you are using the non-GAAP measures, and why they are useful for your investors, to ensure it is accurate, complete, and drafted without boilerplate.

- Consider how the guidance may also apply to your company's use of key operating metrics that may not be based on your financial statements. For example, consider whether your key metrics are accompanied by a clear description of how the metric is calculated, whether they take more prominence than GAAP financial measures and whether any period-over-period changes in the calculation of the key metrics are clearly explained.

- Review your company's disclosure controls and procedures regarding the calculation and presentation of non-GAAP measures and key operating metrics.

- Prepare to address more probing auditor and audit committee questions concerning how non-GAAP financial metrics are calculated and why the non-GAAP measures used are an appropriate way to measure your company's performance and are useful to investors.

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[1] These have included Chair Mary Jo White, SEC Chief Accountant James V. Schnurr and SEC Deputy Chief Accountant Wesley Bricker, among others.

Gunderson Dettmer's lawyers are available to assist in addressing questions you may have regarding the issues discussed in this Alert. Please contact the Gunderson Dettmer attorney with whom you regularly work. Contact information for our attorneys can be found at www.gunder.com.