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SEC Provides Updated Guidance on Use of Non-GAAP Financial Measures

In May 2016, the SEC staff released an updated set of compliance and disclosure interpretations to address compliance issues under Regulation G[1] and Item 10(e) of Regulation S-K[2] (the "**Updated Non-GAAP Guidance**", available here). The publication of this guidance follows several months of signaling in speeches by various SEC officials about impending SEC actions to address misleading or confusing uses of non-GAAP financial measures.

In issuing the Updated Non-GAAP Guidance, the SEC staff is seeking to reign in the use of potentially misleading non-GAAP financial measures. The updated guidance gives SEC-registered companies a chance to self-correct problematic practices. If a U.S. public company discloses a non-GAAP financial measure in a manner that does not comply with the Updated Non-GAAP Guidance, the SEC staff could issue a comment letter challenging the use of such measure and may even seek to initiate an enforcement action. We believe the Updated Non-GAAP Guidance is also instructive to companies preparing offering documents for private placements to qualified institutional buyers in Rule 144A offerings because it provides clear examples of non-GAAP financial measures and related practices that should be avoided because they risk confusing or misleading investors.

What is a non-GAAP financial measure?

A **"non-GAAP financial measure"** is any number or ratio measuring a company's financial position, financial performance or cash flows that either:

- excludes amounts that would otherwise be included in the most directly comparable GAAP measure or
- includes amounts that would otherwise be excluded from the most directly comparable GAAP measure.

For purposes of applying Regulation G and Item 10(e) of Regulation S-K to foreign private issuers, the term **"GAAP"** generally refers to the system of generally accepted accounting principles used by the company to prepare its primary financial statements (such as IFRS or home country GAAP).

Adjustments that Could Result in Misleading Non-GAAP Financial Measures

The Updated Non-GAAP Guidance identifies adjustments to GAAP measures that could result in a non-GAAP financial measure that is misleading, which would constitute a violation of Regulation G if it were published by an SEC-registered company. Specifically, a non-GAAP measure could be misleading if it:

- is a performance measure that excludes normal, recurring, cash operating expenses necessary to operate the company's business;

[1] Regulation G requires any SEC-registered company, including a foreign private issuer (unless its communication is eligible for an exception), to comply with presentation and reconciliation requirements whenever it publicly discloses material information that includes a non-GAAP financial measure.

[2] Item 10(e) of Regulation S-K requires any SEC-registered company, including a foreign private issuer, to comply with requirements related to presentation, reconciliation and disclosure about utility and purpose when a covered SEC filing contains a non-GAAP financial measure.

- 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 – unless the change between periods is disclosed and the reasons for it is explained;
- adjusts only for non-recurring charges but not for non-recurring gains that occurred during the same period;
- substitutes individually tailored recognition and measurement methods for those provided by GAAP, particularly with respect to revenue recognition and measurement; or
- is adjusted to smooth or eliminate items labeled as non-recurring, infrequent or unusual if the charge or gain is reasonably likely to recur within two years or has occurred within the past two years.

Reconciliation When Presenting EBIT or EBITDA as a Performance Measure

Regulation G and Item 10(e) of Regulation S-K require reconciliation of a non-GAAP financial measure to the most comparable GAAP financial measure. The Updated Non-GAAP Guidance specifies that when presenting earnings before interest and taxes (EBIT) or earnings before interest, taxes, depreciation and amortization (EBITDA) as a performance measure, a company must reconcile such measure to ***net income*** as presented in the statement of operations under GAAP. The guidance clearly indicates that operating income should not be used as the most comparable GAAP financial measure when presenting EBIT or EBITDA as a performance measure.

Guidance on Presentation of Comparable GAAP Measures

While Regulation G requires that a non-GAAP financial measure is accompanied by disclosure of the most comparable GAAP financial measure, Item 10(e) of Regulation S-K also calls for the most comparable GAAP measure to be given ***equal or greater prominence*** in the relevant SEC filing. In other words, in an SEC filing that is subject to Item 10(e), the non-GAAP financial measure may not be presented with more prominence than the most comparable GAAP financial measure. The Updated Non-GAAP Guidance provides examples where a non-GAAP measure would be considered by the SEC staff to be presented with more prominence than the most comparable GAAP measure:

- 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;

When does Regulation G apply?

Regulation G applies to any public disclosure of material information that includes a non-GAAP financial measure by a company that is subject to periodic public reporting obligations under U.S. securities laws. For example, Regulation G applies to investor presentations and press releases related to periodic earnings announcements.

Limited exception for foreign private issuers**.** Public disclosure of a non-GAAP financial measure by a foreign private issuer is not subject to Regulation G if:

- the foreign private issuer's securities are listed or quoted on a securities exchange or interdealer quotation system outside the United States;
- the non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with U.S. GAAP; and
- the disclosure is made outside the United States or is included in a written communication that is released outside the United States.

So long as the company does not incorporate by reference such information into a registration statement or report filed with the SEC, this exception is available even in the following circumstances:

- a written communication is also released in the United States contemporaneously with or after the release outside the United States and is not targeted at persons located in the United States;
- the information is published on a website maintained by the foreign private issuer, so long as the website is not available exclusively to, or targeted at, persons located in the United States; or
- following the release of the information outside the United States, the information is included in a report on Form 6-K.

- 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 Item 10(e) without disclosing that fact and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence; and
- 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.

When does Item 10(e) of Regulation S-K apply?

Item 10(e) of Regulation S-K applies to the use of non-GAAP financial measures in certain registration statements and reports that are filed with the SEC (such as, for example, an IPO registration statement on Form F-1, a shelf registration statement on Form F-3 and annual report on Form 20-F).

Limited application to Form 6-K. Item 10(e) only will apply to information provided in a report on Form 6-K if a foreign private issuer chooses to incorporate that information by reference into a registration statement or annual report that it files with the SEC.

Prohibited Per Share Disclosures

While Item 10(e) of Regulation S-K does not explicitly prohibit the use of per share non-GAAP financial measures, Exchange Act Release No. 47226, pursuant to which Item 10(e) was adopted, states that "per share measures that are prohibited specifically under GAAP or [SEC] rules continue to be prohibited in materials filed with or furnished to the [SEC]." The Updated Non-GAAP Guidance clearly indicates that non-GAAP liquidity measures that measure cash generated must not be presented on a per share basis in documents filed or furnished with 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. For example, the Updated Non-GAAP Guidance identifies "free cash flow" as a non-GAAP liquidity measure that must not be presented on a per share basis. In addition, EBIT and EBITDA must not be presented on a per share basis.

Guidance on Presentation of Tax Effects

When a company calculates a non-GAAP financial measure, it may be appropriate for it to take into account the impact that adjustments it makes to a GAAP measure have on income tax expense. The Updated Non-GAAP Guidance advises SEC-registered companies to provide income tax effects on its non-GAAP financial measures depending on the nature of the measures. If a non-GAAP financial measure is a liquidity measure that includes income taxes, the company may consider adjusting GAAP taxes to show taxes paid in cash. If a non-GAAP financial 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.” The guidance instructs companies to show income taxes as a separate adjustment and to clearly explain such adjustment.

Conclusion

The purpose of the Updated Non-GAAP Guidance is to reign in the use of potentially misleading non-GAAP financial measures. While the guidance directly applies only to SEC-registered companies, it should also be reviewed by companies preparing disclosures for Rule 144A offerings to qualified institutional buyers because it provides clear examples of non-GAAP financial measures and related practices that should be avoided because they risk confusing or misleading investors.

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