No. 2016-29
19 May 2016

To the Point

SEC staff updates guidance on non-GAAP financial measures

The SEC staff provided more explicit guidance on when the use of non-GAAP measures may violate SEC rules.

What you need to know

- The SEC staff updated its interpretations of the rules on non-GAAP financial measures and added new guidance to address its concerns about some types of non-GAAP financial measures and the manner of presentation of all such measures in earnings releases and SEC filings.
- Companies that present non-GAAP financial measures need to consider the new staff guidance, especially the examples of presentation of non-GAAP measures that the staff will consider misleading or too prominent.

Overview

The Securities and Exchange Commission (SEC) staff updated its Compliance and Disclosure Interpretations (C&DIs) on the use of non-GAAP financial measures to provide more explicit guidance on when such measures may violate SEC rules.

The updates reflect concerns that SEC officials have been discussing publicly in recent speeches about how non-GAAP measures are being used in SEC filings and earnings releases. Among other things, SEC officials are concerned that companies may be violating the SEC rules that prohibit the use of these measures in ways that are misleading or give them undue prominence.

In its comment letter process, the staff in the Division of Corporation Finance has stepped up its scrutiny of the use of non-GAAP measures, and staff members have said they will "crack down" on inappropriate uses of these measures.

EY
Building a better working world

Our recent Technical Line, *Spotlight on non-GAAP financial measures*, discusses the SEC rules and regulations on non-GAAP measures and recommends that companies reconsider their use of these measures in light of the heightened focus.

Guidance on when non-GAAP measures may be misleading

The updated C&DIs clarify that a non-GAAP measure could be considered misleading if it:

- Excludes normal, recurring cash operating expenses necessary to operate the registrant's business
- Is presented inconsistently between periods without adequate disclosure of the change and explanation of the reasons for the change
- Excludes non-recurring charges but does not exclude non-recurring gains

The C&DIs also state that, depending on the significance of a change in how the non-GAAP measure is calculated, it may be necessary to recast the prior period measures to conform to the current presentation, in addition to disclosing that a change has been made and the reasons for the change.

How we see it

These interpretations are consistent with our understanding of the SEC staff's views historically but appear to indicate the areas in which the staff is most concerned about abuse.

Guidance on tailoring recognition and measurement principles

One of the new C&DIs clarifies that non-GAAP performance measures that accelerate the recognition of revenue to the time of sale or customer billing that under GAAP would be recognized ratably over the performance period are unacceptable under Regulation G and may not be presented publicly, including in SEC filings, earning releases or company websites. Further, other measures that use "individually tailored" recognition and measurement methods for other financial statement items also may be unacceptable. Wesley Bricker, the SEC's Deputy Chief Accountant, and Mark Kronforst, Chief Accountant in the SEC's Division of Corporation Finance, recently expressed similar concerns at a financial reporting conference.

How we see it

While companies may use non-GAAP recognition and measurement methods to calculate segment profit reported under Accounting Standards Codification 280, *Segment Reporting*, we expect that the SEC staff would object to the presentation or discussion of such measures on a consolidated basis.

Guidance on the prominence of non-GAAP measures

The new C&DIs list the following examples of presentations of non-GAAP measures that the SEC staff would consider inappropriate in SEC filings and earnings release because they are presented more prominently than the comparable GAAP measure:

- 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

- Presenting a non-GAAP measure before 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 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)(1)(i)(B) 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

In addition, the C&DIs clarify that the staff considers the presentation of 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, to violate the prohibition on greater prominence.

The new guidance could alter the way companies present non-GAAP measure in earnings releases.

How we see it

Companies may need to reconsider how they present non-GAAP measures, especially in earnings releases. We note that this list of examples is not all inclusive.

Other updates

The C&DIs also address non-GAAP disclosures related to liquidity measures and tax effects.

Presenting liquidity measures on a per-share basis has long been prohibited by the SEC, but the SEC staff has historically not questioned per share measures when a company defined them as performance measures. In recent speeches, the SEC staff has expressed concerns that companies may be characterizing liquidity measures as performance measures to support presentation on a per-share basis, such as measures of adjusted earnings before interest, taxes, depreciation and amortization that appear to function as a liquidity measure.

The C&DIs clarify that the staff will focus on the substance of the non-GAAP per-share measure rather than management's characterization of the measure as a performance measure. Therefore, the SEC staff would object to a per-share measure described as performance measure that in substance is a per-share liquidity measure. Moreover, while free cash flow (FCF) is a commonly used non-GAAP liquidity measure, the C&DIs clarify that FCF measures cannot be presented on a per-share basis because they are liquidity measures.

The presentation of income tax effects related to non-GAAP adjustments has not historically been a focus area for the SEC staff. Following up on recent comments made by SEC officials, the C&DIs clarify that a registrant should appropriately reflect the income tax effects of adjustments made in calculating its non-GAAP measures. This includes potentially adjusting non-GAAP liquidity measures to show taxes paid in cash or reflecting the appropriate tax rate that would apply to adjustments made to calculate the non-GAAP measure of profitability, considering both the applicable current and deferred tax expense. This could differ from the company's GAAP effective tax rate. In a change from the staff's previous interpretations, the new C&DIs say that adjustments to arrive at a non-GAAP measure should not be presented net of tax in the reconciliation to the most comparable GAAP measure. Instead the tax effect of adjustments should be presented as a separate reconciling item.

How we see it

Companies presenting non-GAAP after tax performance measures should consider whether the effective tax rate would change based upon the level of non-GAAP profitability and whether other items in the tax provision (e.g., changes in valuation allowances) should be adjusted.

EY | Assurance | Tax | Transactions | Advisory

© 2016 Ernst & Young LLP.
All Rights Reserved.

SCORE No. 01108-161US

ey.com/us/accountinglink

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.