Memorandum

SEC Issues Guidance on Non-GAAP Financial Measures

May 23, 2016

Amid recent comments from Securities and Exchange Commission ("SEC") Chairman Mary Jo White, SEC Chief Accountant James Schnurr and others, as well as various media reports suggesting increased regulatory scrutiny of financial measures that are not calculated in accordance with U.S. Generally Accepted Accounting Principles ("GAAP"), the SEC issued new and revised compliance and disclosure interpretations ("C&DIs") regarding its rules and regulations on the use of non-GAAP financial measures.[1] The SEC's guidance, released on May 17, 2016, provides greater clarity with regard to the use of non-GAAP financial measures and appears to highlight the specific concerns of the SEC. While much of the guidance is consistent with the current practices in the market, the C&DIs may result in changes to certain practices, particularly in quarterly earnings releases. The SEC's new guidance relates broadly to five issues:

1. What constitutes a misleading non-GAAP financial measure;
2. The presentation of non-GAAP liquidity measures;
3. The use of "funds from operations" ("FFO") in earnings releases and materials filed with or furnished to the SEC;
4. The requirement that, when presenting a non-GAAP measure, the issuer must present the most directly comparable GAAP measure with equal or greater prominence[2]; and

[1] *See* Appendix for the full text of the new and revised C&DIs. For the SEC's complete C&DIs regarding non-GAAP financial measures, *see* "Non-GAAP Financial Measures" (last updated May 17, 2016).

[2] This requirement applies to earnings releases, registration statements and documents filed with the SEC pursuant to the Securities Exchange Act of 1934, as amended ("Item 10(e)(1) Presentations"), but generally does not apply to presentations used at investor meetings.

5. How income tax effects related to adjustments to arrive at a non-GAAP measure should be calculated and presented.

I. Misleading Non-GAAP Financial Measures

Issuers are prohibited from using any non-GAAP financial measure that is misleading. Through four new C&DIs, the SEC clarifies when a non-GAAP financial measure may be deemed misleading.

- **Certain adjustments, though not explicitly prohibited, may still result in a non-GAAP measure that is misleading.** As an example, the SEC notes that "presenting a performance measure that excludes normal, recurring cash operating expenses necessary to operate a registrant's business could be misleading."
- **A non-GAAP measure presented inconsistently between periods may be misleading.** A non-GAAP measure reflecting an adjustment that was not made in prior periods could violate the rules, explains the SEC, "unless the change between periods is disclosed and the reasons for it explained." Additionally, "depending on the significance of the change," issuers may need to "recast prior measures to conform to the current presentation and place the disclosure in the appropriate context."
- **A non-GAAP measure that excludes charges but does not exclude gains may be misleading.** For instance, a non-GAAP measure reflecting adjustments only for non-recurring charges when there were non-recurring gains during the same period could violate the rules.
- **A registrant may not present, in materials covered by Rule 100(b) of Regulation G, "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."** A non-GAAP measure that substitutes individually tailored revenue recognition and measurement methods for those of GAAP could be misleading.

II. Presentation of Non-GAAP Liquidity Measures

In revisions to three existing C&DIs, the SEC expands upon its previous guidance regarding the permissibility of presenting non-GAAP financial measures on a per share basis, which depends on whether the financial measures at issue are performance or liquidity measures.

- **While non-GAAP per share performance measures should be reconciled to GAAP earnings per share, non-GAAP liquidity measures that measure cash generated may not be presented on a per share basis.** Importantly, the determining factor for whether per share data may be presented is "whether the non-GAAP measure can be used as a liquidity measure, even if management presents it solely as a performance measure."
- **Accordingly, EBIT and EBITDA may not be presented on a per share basis, even if**

presented as performance measures.**

- **"Free cash flow" – typically calculated as cash flows from operating activities under GAAP, less capital expenditures – is a liquidity measure and thus may not be presented on a per share basis.**

III. The Use of Funds From Operations in Materials Filed With or Furnished to the SEC

In revisions to two C&DIs, the SEC provides clarification regarding the definition of FFO, expanding upon its previous indication that companies are permitted to use "funds from operations per share" in earnings releases and materials filed with or furnished to the SEC, subject to the guidelines in the applicable non-GAAP disclosure rules.[3]

- **The SEC accepts the current definition of FFO formulated by the National Association of Real Estate Investment Trusts ("NAREIT"), which considers FFO a performance measure.** Accordingly, the SEC does not object to the presentation of FFO on a per share basis.
- **Registrants may present FFO on a basis other than as defined by NAREIT as of May 17, 2016, so long as any adjustments made to FFO comply with the applicable rules.** Registrants should bear in mind that "[a]ny adjustments made to FFO must comply with the requirements of Item 10(e) of Regulation S-K for a performance measure or a liquidity measure, depending on the nature of the adjustments, some of which may trigger the prohibition on presenting this measure on a per share basis." Accordingly, if adjustments are made to FFO, the guidance discussed in this memo should be considered.

IV. Equal or Greater Prominence For Item 10(e)(1) Presentations

Item 10(e) of Regulation S-K provides that when an issuer presents a non-GAAP financial measure in a filing with the SEC, it must include a "presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with" GAAP. This requirement applies equally to non-GAAP measures included in **earnings releases furnished** to the SEC pursuant to Item 2.02 of Form 8-K.

In a heavily revised C&DI, the SEC provides explicit examples of disclosures that would result in a non-GAAP measure being more prominent, in violation of Item 10(e). While cautioning that the prominence question is fact and circumstances dependent, the SEC offers the following examples:

- "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";

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3 *See* "Conditions for Use of Non-GAAP Financial Measures," Exchange Act Release No. 47226, File No. S7-43-02 (Jan. 22, 2003), fn. 50.

- Including a non-GAAP measure in an earnings release headline or caption while omitting the comparable GAAP measure;
- Using a style of presentation, such as bold print or larger font, that emphasizes the non-GAAP measure over the comparable GAAP measure;
- Characterizing a non-GAAP metric as, for example, “record performance” or “exceptional” without using an equally prominent description for the comparable GAAP measure;
- Presenting a non-GAAP financial measure before the most directly comparable GAAP measure (including in an earnings release headline or caption);
- Providing tabular disclosure that includes a non-GAAP measure without including the comparable GAAP measure in the same table or without preceding the non-GAAP measure with equally prominent tabular disclosure of the comparable GAAP measure;
- “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”; and
- Providing a discussion and analysis of a non-GAAP measure while not providing a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence.

V. Tax Effects Related to Adjustments to Arrive at a Non-GAAP Measure

In its revised C&DIs, the SEC explains how income tax effects related to adjustments to arrive at a non-GAAP measure should be calculated and presented.

- **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, the issuer “should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability.”
- **Adjustments should no longer be presented “net of tax”; instead, income taxes should appear as a separate adjustment and be clearly explained.**

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In a time of increasing regulatory attention on non-GAAP financial measures and the attendant focus on the issue by publicly traded companies, the SEC’s new and revised C&DIs afford issuers additional clarity regarding the proper and improper use of non-GAAP financial measures.

Appendix

Non-GAAP Financial Measures

Last Update: May 17, 2016

These Compliance & Disclosure Interpretations ("C&DIs") comprise the Division's interpretations of the rules and regulations on the use of non-GAAP financial measures. The bracketed date following each C&DI is the latest date of publication or revision.

QUESTIONS AND ANSWERS OF GENERAL APPLICABILITY

Section 100. General

Question 100.01

Question: Can certain adjustments, although not explicitly prohibited, result in a non-GAAP measure that is misleading?

Answer: Yes. Certain adjustments may violate Rule 100(b) of Regulation G because they cause the presentation of the non-GAAP measure to be misleading. For example, presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business could be misleading. [May 17, 2016]

Question 100.02

Question: Can a non-GAAP measure be misleading if it is presented inconsistently between periods?

Answer: Yes. 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 violate Rule 100(b) of Regulation G unless the change between periods is disclosed and the reasons for it 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. [May 17, 2016]

Question 100.03

Question: Can a non-GAAP measure be misleading if the measure excludes charges, but does not exclude any gains?

Answer: Yes. 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 violate Rule 100(b) of Regulation G. [May 17, 2016]

Question 100.04

Question: A registrant presents 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. Can this measure be presented in documents filed or furnished with the Commission or provided elsewhere, such as on company websites?

Answer: No. Non-GAAP measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could violate Rule 100(b) of Regulation G. Other measures that use individually tailored recognition and measurement methods for financial statement line items other than revenue may also violate Rule 100(b) of Regulation G. [May 17, 2016]

Section 102. Item 10(e) of Regulation S-K

Question 102.01

Question: What measure was contemplated by "funds from operations" in footnote 50 to Exchange Act Release No. 47226, Conditions for Use of Non-GAAP Financial Measures, which indicates that companies may use "funds from operations per share" in earnings releases and materials that are filed or furnished to the Commission, subject to the requirements of Regulation G and Item 10(e) of Regulation S-K?

Answer: The reference to "funds from operations" in footnote 50, or "FFO," refers to the measure defined as of January 1, 2000, by the National Association of Real Estate Investment Trusts (NAREIT). NAREIT has revised and clarified the definition since 2000. The staff accepts NAREIT's definition of FFO in effect as of May 17, 2016 as a performance measure and does not object to its presentation on a per share basis. [May 17, 2016]

Question 102.02

Question: May a registrant present FFO on a basis other than as defined by NAREIT as of May 17, 2016?

Answer: Yes, provided that any adjustments made to FFO comply with Item 10(e) of Regulation S-K and the measure does not violate Rule 100(b) of Regulation G. Any adjustments made to FFO must comply with the requirements of Item 10(e) of Regulation S-K for a performance measure or a liquidity measure, depending on the nature of the adjustments, some of which may trigger the prohibition on presenting this measure on a per share basis. See Section 100 and Question 102.05. [May 17, 2016]

Question 102.03

Question: Item 10(e) of Regulation S-K prohibits adjusting a non-GAAP financial 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. Is this prohibition based on the description of the charge or gain, or is it based on the nature of the charge or gain?

Answer: The prohibition is based on the description of the charge or gain that is being adjusted. It would not be appropriate to state that a charge or gain is non-recurring, infrequent or unusual unless it meets the specified criteria. The fact that a registrant cannot describe a charge or gain as non-recurring, infrequent or unusual, however, does not mean that the registrant cannot adjust for that charge or gain. Registrants can make adjustments they believe are appropriate, subject to Regulation G and the other requirements of Item 10(e) of Regulation S-K. See Question 100.01. [May 17, 2016]

Question 102.05

Question: While Item 10(e)(1)(ii) of Regulation S-K does not prohibit the use of per share non-GAAP financial measures, the adopting release for Item 10(e), Exchange Act Release No. 47226, states that "per share measures that are prohibited specifically under GAAP or Commission rules continue to be prohibited in materials filed with or furnished to the Commission." In light of Commission guidance, specifically Accounting Series Release No. 142, *Reporting Cash Flow and Other Related Data*, and Accounting Standards Codification 230, are non-GAAP earnings per share numbers prohibited in documents filed or furnished with the Commission?

Answer: No. Item 10(e) recognizes that certain non-GAAP per share performance measures may be meaningful from an operating standpoint. Non-GAAP per share performance measures should be 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 documents filed or furnished with the Commission, consistent with Accounting Series Release No. 142. 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. When analyzing these questions, the staff will focus on the substance of the non-GAAP measure and not management's characterization of the measure. [May 17, 2016]

Question 102.07

Question: Some companies present a measure of "free cash flow," which is typically calculated as cash flows from operating activities as presented in the statement of cash flows under GAAP, less capital expenditures. Does Item 10(e)(1)(ii) of Regulation S-K prohibit this measure in documents filed with the Commission?

Answer: No. The deduction of capital expenditures from the GAAP financial measure of cash flows from operating activities would not violate the prohibitions in Item 10(e)(1)(ii). However, companies should be aware that this measure does not have a uniform definition and its title does not describe how it is calculated. Accordingly, a clear description of how this measure is calculated, as well as the necessary reconciliation, should accompany the measure where 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 must not be presented on a per share basis. See Question 102.05. [May 17, 2016]

Question 102.10

Question: Item 10(e)(1)(i)(A) of Regulation S-K requires that when a registrant presents a non-GAAP measure it must present the most directly comparable GAAP measure with equal or greater prominence. This requirement applies to non-GAAP measures presented in documents filed with the Commission and also earnings releases furnished under Item 2.02 of Form 8-K. Are there examples of disclosures that would cause a non-GAAP measure to be more prominent?

Answer: Yes. Although 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 would consider the following examples of disclosure of non-GAAP measures as more prominent:

- 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 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; 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. [May 17, 2016]

Question 102.11

Question: How should income tax effects related to adjustments to arrive at a non-GAAP measure be calculated and presented?

Answer: A registrant 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 registrant 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. [May 17, 2016]

Question 103.02

Question: If EBIT or EBITDA is presented as a performance measure, to which GAAP financial measure should it be reconciled?

Answer: If a company presents EBIT or EBITDA as a performance measure, such measures should be reconciled to net income as presented in the statement of operations under GAAP. Operating income would not be considered 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 must not be presented on a per share basis. See Question 102.05. [May 17, 2016]

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