PREPARING FOR THE ANNUAL REPORTING SEASON: NON-GAAP MEASURES

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U.S. Corporate Alert

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On 13 December 2022, the Division of Corporation Finance of the U.S. Securities and Exchange Commission (SEC) revised three and issued four new Compliance and Disclosure Interpretations (C&DIs) updating guidance on the use of non-GAAP measures. Non-GAAP measures are numerical measures of performance, financial position, or cash flows that are not calculated in accordance with generally accepted accounting principles (GAAP). This is the SEC staff's first update of the non-GAAP measure C&DIs since May 2016, and these new and revised C&DIs highlight the SEC staff's continued sharp focus on the use of non-GAAP measures, in particular such disclosures that the SEC staff considers to be (i) potentially misleading, or (ii) in violation of the equal or greater prominence requirement.

As the SEC staff has previously made clear, non-GAAP measures should only supplement a company's financial statement information. If a company decides to publicly disclose a non-GAAP measure, federal securities laws set forth several requirements for how the non-GAAP measure can be presented. For instance, a non-GAAP measure cannot be presented in a way that would make it misleading nor can a non-GAAP measure be presented without the most directly comparable GAAP measure. Additionally, a quantitative reconciliation of the difference between the non-GAAP measure and the most directly comparable GAAP measure is required (except in limited circumstances with respect to forward-looking non-GAAP measures). If the non-GAAP measure is included in a document filed or furnished with the SEC, federal securities laws additionally prohibit the non-GAAP measure from being presented with greater prominence than the most directly comparable GAAP measure. Given the federal securities law requirements around non-GAAP measures and the SEC staff's focus on the use of non-GAAP measures and its concern that many companies are still too aggressive and creative in presenting non-GAAP measures, these new and revised C&DIs should serve as another strong reminder for companies to review their use of these measures when preparing SEC filings and making other public disclosures during the upcoming annual reporting season. Companies should expect that the SEC staff will review these upcoming SEC filings for compliance with the new and revised C&DIs.

NEW AND REVISED C&DIS

The SEC staff updated its guidance on the use of non-GAAP measures with the following new and revised C&DIs:

Misleading Non-GAAP Measures

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Update to Question 100.01

This C&DI was revised to clarify that a company's specific facts and circumstances determine whether an adjustment renders a non-GAAP measure misleading. For example, a normal operating expense will be evaluated by the SEC staff by reviewing an adjustment's nature, effect, and its relationship to the company's "operations, revenue generating activities, business strategy, industry and regulatory environment." The C&DI goes on to state that a recurring operating expense includes not only one that occurs repeatedly, but also one that occurs occasionally (even at irregular intervals).

The revisions to this C&DI highlight that there is not a one-size-fits-all approach for companies to take when determining what adjustments to make to a non-GAAP measure. Companies need to carefully consider their own specific circumstances when deciding what adjustments to make to a non-GAAP measure.

Update to Question 100.04

This C&DI was completely revised to provide guidance on calculating non-GAAP measures using measurement and recognition principles inconsistent with GAAP. Specifically, a non-GAAP measure may be misleading if an adjustment used in the calculation changes the application of GAAP measurement and recognition principles. The SEC staff provided the following examples of when a non-GAAP measure could be considered misleading in this regard:

- A non-GAAP adjustment that changes when revenue is recognized from ratably over time to at the time of billing a customer;
- Presenting a non-GAAP revenue measured on a gross basis when GAAP requires a net basis or the inverse; and
- A non-GAAP adjustment that changes the accounting basis from accrual to cash.

The revisions to this C&DI highlight the SEC staff's view that non-GAAP measures are meant to supplement financial statement information, and adjustments that change accounting treatment could cause the non-GAAP measure to be misleading

New Question 100.05

This new C&DI offers guidance on when an inappropriate label or unclear description could make a non-GAAP measure misleading. The SEC staff noted that a non-GAAP measure would be misleading if it is not identified or clearly described as such or if its label is not reflective of its nature as a non-GAAP measure. The SEC staff then provided the following examples of when a label is not reflective of a non-GAAP measure's nature:

- A "net revenue" label for a non-GAAP contribution margin measure that is calculated by removing certain expenses from GAAP revenue;
- Labeling a non-GAAP measure as a GAAP line item or GAAP subtotal even though the GAAP measure, which is similarly labeled, is calculated differently; and
- Using a "pro forma" label for a non-GAAP measure that is not calculated in accordance with applicable pro forma requirements.

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This new C&DI showcases the importance of how a company labels non-GAAP measures. It also highlights that multiple factors, individually or in the aggregate, could cause a non-GAAP measure to be misleading.

New Question 100.06

This new C&DI discusses the SEC staff's view that a non-GAAP measure can be so misleading that "even extensive, detailed disclosure about the nature and effect of each adjustment would not prevent the non-GAAP measure from being materially misleading."

This new C&DI makes clear that even extensive and detailed disclosures cannot prevent a non-GAAP measure from being misleading.

PRESENTING A NON-GAAP MEASURE WITH GREATER PROMINENCE

Update to Question 102.10(a)

This C&DI revised prior Question 102.10 to provide a new example that a non-GAAP measure would be presented with greater prominence than the most directly comparable GAAP measure if a ratio is calculated using a non-GAAP measure in the numerator or denominator and the company does not also present with greater or the same prominence and calculate the same ratio using the most directly comparable GAAP measure.

As a result of the revisions to this C&DI, companies should review any non-GAAP measures calculated and presented in a ratio to ensure that the ratio is similarly calculated and presented with the most directly comparable GAAP measure.

New Question 102.10(b)

The SEC staff issued this new C&DI to provide the following examples of when a non-GAAP measure would be impermissibly disclosed more prominently than the most directly comparable GAAP measure:

- A non-GAAP measure starting a reconciliation;
- Reconciling non-GAAP to GAAP measures through the presentation of a non-GAAP income statement; and
- A forward-looking non-GAAP measure that excludes the quantitative reconciliation to the comparable GAAP measure without disclosing, in a place of equal or greater prominence, this fact and the information (and its probable significance) that is unavailable.

Companies should review non-GAAP measures in their SEC filings to make sure they are not being presented in a manner similar to any of the examples in this C&DI.

New Question 102.10(c)

The SEC staff issued this new C&DI to define a non-GAAP income statement as "one that is comprised of non-GAAP measures and includes all or most of the line items and subtotals found in a GAAP income statement."

Similar to new Question 100.05 above, this new C&DI showcases the importance of how a company presents its non-GAAP measures and the multiple factors that need to be considered by companies when disclosing non-GAAP measures in SEC filings.

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WHAT COMPANIES SHOULD DO IN LIGHT OF THE NEW AND REVISED C&DIS

The SEC staff's timing in issuing new and revised non-GAAP measure C&DIs right before most companies will begin issuing their annual earnings release and filing their annual reports is likely not a coincidence. As these are the first updates to the non-GAAP measure C&DIs since May 2016, they are likely the distillation of many non-GAAP measure comments issued by the SEC staff in the more than six years that followed the last update. As a result, companies should use this annual reporting season as an opportunity to look at their non-GAAP measures with fresh eyes and consider the following:

- Review adjustments made to calculate non-GAAP measures and consider whether a facts-and-circumstances analysis, taking into consideration a company's business activities and strategies as well as its industry and regulatory environment, could render the non-GAAP measure misleading under the SEC staff's new and expanded guidance;
- Review the examples provided in Question 100.04 to make sure any non-GAAP measures do not improperly change GAAP measurement and recognition principles;
- Review the labeling and description of non-GAAP measures in light of the new examples provided in Question 100.05 to determine if the labels and descriptions properly reflect the nature of each non-GAAP measure; and
- Review non-GAAP measures in SEC filings to make sure they are not presented with greater prominence than the comparable GAAP measure in light of the new examples provided by the SEC staff in Questions 102.10(a) and (b).

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