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Non-GAAP Measures: What's All the Fuss About?

An article by Brad Davidson, CPA

Over the past several months, the U.S. Securities and Exchange Commission (SEC) has expressed concern about the prevalence of non-GAAP measures used by public companies to present financial results in place of GAAP measures rather than as a supplement to them.

Non-GAAP measures appear in various documents, including filings with the SEC, annual and quarterly reports, and earnings releases as well as investor presentations and other publicly available company information. Companies should re-examine their use of non-GAAP measures and determine whether it is appropriate under the SEC's existing rules and recent guidance.

Companies choosing to employ non-GAAP measures in their publicly available materials need to be aware of the existing disclosure requirements and prohibitions (see table, "Non-GAAP Measures – SEC Rules and Disclosure Requirements") as well as the SEC's supplementary guidance and interpretations of the related rules and regulations, including a May 17, 2016 released update to the SEC's Division of Corporation Finance (Corp Fin) Compliance and Disclosure Interpretations (C&DIs), "[Non-GAAP Financial Measures](#)," which helps clarify what constitutes a misleading presentation.

Requirements for the use of non-GAAP measures were put in place by the *Sarbanes-Oxley Act of 2002* and implemented by the SEC in 2003, when the [final rule in SEC Release No. 33-8176](#) went into effect. That final rule defined a non-GAAP measure in Item 10(e) of Regulation S-K as "a numerical measure of a registrant's historical or future financial performance, financial position or cash flows" that is different from that reported in accordance with U.S. generally accepted accounting principles. In other words, it is a measure that includes amounts that are excluded from, or excludes amounts that are included in, the most directly comparable GAAP measure. Some common examples are funds from operations; earnings before interest, taxes, depreciation, and amortization (EBITDA) and adjusted EBITDA; adjusted revenues; free cash flow; and core earnings.

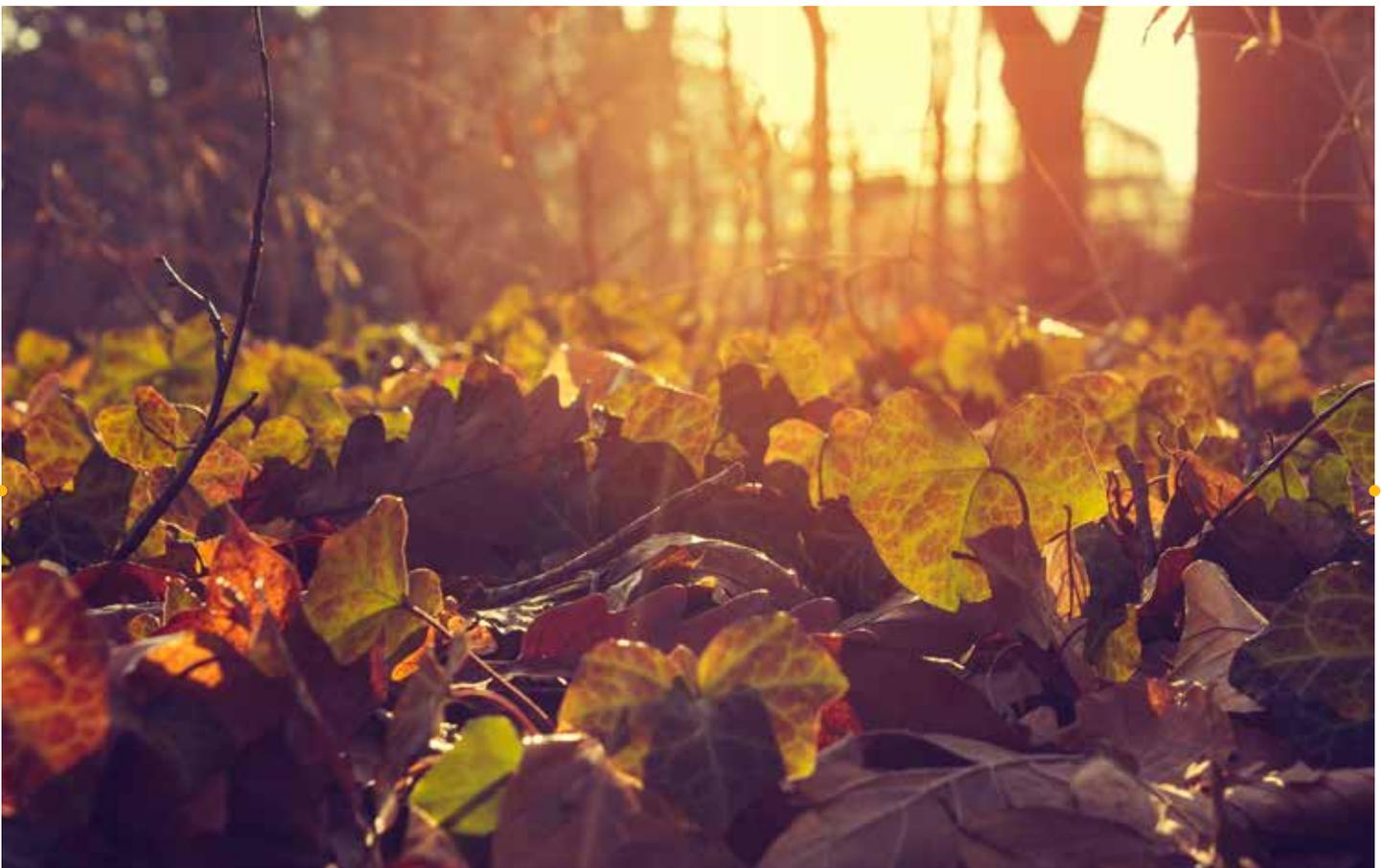
When used, non-GAAP disclosures, in addition to the disclosures based on GAAP measures, to inform investors about the performance of a company. As a general rule, the SEC staff does not encourage the use of non-GAAP measures; however, when companies do use them, the disclosure requirements and prohibitions must be applied.

Companies are not required to include non-GAAP measures in SEC filings, even when management uses the non-GAAP measures outside of SEC filings, but any measure that is disclosed in a public document or on a website must not be misleading. Furthermore, the story that management tells publicly and outside of SEC filings should be consistent with the disclosures in its filings, and any non-GAAP measures used outside of SEC filings should not result in a story that is inconsistent with the one told in the SEC filings.

SEC's Renewed Focus on Non-GAAP Measures

Although the SEC's rules on non-GAAP measures have existed around since 2003, the SEC has demonstrated a renewed focus on non-GAAP disclosures in recent months, through public speeches by the SEC chair and senior officers from the commission's Office of the Chief Accountant (OCA) and Corp Fin as well as the previously mentioned updated C&DIs.

Misleading measures have never been allowed under the SEC's rules, and the updated C&DIs – which is further evidence of the SEC's emphasis on non-GAAP measures – discuss non-GAAP measures and include specific examples of what may or may not constitute a misleading measure.



Non-GAAP Measures – SEC Rules and Disclosure Requirements

	All public statements and disclosures unless otherwise noted	Item 2.02 of Form 8-K (includes earnings releases)	Periodic report and registration statement filings (e.g., Forms 10-K, 10-Q, S-1, and S-4)
Regulation G	<p>Required:</p> <ul style="list-style-type: none"> • The most directly comparable GAAP measure • A reconciliation between the non-GAAP and comparable GAAP measures <p>Prohibited: Any measure that is misleading</p>	<p>Required:</p> <ul style="list-style-type: none"> • The most directly comparable GAAP measure • A reconciliation between the non-GAAP and comparable GAAP measures <p>Prohibited: Any measure that is misleading</p>	<p>Required:</p> <ul style="list-style-type: none"> • The most directly comparable GAAP measure • A reconciliation between the non-GAAP and comparable GAAP measures <p>Prohibited: Any measure that is misleading</p>
Item 10(e)(1)(i) of Regulation S-K	Not applicable	<p>Required:</p> <ul style="list-style-type: none"> • Presentation, with equal or greater prominence, of the most directly comparable GAAP measure • A reconciliation between the non-GAAP and comparable GAAP measures • Reasons why management believes the presentation of the non-GAAP measure is useful to investors • Any additional purposes for which management uses the non-GAAP measure 	<p>Required:</p> <ul style="list-style-type: none"> • Presentation, with equal or greater prominence, of the most directly comparable GAAP measure • A reconciliation between the non-GAAP and comparable GAAP measures • Reasons why management believes the presentation of the non-GAAP measure is useful to investors • Any additional purposes for which management uses the non-GAAP measure
Item 10(e)(1)(ii) of Regulation S-K	Not applicable	Not applicable	<p>Prohibited:</p> <ul style="list-style-type: none"> • Liquidity measures excluding charges or liabilities that require cash settlement or would have required cash settlement absent an ability to settle in a different manner; not applicable to EBIT and EBITDA • An adjustment of a non-GAAP performance measure to eliminate or smooth items identified as nonrecurring, infrequent, or unusual when 1) the nature of the item is reasonably likely to recur within two years or 2) there was a similar item in the prior two years • Presentation of non-GAAP financial measures on the face of the GAAP financial statements or in the notes • Presentation of non-GAAP financial measures on the face of any pro forma required by Article 11 of Regulation S-X • Use of titles or descriptions of non-GAAP measures that are the same as or confusingly similar to titles of GAAP measures

Examples of Corp Fin's Objections to Non-GAAP Measures

In remarks before the [2016 Baruch College Financial Reporting Conference](#) on May 5, 2016, SEC Deputy Chief Accountant Wesley R. Bricker discussed the SEC's recent comment process for non-GAAP measures and noted that the Corp Fin staff has objected to certain non-GAAP measures. He said that the comments "have focused on" three things: 1) "a company's disclosure as to why their non-GAAP measures are useful", 2) "apparent cherry picking [of] adjustments within a non-GAAP measure", and 3) "adjustments to remove normal, cash operating expenses."

An April 28, 2016, Wall Street Journal article¹ included an example of the SEC objecting to apparent cherry-picking of adjustments in a non-GAAP measure. In a 2011 initial public offering, an online marketing company used a non-GAAP profit measure that excluded marketing costs that represented the largest expense necessary for the company's revenue generation. According to the article, the company responded by "scal[ing] back its use of the metric in response to the SEC's concerns."

As discussed in a March 1, 2016, Bloomberg article,² another objection by the SEC to the cherry-picking of non-GAAP adjustments was included in a letter to a worldwide energy company, in which the SEC staff gained some assurances (from the CFO) that the company would make no further disclosures of a measure that had removed the impact of energy price changes on the company's earnings for the period. The company argued that using the measure was an effort to present earnings trends based on factors the company could control. This measure was disallowed by the SEC staff.

Additional Non-GAAP Measures That Have Caused Concern

In his May 5 remarks, Bricker also discussed "recent examples of company practices related to non-GAAP measures [that] have caused concern," including: 1) "the use of individually-tailored accounting principles to calculate non-GAAP earnings," 2) "providing per share data for non-GAAP performance measures that look like liquidity measures," and 3) "non-GAAP tax expense."

In addition, he noted that "practices related to operating metrics have also caused concern."

Non-GAAP Measures That Use Individually Tailored Accounting Principles

As an example of “the use of individually-tailored accounting principles,” Bricker discussed a company with a subscription-based business that bills for and receives the entire subscription amount up front and, under GAAP, recognizes revenue over the subscription delivery period. The company then presents a non-GAAP measure that accelerates the recognition of revenue to the up-front billing date instead of over the service period. Bricker said that this non-GAAP measure is “a replacement of an important accounting principle with an alternate accounting model that does not match the company’s subscriptions business or earnings process, which is over time.”

Bricker warned that Corp Fin will issue comments to a company that presents a non-GAAP measure that adjusts revenue and that the staff will “closely, and skeptically,” review the company’s basis for any non-GAAP revenue adjustments.

Mark Kronforst, Corp Fin’s chief accountant, cited the same example – a subscription-based business that accelerated its revenue recognition – at a Northwestern University legal conference. The April 28 Wall Street Journal article noted that the SEC is “signaling it plans to target firms that inflate their sales results and employ customized metrics that stray too far from

accounting rules.” Kronforst told the Journal that the SEC will push back on non-GAAP measures that “accelerate the recognition of revenue that is supposed to be deferred into the future.” Kronforst also noted that the SEC will take exception to the practice of a company “[creating] a measure that no longer reflects its business model.” The article stated that letters that address this issue will be released to the public in the coming months.

According to the April 28 Journal article, the SEC recently observed an additional example of using individually tailored accounting principles: a non-GAAP measure extending the useful life of equipment in the non-GAAP measure, with the goal of extending the recognized costs over a longer period of time.

Crowe Observation: In the context of using individually tailored accounting principles, Wesley Bricker’s remarks were specific to revenue adjustments. The May 17 updated C&DIs make it clear that similar non-GAAP adjustments to other financial statement amounts using individually tailored accounting principles would also be disallowed. See Question 100.04 of the C&DIs.

Non-GAAP Measures That Provide per Share Data for Non-GAAP Performance Measures That Look Like Liquidity Measures

In the same April 28 article, Kronforst was quoted as acknowledging that the SEC plans to challenge the use of adjusted earnings on a per share basis because those amounts on a non-GAAP basis often are higher than the GAAP per share amounts and look too much like liquidity (or cash flow) measures. The basis for such a challenge is that GAAP (specifically, Accounting Standards Codification (ASC) 230-10-45-3) does not allow cash flow measures to be presented on a per share basis because cash flows could then be confused with actual earnings.

In the May 17 updated C&DIs, Question 102.05 states 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 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.”

Therefore, companies must carefully analyze whether the non-GAAP per share measures presented are prohibited on the basis that those per share measures “can” be used as liquidity measures, which is a more restrictive threshold than whether they *are* used as liquidity measures.

Non-GAAP Tax Expense

Corp Fin addressed non-GAAP tax expense adjustments in the May 17 updated C&DIs. Specifically, Question 102.11 clarifies that income tax effects on non-GAAP adjustments should be presented and explained separately, and they should be calculated based on the nature of the measure. The C&DIs provide examples: If a liquidity measure that includes income taxes is used, GAAP taxes might need to be adjusted to show cash paid for taxes. If a performance measure is used, current and deferred tax expense should be included in the measure.

Corporate Governance and Other Reminders From Recent SEC Speeches

In his May 5 remarks, Bricker reminded the audience of the four following points that have been made recently by SEC personnel. To quote him directly:

- First, preparers should consider how their disclosure controls and procedures apply to the disclosure of non-GAAP measures.
- Second, despite the fact that GAAP measures sometimes gets forgotten once analysts and the press start commenting on a company's results, investors should refer back to a company's financial statements so that the non-GAAP measures are put into the proper context.
- Third, audit committees should be paying close attention to the non-GAAP measures a company presents, including the required related disclosures, and the processes it follows to consider both the appropriateness and reliability of the measures.
- I also would note that Chair White has mentioned the possibility of future rulemaking in this area.

Framework for Evaluating Non-GAAP Measures Provided in Recent SEC Chair Speech

In the [keynote address](#) of the 2015 American Institute of CPAs National Conference, "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility," SEC Chair White mentioned the use of non-GAAP measures, noting that although they are allowed for purposes of presenting relevant and useful performance information, "the measures are used extensively and [...] may be a source of confusion." She urged preparers, finance and legal teams, and audit committees to consider the following questions when using non-GAAP measures:

- Why are you using the non-GAAP measure, and how does it provide investors with useful information?
- Are you giving non-GAAP measures no greater prominence than the GAAP measures, as required under the rules?
- Are your explanations of how you are using the non-GAAP measures – and why they are useful for your investors – accurate and complete, drafted without boilerplate?
- Are there appropriate controls over the calculation of non-GAAP measures?

New Guidance – Updated C&DIs on Non-GAAP Measures

Press releases, analyst calls, periodic filings, and other investor presentations should not include potentially misleading non-GAAP measures, and proper disclosure should be made in order to avoid investor confusion. Furthermore, if non-GAAP measures are used, there are additional disclosure requirements and prohibitions pursuant to Regulation G and Item 10(e) of Regulation S-K (see table). The disclosure requirements include reconciling the differences between the non-GAAP measure and the comparable GAAP measure and presenting the GAAP measure with prominence equal to or greater than that of the non-GAAP measure.

C&DIs are issued by Corp Fin to inform SEC registrants and other stakeholders about the division's views on certain non-GAAP topics. The May 17, 2016 updated interpretations of non-GAAP measures describe measures that can be misleading due to the nature of the adjustments or inconsistency in the adjustments. The update also addresses presentation prohibitions related to specific non-GAAP measures and to the greater prominence of the non-GAAP measure than that of the comparable GAAP measure.

Nature and Consistency of Non-GAAP Adjustments

As indicated by Question 100.01 of the C&DIs, certain adjustments can make a non-GAAP measure misleading. That question provides an example of potentially misleading performance (or profit) measures: one that excludes “normal, recurring, cash operating expenses necessary to operate a registrant’s business.”

Another example of a misleading non-GAAP measure is in Question 100.02: one that is presented inconsistently in multiple periods if the change in presentation is not disclosed and properly explained. The guidance states that “it may be necessary to recast prior measures to conform to the current presentation.” Question 100.03 also says that a non-GAAP measure can be misleading if it is adjusted only for nonrecurring charges when there were also nonrecurring gains in the same period. Under this guidance, companies should evaluate not only whether their non-GAAP measures are presented consistently from period to period but also whether the presentation of non-GAAP adjustments is consistent for both gains and losses of a similar nature.

Presentation Prohibitions Related to Specific Non-GAAP Measures

The updated C&DIs address specific non-GAAP measures presented by registrants. For example, Questions 102.01 and 102.02 discuss the use of “funds from operations” as a non-GAAP measure. The respective answers clarify that, when presented as defined by the National Association of Real Estate Investment Trusts, the measure can be used as a performance measure and presented on a per share basis. However, certain adjustments to the defined measure could result in a prohibited presentation.

Another non-GAAP measure that the C&DIs address is related to the prohibition of nonrecurring, infrequent, or unusual adjustments contained in Item 10(e) of Regulation S-K, as clarified in Question

102.03: The prohibition is specific to the description of the amount that is being adjusted. Although specific to “non-recurring, infrequent, or unusual” adjustments, this guidance can be applied to all non-GAAP adjustments – that is, adjustments should be described in a manner that is consistent with the adjustments’ nature and should not be described using misstatements of fact.

Regarding the specific non-GAAP measure “free cash flow,” Question 102.07 says that a clear description of the free cash flow calculation and a reconciliation of it to the comparable GAAP measure should be presented, because the measure is not defined uniformly. In addition, the measure is not representative of, and should not be presented as, the residual cash flow available for discretionary expenses, because some mandatory or nondiscretionary expenses are not

Crowe Observation: In a review of comment letters that were publicly released by the SEC in 2015 and early 2016, we noted that the SEC staff objected to the use of certain descriptions but allowed the use of the described non-GAAP measures when described in a different manner.

- “Core earnings” (a measure used in a number of industries, but the SEC staff took particular exception to practices observed in the banking industry) should not exclude income or expense that is integral to the company’s core operations.
- “Adjusted EBITDA” should not be labeled as “EBITDA.”

The basis for the staff’s objections appear to be in the “description” concept addressed by updated Question 102.03 in the C&DIs. That is, the description of the non-GAAP measure should accurately describe the adjustments made to arrive at that measure.

deducted from the measure. Consistent with other liquidity measures, free cash flow is prohibited from being presented on a per share basis.

Regarding EBIT or EBITDA, Question 103.02 states that, when presented as a performance measure, it should be reconciled to net income, and it cannot be presented on a per share basis because the measure can be used as a liquidity measure.

Prominent Presentation of Comparable GAAP Measures

In filings with the SEC and earnings releases, the most directly comparable GAAP measure must be presented as prominently as or more prominently than the non-GAAP measure. Examples of non-GAAP measures presented more prominently than the comparable GAAP measure, and therefore prohibited under Item 10(e)(1) of Regulation S-K, are provided in Question 102.10 of the updated C&DIs:

- A full non-GAAP income statement, even when it represents the reconciliation to the comparable GAAP measure

- Headlines or captions that omit the comparable GAAP measures
- Formatting of a non-GAAP measure that emphasizes it more than the comparable GAAP measure
- Non-GAAP measures that precede the comparable GAAP measures
- Descriptive characterization of the non-GAAP measure that is not at least equally as prominent as the description of the comparable GAAP measure
- Table of non-GAAP financial measures that is not preceded by a table of the comparable GAAP measures, or a table that consists of non-GAAP financial measures only and does not include the comparable GAAP measures
- Forward-looking non-GAAP measures that exclude reconciliations based on the “unreasonable efforts” exception in Item 10(e)(1) of Regulation S-K without disclosing reliance on that exception and stating the information that is unavailable and its probable significance
- A discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure

Crowe Observation: Because non-GAAP measures are a departure from GAAP, a key consideration for evaluating the quality of non-GAAP disclosures is the verification that such disclosures are not misleading (see Regulation G). The measures should provide valuable information to investors, and they should not be used to present a picture that is inconsistent with the one painted by GAAP measures in earnings calls, investor presentations, SEC filings, and any other publicly available information.

SEC Resources

- Corp Fin's Compliance and Disclosure Interpretations, "[Non-GAAP Financial Measures](#)," updated May 17, 2016
- SEC Release No. 33-8176, "[Final Rule: Conditions for Use of Non-GAAP Financial Measures](#)"
- Topic 8 of Corp Fin's [Financial Reporting Manual](#)

Contact Information

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¹ Dave Michaels, "SEC Cracks Down on Novel Earnings Measures That Boost Profits," Wall Street Journal, April 28, 2016.

² Dave Michaels, "Fuzzy-Math Accounting Chided by Buffett Gets Fresh SEC Scrutiny," Bloomberg, March 1, 2016.