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SEC Guidance on Non-GAAP Financial Measures

Authors: Jeffrey Nadler and Nir Servatka

On May 17, 2016, the staff of the U.S. Securities and Exchange Commission (SEC) updated its Compliance and Disclosure Interpretations (C&DIs) to provide guidance on the use and presentation of non-GAAP financial measures, to address increasing concerns that these measures were being used improperly. This guidance is also relevant to Canadian public companies and other foreign private issuers that are SEC registrants, especially to those that prepare financial statements in accordance with generally accepted accounting principles (GAAP) in the United States.

Background

Non-GAAP financial measures are those numerical measures of a company's historical or future financial performance, financial position or cash flows that either exclude amounts that are included by GAAP or include amounts that are excluded by GAAP, such as EBIT (earnings before interest and taxes) and EBITDA (earnings before interest, taxes, depreciation and amortization). Reporting companies often supplement their financing statements and other financial disclosures with non-GAAP financial measures to present unique measures that are intended to help investors evaluate performance.

In 2003, pursuant to a mandate under the *Sarbanes-Oxley Act of 2002*, the SEC adopted Regulation G to regulate the use of non-GAAP financial measures in press releases and other public statements (for example, webcasts) made by SEC reporting companies. Whenever a reporting company chooses to use a non-GAAP financial measure, it must also include the most comparable measure calculated in accordance with GAAP and a reconciliation of the non-GAAP financial measure to that GAAP measure. Regulation G also includes a general anti-fraud provision.[1] While Regulation G exempts foreign private issuers that satisfy certain requirements, the exemption is not available to foreign private issuers (including Canadian issuers) that use a non-GAAP financial measure derived from or based on a measure calculated and presented in accordance with U.S. GAAP.[2]

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[1] No registrant shall make public a non-GAAP financial measure that, taken together with the information accompanying that measure and any other accompanying discussion of that measure, contains an untrue statement of a material fact, or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, misleading.

[2] Foreign private issuers are exempt from Regulation G if the following conditions are satisfied: (i) the foreign private issuer's securities are listed on a non-U.S. exchange; (ii) the non-GAAP financial measures included in the foreign private issuer's public communication are not derived from or based on a measure calculated and presented in accordance with GAAP; and (iii) the communication is made

In addition, a reporting company cannot include a non-GAAP financial measure in a document filed with the SEC unless it also complies with the stricter requirements set forth in Item 10(e) of Regulation S-K.[3] Item 10(e) requires a reconciliation of the non-GAAP financial measure to the most *directly* comparable GAAP financial measure and a presentation with "equal or greater prominence" of the most *directly* comparable GAAP financial measure. A narrative description of the use and purpose of the non-GAAP financial measure is also required, including disclosure of the reasons why management believes that the non-GAAP financial measure provides useful information to investors regarding the issuer's financial condition and results of operations and material disclosure of any additional purposes for which management uses the non-GAAP financial measure. In addition, the use of certain potentially misleading non-GAAP financial measures is completely prohibited.[4] Foreign private issuers are generally subject to the stricter non-GAAP financial measure requirements of Item 10(e) of Regulation S-K in documents filed with the SEC, except that Canadian issuers are not subject to these stricter requirements in annual reports on Form 40-F or multijurisdictional disclosure system registration statements they file with the SEC.

Staff Guidance on Regulation G

The updated C&DIs provide examples of non-GAAP financial measures that the SEC staff believes could be potentially misleading and, therefore, could violate the anti-fraud provisions of Regulation G, including the following:

- presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business;
- presenting a non-GAAP financial measure inconsistently between periods by adjusting a particular charge or gain in the current period for which other similar charges or gains were not adjusted in prior periods; and
- presenting a non-GAAP financial measure that is adjusted for non-recurring charges but not for non-recurring gains that occurred during the same period.

Finally, non-GAAP financial measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could violate the anti-fraud provision of Regulation G.

Staff Guidance on Item 10(e) of Regulation S-K

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by or on behalf of the foreign private issuer outside the United States, or is included in a written communication that is released by or on behalf of the foreign private issuer outside the United States. This exemption is not available for foreign private issuers that prepare and report financial statements in accordance with U.S. GAAP.

[3] Regulation S-K applies to registration statements filed under the *Securities Act of 1933*, as amended, as well as registration statements, periodic and current reports and other documents filed under the *Securities Exchange Act of 1934*, as amended.

[4] Among other things, a registrant is not permitted to (i) exclude from non-GAAP liquidity measures (except for EBIT and EBITDA) charges or liabilities that required or will require cash settlement (or would have required cash settlement absent an ability to settle in another manner); or (ii) adjust a non-GAAP performance measure to eliminate or smooth a nonrecurring, infrequent or unusual item when the nature of the charge or gain is reasonably likely to recur within two years or where there has been a similar charge or gain within the prior two years.

The updated C&DIs provide examples of presentations of non-GAAP financial measures that the SEC staff would consider to violate Item 10(e) of Regulation S-K because they are presented more prominently than the comparable GAAP measures, including the following:

- presenting a full income statement of non-GAAP financial measures or presenting a full non-GAAP income statement when reconciling non-GAAP financial measures to the most directly comparable GAAP measures;
- omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP financial measures;
- presenting a non-GAAP financial measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP financial measure over the comparable GAAP measure;
- having a non-GAAP financial measure that precedes the most directly comparable GAAP measure;
- describing a non-GAAP financial measure (for example, as “record performance” or “exceptional”) without an at least 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; and
- providing discussion and analysis of a non-GAAP financial measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence.

While Item 10(e) of Regulation S-K does not prohibit the use of per share non-GAAP financial measures, it has been the SEC staff’s long-standing position that a per share non-GAAP financial measure that is used as a liquidity measure (as opposed to a performance measure) cannot be presented on a per share basis in documents filed or furnished with the SEC. The updated C&DIs indicate that whether per share data is prohibited depends on whether the non-GAAP financial measure can be used as a liquidity measure, even if management presents it solely as a performance measure. According to the updated C&DIs, when analyzing these questions, the SEC staff will focus on the substance of the non-GAAP financial measure and not management’s characterization of such measure. In addition, the updated C&DIs expressly provide that free cash flow is a liquidity measure that must not be presented on a per share basis and that EBIT or EBITDA must not be presented on a per share basis.

The updated C&DIs clarify that if an issuer presents EBIT or EBITDA as a performance measure, these measures should be reconciled to GAAP net income. GAAP operating income would not be considered the most directly comparable GAAP financial measure under Item 10(e) of Regulation S-K because EBIT and EBITDA make adjustments for items that are not included in operating income.

The updated C&DIs also clarify how income tax effects should be calculated and presented in relation to adjustments to arrive at a non-GAAP financial measure. According to the SEC staff, reporting companies should provide income tax effects on their non-GAAP financial measures depending on the nature of the measures. If the non-GAAP financial measure is a liquidity measure that includes income taxes, it might be acceptable to adjust GAAP taxes to show taxes paid in cash. If the non-GAAP financial measure is a performance measure, the issuer should include current and deferred income tax expense commensurate with the non-GAAP financial measure of profitability. In addition, adjustments to arrive at a non-GAAP financial measure should not be presented “net of tax.” Rather, income taxes should be shown as a separate adjustment and clearly explained.

Reporting companies are encouraged to establish appropriate controls over the calculation and use of non-GAAP financial measures to ensure compliance with Regulation G and Item 10(e) of Regulation S-K, particularly in light of the updated SEC guidance, and to have their audit committee carefully oversee and monitor the use of such measures.

If you have any questions regarding the foregoing, please contact Jeffrey Nadler (212.588.5505) or Scott D. Fisher (212.588.5596) in our New York office.

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