What you need to know

- SEC officials are publicly expressing concerns about companies’ growing use of non-GAAP financial measures, particularly when those measures differ significantly from US GAAP metrics.

- In light of these comments, companies should review the applicable SEC rules and reconsider whether any non-GAAP financial measures they communicate to investors are useful and appropriately supplement their GAAP metrics.

- Management and the audit committee also should consider enhancing the company’s controls to maintain ongoing compliance with SEC regulations on the disclosure of non-GAAP financial measures.

Overview

Securities and Exchange Commission (SEC or the Commission) officials are publicly expressing concerns about companies’ growing use of non-GAAP financial measures in filings with the Commission and in earnings releases, particularly when those measures differ significantly from GAAP metrics.¹

At the AICPA National Conference on Current SEC and PCAOB Developments in December 2015, SEC Chair Mary Jo White said companies’ extensive use of non-GAAP financial measures can be confusing. She questioned whether current SEC rules “are being followed” and are “sufficiently robust in light of current market practices.” SEC Chief Accountant James Schnurr recently called the increasing use of non-GAAP measures by companies, analysts and the
media “troubling.” The staff in the SEC’s Division of Corporation Finance focuses on non-GAAP measures in its filing reviews and comment letters, and Mr. Schnurr said the staff “will continue to be vigilant.”

These comments suggest that the SEC staff is likely to object more frequently to the disclosure of non-GAAP measures and that enforcement actions are possible if the SEC believes that a company’s conduct is egregious. SEC officials are obviously concerned that non-GAAP financial measures can be potentially misleading, can obscure the relevant US GAAP measures, may not be comparable among companies or between periods and may not be sufficiently transparent.

Non-GAAP financial measures provide an alternative source of information, and management may disclose them to help investors better understand a company’s operating performance, cash flows or financial position. Common non-GAAP measures include earnings before interest, taxes, depreciation and amortization (EBITDA) and, for real estate investment trusts, funds from operations (FFO). Companies also may adjust other GAAP measures or further adjust common non-GAAP measures to exclude, for example, nonoperating gains and losses, restructuring charges, integration costs, stock compensation costs, impairment charges or gains and losses from asset dispositions.

Given the increased focus at the SEC, management and the audit committee should review the applicable SEC rules and, at a minimum, make sure their non-GAAP measures comply with those requirements. They also may want to consider enhancing the company’s disclosure controls to maintain ongoing compliance with SEC rules. In light of the growing scrutiny from regulators and the financial media, it is important for companies to follow disciplined practices when constructing non-GAAP measures and to be transparent and evenhanded when disclosing such measures.

Background

While the SEC staff has long expressed concerns about the improper use of non-GAAP financial measures, the SEC didn’t regulate these measures until Congress passed the Sarbanes-Oxley Act of 2002 (the Act).² The Act directed the SEC to implement and enforce rules requiring that, when non-GAAP financial measures are disclosed, they must be presented in a manner that (1) does not contain an untrue statement of a material fact or omit a material fact necessary to make the “pro forma financial information,” in light of the circumstances under which it is presented, not misleading, and (2) reconciles the “pro forma financial information” presented with the financial condition and results of operations of the company under US GAAP.

The SEC adopted a final rule in 2003 that implemented the following requirements:

- Regulation G, which applies to a company’s public disclosures or releases of material information that include non-GAAP financial measures
- Item 10(e) of Regulation S-K (Item 10), which applies to the use of non-GAAP financial measures in filings with the Commission
- Item 2.02 of Form 8-K, which requires public companies to furnish to the SEC earnings releases or announcements that disclose material nonpublic financial information about completed annual or quarterly fiscal periods
In a series of frequently asked questions called *Regarding the Use of Non-GAAP Financial Measures — Frequently Asked Questions* (FAQs), the SEC staff significantly limited the use of non-GAAP financial measures in SEC filings. This resulted in many companies choosing to present non-GAAP measures only in earnings releases and other investor communications and excluding them from their SEC filings. In 2010, the staff issued a series of less restrictive Compliance and Disclosure Interpretations (C&DI) that superseded those FAQs. The C&DI effectively encouraged companies to disclose non-GAAP financial measures in their SEC filings if they did so in other financial communications.

Now SEC officials are expressing concerns that the pendulum has swung too far and that companies may be inappropriately using non-GAAP measures in both SEC filings and other communications and that analysts and the media are focusing too much on these measures.

**SEC rules on non-GAAP financial measures**

The SEC rules describe the requirements and prohibitions for disclosing non-GAAP measures in SEC filings, earnings releases and other communications. The appendix to this publication summarizes these by the form of corporate communication.

**Requirements**

- *Presentation and reconciliation of non-GAAP measures* — Non-GAAP amounts must be accompanied by, and reconciled to, the corresponding GAAP measures in a manner that is consistent with their use as either performance measures or liquidity measures, and those GAAP measures must be presented with equal or greater prominence. Any non-GAAP measure should be presented in proximity to the GAAP measure with an appropriate balance of discussion. The reconciliation should be presented with each adjustment clearly labeled and separately quantified. These requirements, which are intended to make sure investors understand the relationship of non-GAAP measures to the most comparable GAAP measures, apply to both SEC filings and earnings releases.

- *Discussion of measures* — Non-GAAP measures must be accompanied by disclosures that explain (1) why the measures are useful to investors and (2) any additional ways management uses the measure, if material. These disclosures need to include sufficient detail that fully explains how management uses the non-GAAP measures and how they are useful to users.

**Prohibitions**

- *Not to be misleading* — Companies are prohibited from making public a non-GAAP financial measure that, taken together with any accompanying information, contains an untrue statement of material fact or omits a material fact necessary to make the presentation of the non-GAAP measure not misleading.

- *Prohibitions related to presentation* — Companies are prohibited from presenting non-GAAP measures on the face of the financial statements or on the face of Article 11 pro forma financial information. Companies also are prohibited from using titles or descriptions for non-GAAP measures that are the same as or similar to those of GAAP measures.

By definition, non-GAAP financial measures exclude segment profit measures that must be disclosed under Accounting Standards Codification (ASC) 280, *Segment Reporting*. However, companies should be aware that presenting segment-level profit information on a consolidated basis, which ASC 280 does not require, creates a non-GAAP financial measure that must comply with the applicable SEC disclosure rules.
Use of non-GAAP financial measures

When evaluating a company’s use and presentation of non-GAAP financial measures, management and the audit committee may want to consider the following questions Chair White posed in her speech in December:

- Why is the non-GAAP measure being used, 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 measure – 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?

Providing useful information

Non-GAAP measures that management presents should provide investors with useful and meaningful insights about a company’s performance, operations, profitability or cash flows. If the SEC staff believes a non-GAAP measure a company presents is not meaningful or may be misleading, the staff may request that the company remove the measure from its SEC filing or earnings release. The SEC staff has made these requests when companies have disclosed non-GAAP profit measures that go beyond accepted industry practices, eliminate items related to core operations or use different recognition and measurement principles than US GAAP.

**Example SEC comment — Non-GAAP measure that uses different recognition and measurement principles than US GAAP**

- We note that the non-GAAP measure labeled Adjusted EBITDA includes an adjustment to defer actuarial gains / losses that have been recognized in pension costs under your accounting policy. Please explain how the non-GAAP adjustment to eliminate actuarial gains / losses is useful to investors as it appears to modify your accounting by reflecting an expected return on plan assets rather than the actual return on plan assets.

**How we see it**

- We believe that, in the current environment, the SEC staff may more frequently challenge companies' use of measures that it believes are inappropriate.

- Based on recent SEC comment letters, companies should carefully evaluate the appropriateness of modifying GAAP recognition and measurement principles to produce non-GAAP measures.

Companies should carefully evaluate adjustments they make in calculating a non-GAAP measure and challenge whether they appropriately help investors understand and evaluate the company. For example, it would appear misleading for an early-stage life sciences company that focuses on research and development (R&D) to adjust EBITDA by adding back R&D expense. In this case, given R&D is the significant operating and business focus of the company, it likely would be inappropriate to present a profitability metric that removes these charges.

**Example SEC comment — Are the non-GAAP measures presented misleading?**

- We note your use of the non-GAAP measure Adjusted Operating Income, which excludes, among other items, certain operating expenses. It appears that the excluded operating expenses are normal, recurring operating cash expenditures of the company. Your removal of this item from your results of operations creates a non-GAAP measure that is potentially misleading to readers.
**Prominence**

The prominence of a non-GAAP measure refers to both the order and manner of its presentation, as well as the emphasis of the related discussion versus the comparable GAAP measure. Given the heightened focus of analysts and the financial media on non-GAAP amounts, it is likely that the prominence of a company's disclosure of non-GAAP measures will receive increased SEC staff scrutiny. At a minimum, it is important for the company's discussion of GAAP and non-GAAP metrics to be balanced. Since non-GAAP measures can receive no more than equal prominence, a company may want to err on the side of giving greater emphasis and prominence to its discussion of GAAP amounts. For example, it would be inappropriate for a company to discuss positive results and trends in its non-GAAP measures without a balanced discussion of any negative results or trends in its GAAP metrics. Moreover, the appropriateness of non-GAAP measures garners heightened regulatory attention when they differ significantly from GAAP amounts (e.g., a non-GAAP profit and a GAAP loss).

### Example SEC comment – Prominence of a Non-GAAP financial measure

- We note that you disclose adjusted operating income and adjusted operating income margin, two non-GAAP financial measures, without disclosing the comparable financial measures calculated in accordance with GAAP. Please revise this section to present with equal or greater prominence, the most directly comparable financial measures calculated and presented in accordance with GAAP. See Item 10(e)(1)(i)(A) of Regulation S-K and Instruction 2 to Item 2.02 of Form 8-K.

Given the prevalent use of non-GAAP measures in earnings releases and calls, the media often report a company's performance solely on the basis of non-GAAP financial measures. While media reports are not subject to SEC regulations, SEC officials have expressed concern about this phenomenon, particularly when the non-GAAP measure is unique to the company or differs significantly from the amounts or trends reported under GAAP. In light of this, companies should be careful of the prominence they give to non-GAAP financial measures in their earnings calls and financial presentations.

**Accurate explanation**

Management should clearly describe what each non-GAAP measure represents, why the measure is of interest to users and why the various adjustments, individually or in the aggregate, are consistent with the measure’s intended purpose. Providing a thorough discussion about the usefulness of a non-GAAP measure, rather than mere boilerplate, can help a company justify that its disclosure is appropriate. It is not sufficient to say that a non-GAAP measure is presented because it is used by analysts.

For example, a company with an unusual legal settlement unrelated to its core operations that negatively affected reported earnings should provide enough detail to explain why adding back the charge is useful to investors (e.g., the lawsuit didn’t relate to the core business and eliminating the legal charge helps users understand and develop expectations for that business).

With many companies now disclosing more than one non-GAAP financial measure, it has become more challenging for users to understand the purpose of the various measures and the differences among them. For example, companies may present both EBITDA and Adjusted EBITDA (or FFO and Adjusted FFO), but the objectives of the adjusted measure may not be readily apparent. In such cases, it is important that the company clearly explain the basis of each computation, how the adjusted measure differs from the standard one and why each measure is useful in different ways.
Companies should also describe any other material ways that management uses the non-GAAP financial measures. For example, companies may have debt covenants or incentive compensation arrangements that are solely based upon non-GAAP financial measures. In those situations, the company should disclose those additional uses when the non-GAAP financial measure is disclosed because it is useful to investors. In other cases, it may be necessary to disclose the non-GAAP financial measure because it becomes material to investors (e.g., the company is at risk of violating a debt covenant based on a non-GAAP measure that could have material liquidity implications for the company).

The example below shows how a company might respond to an SEC staff request for more robust disclosure about a non-GAAP financial measure.

<table>
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<tr>
<th>Company disclosure before and after receiving comments from the SEC staff</th>
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<tbody>
<tr>
<td><strong>Before</strong></td>
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<tr>
<td>We have presented adjusted operating income and adjusted EBITDA as supplemental measures of financial performance that are not required by, or presented in accordance with, GAAP. Management believes these non-GAAP financial measures provide meaningful supplemental information regarding our results because they exclude amounts that management does not consider part of our normal and recurring operations when assessing and measuring the operational and financial performance of the organization.</td>
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<td><strong>SEC staff comment</strong></td>
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<tr>
<td>Please revise the disclosure to provide the reasons why you believe that your presentation of each of the non-GAAP financial measures provides useful information to investors regarding your financial condition and results of operations. The justification for the use of the non-GAAP financial measure must be substantive. Merely indicating that you provide such non-GAAP financial measures to give investors additional data to evaluate your operations is not sufficient support for disclosure of the non-GAAP financial measures. Please also revise to expand your disclosure of the additional purposes for which management uses each of the non-GAAP financial measures.</td>
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<tr>
<td><strong>After</strong></td>
</tr>
<tr>
<td>Management believes that adjusted operating income and adjusted EBITDA provide relevant and useful information, which is widely used by analysts, investors and competitors in our industry as well as by our management in assessing both consolidated and business unit performance.</td>
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<tr>
<td>Adjusted operating income provides us with an understanding of the results from the primary operations of our business by excluding the effects of certain dispositions and special items that do not reflect the ordinary earnings of our operations. We use adjusted operating income to evaluate our period-over-period operating performance because our management believes this provides a more comparable measure of our continuing business as it adjusts for dispositions and special items that are not reflective of the normal earnings of our business. This measure may be useful to an investor in evaluating the underlying operating performance of our business.</td>
</tr>
<tr>
<td>Adjusted EBITDA provides us with an understanding of one aspect of earnings before the impact of investing and financing charges and income taxes. Adjusted EBITDA may be useful to an investor in evaluating our operating performance and liquidity because this measure:</td>
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<tr>
<td>• Is widely used by investors to measure a company’s operating performance without regard to items excluded from the calculation of such measure, which can vary substantially from company to company depending upon accounting methods, book value of assets, capital structure and the method by which assets were acquired, among other factors.</td>
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• Is a financial measurement that is used by rating agencies, lenders and other parties to evaluate our creditworthiness
• Is used by our management for various purposes, including as a measure of performance of our operating entities and as a basis for strategic planning and forecasting

Controls over non-GAAP measures

Non-GAAP measures generally aren’t required to be disclosed in periodic SEC reports, and some may question whether their disclosure falls within the scope of the company’s disclosure controls and procedures. Nevertheless, given the need to comply with SEC disclosure rules and the potential consequences of material errors and omissions or misleading non-GAAP presentations, companies should develop and implement controls over the creation and reporting of non-GAAP measures.

Among other things, controls should address whether there is sufficient transparency about non-GAAP financial measures, including their reconciliation to GAAP, whether their calculation might be biased and whether they are presented on a consistent basis from period to period. For example, in defining a non-GAAP profit metric, it is important for companies to treat gains and losses of a similar nature in the same manner by consistently including or excluding both. Further, when a non-GAAP measure includes a new adjustment, it is important that prior period measures also be revised to reflect similar items that existed in those earlier periods.

In light of the heightened scrutiny of non-GAAP disclosure practices, it is important that the related controls be applied with appropriate rigor and oversight. Companies should consider formally documenting these policies and controls, as well as any updates to them. If the company has a disclosure committee, its responsibilities for non-GAAP disclosures should be clearly articulated and understood. If the presentation of a non-GAAP measure requires judgment or interpretation, a company should consider maintaining contemporaneous documentation to address any subsequent challenges.

Next steps

Companies should reconsider and challenge their disclosure of non-GAAP measures. This effort should involve executive and financial management, investor relations, the legal department, securities counsel and the audit committee.

Endnotes:

1 In this publication, GAAP refers to generally accepted accounting principles in accordance with which a company prepares its financial statements. This includes US GAAP and other sets of principles such as IFRS that foreign private issuers use to prepare their financial statements.

2 Section 401 of the Sarbanes-Oxley Act – Disclosures in periodic reports.
## Appendix: SEC rules on non-GAAP financial measures

<table>
<thead>
<tr>
<th>Requirements</th>
<th>Earnings releases</th>
<th>Other communications</th>
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<tr>
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<tr>
<td>• A statement disclosing the reasons why management believes the presentation of the non-GAAP measure provides useful information to investors</td>
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<td>• Disclosing a non-GAAP financial measure that, taken together with accompanying information, misstates a material fact or omits a material fact necessary to make the presentation not misleading</td>
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<td>• Excluding from non-GAAP liquidity measures charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner</td>
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<td>• Adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent, or unusual, when it is likely to recur or has occurred over a two-year period</td>
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