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# Technical Line

## How to appropriately use non-GAAP measures to discuss the effects of COVID-19

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### What you need to know

- A new accommodation from the SEC staff allows registrants to reconcile non-GAAP measures to provisional GAAP amounts if they haven't completed their accounting measurements due to the effects of the COVID-19 pandemic.
- Item 10(e) of Regulation S-K and Regulation G and the SEC staff's guidance on non-GAAP measures continue to apply to adjustments related to the effects of COVID-19.
- Registrants that want to portray the effects of COVID-19 should limit adjustments in their non-GAAP measures to charges incurred or gains recognized that clearly relate to COVID-19 and are incremental to, and separable from, normal operations. They can't present a non-GAAP measure that includes estimates of lost revenue.
- Registrants can quantify and discuss other effects of COVID-19 on their operations or their financial condition as long as they don't adjust GAAP measures to reflect what their performance or condition would have been without those effects.

## Overview

Registrants that are considering using non-GAAP financial measures to discuss the effects of the coronavirus (COVID-19) pandemic need to understand the accommodation the Securities and Exchange Commission (SEC) staff in the Division of Corporation Finance provided in Disclosure Guidance: Topic No. 9, Coronavirus (COVID-19).[1]

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The accommodation relates to the reconciliation requirements in Regulation G and Item 10(e) of Regulation S-K. The SEC staff has said it will not object if a registrant that is facing difficulties reporting financial results due to COVID-19 reconciles a non-GAAP measure to the corresponding GAAP measure, even if that GAAP measure includes provisional items (i.e., best estimates or ranges). The accommodation can be used for measures presented in connection with an earnings release but cannot be used for measures presented in periodic reports filed with the SEC.

The accommodation applies only to measures that have been provided to the board of directors. The SEC staff said it believes that a registrant should disclose only non-GAAP financial measures that are consistent with how management and the board are analyzing the current and potential effects of the COVID-19 pandemic on the registrant's financial condition and operating results. Accordingly, a registrant should not present a non-GAAP measure "for the sole purpose of presenting a more favorable view of the company," the SEC staff said.

The other requirements of Item 10(e) of Regulation S-K, Regulation G and the SEC staff Non-GAAP Compliance and Disclosure Interpretations continue to apply to the use of non-GAAP measures with adjustments related to COVID-19.

The following questions and answers are intended to help registrants understand and use this new accommodation in communications outside of periodic filings and make acceptable non-GAAP adjustments related to the pandemic that comply with the SEC's rules and staff guidance.

## Key considerations

### Understanding and using the accommodation

***Which GAAP items can be estimated for use in a reconciliation of a non-GAAP measure?***

While the staff didn't specify which GAAP items would qualify under the accommodation, we believe that they would include line items affected by a broad range of accounting measurements that are challenging and time consuming to complete because of the pandemic. These items include those affected by asset impairments involving inventory, goodwill, indefinite-lived intangible assets and other long-lived assets. Items affected by relief provided by the Coronavirus Aid, Relief, and Economic Security (CARES) Act, the $2.2 trillion stimulus package that was enacted on 27 March 2020, may also include provisional measurements.

See our Technical Lines, ***Accounting and reporting considerations for the effects of the coronavirus outbreak*** and ***Accounting for impairment of goodwill and indefinite-lived intangible assets due to the coronavirus,*** for more information about asset impairments and other items that may be affected by COVID-19. See our Technical Line, ***Accounting for the income tax effects of the CARES Act and the COVID-19 pandemic,*** and To the Point, ***Relief provided by the CARES Act will affect accounting and financial reporting***, for information about items that may be affected by provisions of the CARES Act.

***Can a non-GAAP measure be reconciled to the corresponding GAAP measure that includes an estimate of the results of an entire consolidated subsidiary if the registrant experiences challenges accessing certain records of that subsidiary and/or its key personnel?***

Yes, if enough information is available to develop a reasonable estimate. Excluding the results of a subsidiary would not be appropriate, given the longstanding SEC staff position that presentations that exclude consolidated subsidiaries would be considered a misleading use of individually tailored accounting principles.

***What disclosures does a company need to make if it reconciles a non-GAAP measure to a GAAP measure that incorporates provisional amounts?***

A registrant should comply with the disclosure requirements in Item 10(e) of Regulation S-K by making sure that the non-GAAP measure is not more prominent than the GAAP measure that incorporates provisional amounts and explaining why the non-GAAP measure provides useful information to investors. In addition, a registrant should disclose, to the extent material, how management and the board of directors use the non-GAAP measure.

The guidance requires a registrant to explain, to the extent practicable, why the GAAP line item(s) or accounting is incomplete, and what additional information or analysis may be needed to complete the accounting. We believe most registrants should be able to make this disclosure.

***Can the provisional GAAP measure used in the reconciliation also be presented in the earnings release using a full income statement format?***

Yes, if the estimated item or range is clearly identified using parentheses or footnotes and the income statement includes only GAAP line items. A registrant that uses a range in such a presentation should also express the subtotals and totals that follow it as a range.

We believe such a presentation would be acceptable in an earnings release, regardless of whether the release includes any non-GAAP measures.

Registrants must comply with the SEC's rules and guidance when reporting non-GAAP measures that reflect adjustments for COVID-19.

However, the SEC staff does not permit a registrant to use a full income statement format to convey any non-GAAP information.

***Can an earnings release present a partial income statement or selected GAAP subtotals without presenting a full income statement?***

Yes, unless the partial income statement or individual GAAP subtotals would be misleading without the omitted information. We believe that the staff is more likely to accept the omission of income statement line items that are presented closer to net income because the omission of these items may not materially alter an investor's understanding of the company's performance. For example, a registrant might be able to provide an income statement that ends with income before income taxes or present that line item on its own, along with an explanation about why the registrant couldn't provide a full income statement. We believe such a presentation would be acceptable in an earnings release, regardless of whether the release includes any non-GAAP measures.

## How we see it

Registrants with acute challenges in reporting financial information should consider contacting the SEC staff to discuss those challenges. For example, a registrant that cannot release financial information to investors without excluding a material subsidiary affected by the pandemic should consider contacting the SEC staff to discuss alternatives that would allow for disclosure of material information to investors in a timely manner.

### COVID-19-related non-GAAP adjustments

***What framework can a registrant use to evaluate whether COVID-19-related adjustments are acceptable?***

As noted above, the requirements in Item 10(e) of Regulation S-K and Regulation G as well as the SEC staff's related guidance continue to apply to all non-GAAP measures. A registrant must consider how the rules and guidance apply to its own facts and circumstances and should never present a non-GAAP measure in a way that is misleading. We expect the staff to focus intently on how companies use non-GAAP measures in their upcoming earnings release and periodic reports.

The SEC staff's guidance and comment letters on registrants' uses of non-GAAP measures in SEC filings in the past provide a framework to help registrants evaluate whether COVID-19-related adjustments are acceptable.

Therefore, we believe that non-GAAP measures that are adjusted for the effects of COVID-19 should generally exclude only items that are directly attributable to the pandemic and are both:

- Incremental to charges incurred prior to the outbreak and not expected to recur once the crisis has subsided and operations return to normal
- Clearly separable from normal operations

We also note that the SEC staff has not suggested there is a need to revisit whether common adjustments in non-GAAP measures remain appropriate (e.g., asset impairments; restructuring charges, including severance payments). However, a registrant using one of these common adjustments for the first time should retrospectively adjust its non-GAAP measures for prior periods if the item also materially affected those periods.

***What types of adjustments would be consistent with this framework*?**

We believe that adjustments for charges or gains related to the following activities may be acceptable if the charges or gains are attributable to COVID-19 and are incremental to and separable from normal operations:

- Temporarily paying a premium to compensate employees for performing their normal duties at increased personal risk (e.g., hazard pay)
- Cleaning and disinfecting facilities more thoroughly and/or more frequently
- Terminating contracts or complying with contractual provisions invoked directly due to the events of the pandemic (e.g., contract termination fees or penalties)
- Insurance recoveries

A registrant that incurs charges and recognizes gains attributable to COVID-19 should be mindful of the SEC staff's guidance that says a non-GAAP measure can be misleading if it excludes nonrecurring charges but does not exclude nonrecurring gains.

***What adjustments should a registrant avoid?***

Adjustments related to the following items would not be consistent with the framework described above and should be avoided unless further guidance is provided by the SEC staff:

- Paying idled employees
- Rent and other recurring expenses (e.g., security, utilities, insurance, maintenance) related to temporarily idled facilities
- Excess capacity costs expensed in the period due to lower production
- Paying employees for increased hours required to perform their normal duties
- Paying more for routine inventory costs (e.g., shipping costs)

In addition, a registrant should not use a non-GAAP measure that includes adjustments to normalize operations, such as including estimates of lost revenue to show what results would have been without the effects of the pandemic.

***If a registrant cannot use a non-GAAP measure to convey information about a COVID-19-related item and its effects, how can the registrant convey information to investors about the item and its effects?***

A registrant can typically supplement its non-GAAP measures with disclosure about other items that had a material effect on the company but could not be reflected as an adjustment. For example, payroll expenses related to employees idled during the pandemic could be highlighted in earnings release materials as follows:

> "Payroll paid to employees idled due to the COVID-19 pandemic of approximately $xx million are included within cost of revenue, selling, general and administrative and research and development expenses."

This type of disclosure is not considered a non-GAAP presentation because it does not provide payroll calculated on both a GAAP basis and an adjusted basis excluding amounts paid to idled employees. It merely draws investors' attention to an unusual expense and conveys useful information about it. Because such a presentation is not subject to the SEC's non-GAAP rules or the staff's guidance, there is neither a prohibition against presenting it more prominently than GAAP information nor any explicit requirements to disclose why the information is useful to investors or how it is used by management or the board of directors.

## How we see it

A registrant can describe and quantify the effects of the pandemic (including those that would otherwise be prohibited non-GAAP adjustments) in one place by listing those effects separately without adjusting its GAAP results. For example, this could be done in a supplemental table that describes each item and includes dollar amounts. While the non-GAAP rules and related SEC staff guidance would not apply to this supplemental information, a registrant that presents such a table should consider explaining how and why it can help investors analyze the registrant's results.

**Endnote:**

[1] See our To the Point, ***SEC extends relief and issues staff guidance on COVID-19 disclosures***, for a full discussion of the guidance.