WINSTON & STRAWN LLP

CLIENT ALERT

Public Company Update: New Non-GAAP Guidance

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On May 17, 2016, the Securities and Exchange Commission (the “SEC”) issued formal guidance on the use of non-GAAP financial measures in the form of new and revised Compliance and Disclosure Interpretations (“C&DIs”). The C&DIs are the culmination of several months of indications from Chairman Mary Jo White and others at the SEC of a renewed focus by the SEC on non-GAAP financial measures and, in particular, whether non-GAAP measures can potentially be misleading or are otherwise given undue prominence in earnings releases and elsewhere in a public company’s SEC filings. This new guidance is effective immediately and public companies should review their earnings releases and related investor decks and regular Securities Exchange Act of 1934, as amended (the “Exchange Act”), reporting disclosure in advance of second quarter earnings and consider what revisions may be necessary to comply with such guidance.

Non-GAAP Background

A non-GAAP financial measure is a measure of a company’s future or historical financial performance, financial position or cash flows that includes or excludes amounts from the most directly comparable measure under U.S. generally accepted accounting practices (“GAAP”). Regulation G and Item 10(e) of Regulation S-K govern the use of non-GAAP financial measures by public companies. Regulation G governs all public disclosures by companies reporting pursuant to the Exchange Act, including earnings press releases. Pursuant to Regulation G, when providing a non-GAAP financial measure, companies must (i) present the most directly comparable GAAP measure and (ii) provide a reconciliation between the non-GAAP financial measure and such comparable GAAP measure. Item 10(e) of Regulation S-K governs all filings made pursuant to the Securities Act of 1933, as amended (the “Securities Act”) or the Exchange Act. In addition to the requirements of Regulation G, to comply with Item 10(e) in a securities filing, a company must (i) disclose the reasons that management believes the non-GAAP measure is useful to investors and (ii) to the extent material, disclose the additional purposes for which management uses such non-GAAP measure.

When disclosing non-GAAP financial measures, public companies:

- may not exclude charges or liabilities from liquidity measures (other than EBITDA and EBIT) that require cash settlement, absent an ability to settle in another manner;

- cannot adjust a non-GAAP measure to eliminate or smooth non-recurring, infrequent or unusual items where such items reasonably are likely to recur within two years or there has been a similar charge or gain within the prior two years; and

- may not use titles or descriptions of non-GAAP measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.

In addition, when taken together with the information accompanying a non-GAAP measure and any other accompanying disclosure, a non-GAAP measure may not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances in which it is presented, misleading.

New Non-GAAP Guidance

In issuing its new and revised C&DIs, the SEC focused on (i) non-GAAP measures and related disclosure that potentially may be misleading to investors and (ii) how to avoid giving undue prominence to non-GAAP financial measures.

Potentially Misleading Non-GAAP Measures

In four new C&DIs, the SEC specifically addressed the requirement that non-GAAP financial measures not be misleading and clarified that even when a non-GAAP measure includes an adjustment that is not otherwise explicitly prohibited, the presentation of such measure still may be misleading. In particular, the SEC identified the following non-GAAP practices that may be deemed to be misleading:

- Excluding normal, recurring, cash operating expenses necessary to operate a company’s business.

- Presenting adjustments inconsistently between periods.

  - This situation would arise, for example, when a particular charge or gain is adjusted in the current period but other, similar charges or gains were not also adjusted in prior periods. Companies should consider disclosing the change and the reason for such change between periods to avoid being misleading and, if the change is significant enough, companies should consider recasting the prior presentation to conform to the current presentation to avoid being misleading.

- Excluding non-recurring charges when non-recurring gains occurred during the same period and are not excluded.

- Utilizing individually tailored recognition and measurement methods for financial statement line items.

  - The Staff has cautioned against using non-GAAP measures to substitute GAAP accounting principles for a company’s own accounting principles. For example, where GAAP requires a company to recognize revenue over the term of a contract, the company should not disclose a non-GAAP measure that accelerates revenue recognition as though it earned revenue when customers are billed.

Undue Prominence of Non-GAAP Measures

The new SEC guidance states that whether a non-GAAP measure is more prominent than the comparable GAAP measure generally depends on the facts and circumstances in which the disclosure is made. However, the SEC provided the following specific examples of non-GAAP disclosure that would be considered more prominent than the related GAAP disclosure:

- Presenting a full income statement of non-GAAP measures or including a full non-GAAP income statement as part of a GAAP reconciliation.

- Including only non-GAAP measures in earnings release headlines or captions or having such non-GAAP measures precede the related GAAP measures.
- Presenting a non-GAAP measure using a style presentation (i.e. bold, italics, larger font) that emphasizes the non-GAAP measure over the GAAP measure.
- Providing tabular disclosure of only non-GAAP financial measures without preceding such disclosure with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table.
- Providing a descriptive characterization of a non-GAAP measure, such as “record performance” or “exceptional,” without an equally prominent description of performance on a GAAP basis.
- Excluding a quantitative reconciliation with respect to a forward-looking non-GAAP measure in reliance on the “unreasonable efforts” exception without appropriate disclosure.
    - Companies historically have relied on the safe harbor in Item 10(e) of Regulation S-K that requires companies to include a reconciliation for forward-looking non-GAAP information “to the extent available without unreasonable efforts.” The new SEC guidance states that companies relying on this safe harbor must explicitly disclose that they are doing so and also identify the information unavailable for the reconciliation and its probable significance and give such information equal or greater prominence as the forward-looking non-GAAP information.
- Providing discussion and analysis of a non-GAAP measure without a similar discussion of the GAAP measure.

Per Share Non-GAAP Measures

The SEC guidance clarified that non-GAAP liquidity measures that measure cash generated may not be presented on a per cash basis. In determining whether a non-GAAP measure is a performance measure (which may be presented on a per share basis) or a liquidity measure (which may not be presented on a per share basis), the SEC will focus on the substance of the measure, regardless of whether management has characterized the measure as a performance measure. The SEC further clarified that free cash flow is a liquidity measure that may not be presented on a per share basis.

Income Tax Adjustments

Finally, the SEC guidance provided that the presentation of income tax effects on a company’s non-GAAP measures depends on the nature of the measures. If a measure is a liquidity measure that includes income taxes, it might be acceptable to adjust GAAP taxes to show taxes paid in cash. If a measure is a performance measure, current and deferred income tax expense should be included in the non-GAAP measure. Finally, the SEC provided that adjustments to arrive at non-GAAP measures should not be presented “net of tax.” Rather, income taxes should be shown as a separate adjustment and clearly explained.

Recommendation

In light of the new non-GAAP guidance, we recommend that our public company clients review their earnings releases and related investor decks and regular Exchange Act reporting disclosure in advance of second quarter earnings and consider what revisions may be necessary to comply with such guidance. Clients should also assume that the SEC will be reviewing earnings releases and other publicly available communications containing non-GAAP measures as part of regular Exchange Act reviews and all communications should comply with the new guidance.

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