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The Do's And (Mostly) Don'ts Of Non-GAAP Measures

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When it comes to a company's financial disclosures, you might think that more is better. For example, in securities class actions, plaintiffs often allege that a company, its directors and officers, or its auditors made or endorsed inadequate disclosures; too much disclosure is rarely, if ever, the complaint. The U.S. Securities Exchange Commission, however, has its own opinion, at least regarding disclosures of non-GAAP (generally accepted accounting principles) measures. The increased use of non-GAAP measures, such as adjusted earnings or adjusted earnings per share, became a repeat topic of conversation in 2015 and 2016 for Mary Jo White, former chairwoman of the SEC.[1][2] White noted that the presentation of non-GAAP measures should not be misleading to investors.[3] In particular, White was concerned that "[i]n too many cases, the non-GAAP information ... [is] crowding out and effectively supplanting the GAAP presentation."[4] Her concerns culminated with the SEC's issuance of compliance and disclosure interpretations (C&DIs) regarding non-GAAP financial measures in May 2016.[5]

With these C&DIs as its framework, the SEC has since issued numerous letters to companies noting concerns with specific disclosures of non-GAAP information. Given that the SEC is a frequent source of enforcement actions, including litigation, this article examines a sample of that correspondence to understand the SEC's implementation of the C&DIs and identifies and categorizes the SEC's hot buttons.

Background

The reporting of non-GAAP measures in companies' public filings and news releases has increased steadily over the past few decades. The trend reversed temporarily following the SEC's 2003 release of Regulation G, which requires public companies that disclose non-GAAP financial measures to present, and reconcile to, the most directly comparable GAAP financial measures.[6] But the use of non-GAAP measures gradually regained its prevalence and has recently been at historic highs.[7] In the third quarter of 2015, more than 80 percent of the S&P 500 companies reported non-GAAP measures in earnings releases.[8]

This trend has not gone unnoticed by the SEC, which is concerned that some companies might opportunistically disclose misleading non-GAAP information.[9] Indeed, recent empirical research shows that some firms may report non-GAAP measures when they are higher than GAAP measures but not vice versa.[10] Also, some companies may design and report non-GAAP earnings that meet or beat consensus analyst forecasts; companies are more likely to meet or beat analyst estimates when using non-GAAP earnings that are higher than GAAP earnings.[11]

Focus on Comparability, Prominence and Purpose of Non-GAAP Measures

To identify what reporting practices draw the SEC's attention, we reviewed a sample of company correspondences addressing comments from the SEC staff.[12] The sample consists of 72 correspondences filed between June 1, 2016, and July 21, 2016, after the SEC's issuance of C&DIs regarding non-GAAP financial measures in May 2016.[13]

In 53 percent of the correspondences, the SEC's comments addressed disclosures in 10-Ks while 40 percent concerned 8-Ks (e.g., earnings releases). The SEC appears to focus on 1) whether comparable GAAP measures are presented when a non-GAAP measure is reported (28 percent of the sampled correspondences), 2) whether the presentation of GAAP measures is more prominent than that of non-GAAP measures (31 percent), and 3) the purpose of disclosing the non-GAAP measures (33 percent). In addition, the SEC frequently targets the following non-GAAP financial measures: 1) adjusted EBITDA, or earnings before interest, tax, depreciation and amortization (25 percent), and 2) adjusted earnings/net income (17 percent) or adjusted earnings per share (17 percent).

Below are examples of companies' disclosures that drew fire from the SEC.[14]

Show Comparable GAAP Measures

SEC: "You present non-GAAP financial measures related to HSNi in the bullet points just below your headline of the earnings release while omitting comparable GAAP measures." (HSN Inc., July 6, 2016)

HSNi Results for the First Quarter 2016:

- Net sales decreased 3% and Adjusted EBITDA decreased 10%
- Digital sales up 3% with sales penetration of 52%
- Adjusted EPS was $0.54 compared to $0.63 per share

SEC: "You provide tabular disclosure of your 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." (Nationstar Mortgage Holdings Inc., July 8, 2016)

	Quarter Ended			
($ in millions, unless noted)	Q4'15		Q1'16	
	$	BPS	$	BPS
Adjusted Pretax Income:				
Income (loss) before taxes (GAAP)	$ 118	11.7	$ (208)	(21.2)
Other mark-to-market	(67)	(6.7)	253	25.8
Non-recurring expenses	—	—	4	0.4
Adjusted pretax income	$ 51	5.1	$ 49	5.0

SEC: "Your narrative appears to place more prominence on non-GAAP financial measures such as adjusted EBITDA and adjusted EPS without providing a discussion of the corresponding GAAP financial measures." (Cabot Corp., July 8, 2016)

Keohane continued, "As a result, we anticipate that we will not achieve the target of $0.75 of adjusted EPS improvement. However, with the current positive momentum, we expect a significantly stronger second half of the year and currently anticipate fiscal year 2016 adjusted EPS in the range of $3.05 to $3.25. In addition, we continue to drive strong cash flow generation through our adjusted EBITDA growth and discipline around capital spending and net working capital."

GAAP Measures Must Be Equally or More Prominent

SEC: "You present non-GAAP adjusted EPS before your GAAP diluted EPS in your earnings release headline." (Cabot Corp., July 8, 2016)

Cabot Corporation Reports Second Quarter Fiscal 2016 Results

Adjusted EPS of $0.70 and Diluted EPS of $0.76

SEC: "You present non-GAAP adjusted earnings of $.27 per share that precedes a GAAP loss of $1.28 per share in your earnings release headline ..." (Nationstar Mortgage Holdings Inc., July 8, 2016)

Nationstar Reports First Quarter 2016 Financial Results

- **Q1'16 Adjusted EPS of 27 cents, GAAP loss of $1.28 per share**
- **Servicing profitability of 5.0 basis points (bps)**

SEC: "Within the Key Data table ... you present non-GAAP adjusted IFO before GAAP income from operations." (Koninklijke Philips NV, July 11, 2016)

Key data in millions of EUR unless otherwise stated
2014 - 2015

	2014	2015
Sales	21,391	24,244
Comparable sales growth	(1)%	2%
Adjusted IFO	821	1,372
as a % of sales	*3.8%*	*5.7%*
IFO	486	992
as a % of sales	*2.3%*	*4.1%*
Net income	411	659

Explain Purpose of Disclosure

In addition to focusing on how the non-GAAP information is presented, the SEC staff also requests companies to provide more information regarding the purpose of disclosing non-GAAP measures and how they are useful to investors. In some instances, the SEC staff demands companies to further elaborate on how they define the non-GAAP measures.

- SEC: “Please disclose how your non-GAAP financial measures provide useful information to investors regarding your financial condition and results of operations.” (Nationstar Mortgage Holdings Inc., July 8, 2016)

- SEC: “It is not clear that the additional disclosures you intend to provide adequately address why you believe it is necessary to present 10 non-GAAP measures to enhance comparability of your financial results.” (Colgate-Palmolive Co., July 8, 2016)

- (For a company that modified its non-GAAP measures) SEC: “Please include disclosure in future filings that describes the adjustments made to previously reported Non-GAAP measures, the reasons for such adjustments and why the revised measure disclosed represents a more useful presentation of the Company’s operating performance.” (Nasdaq Inc., July 14, 2016)

To Conclude

The articulation of the examples above should not discourage companies from disclosing non-GAAP measures that they believe are useful to users of their financial statements. Rather, preparers of financial statements can look to these examples to modify their own companies’ disclosures to reduce the likelihood of SEC scrutiny and to avoid presenting non-GAAP measures that financial statement users may find misleading.

Moreover, while the SEC has been focusing on non-GAAP measures presented in 8-Ks and 10-Ks, companies should not limit their consideration to such filings. The SEC is not the only party scrutinizing non-GAAP measures, and companies may find themselves subject to litigation regarding the disclosure of non-GAAP measures in other company announcements.

For example, shareholders of Time Warner recently filed a suit claiming that the company’s proxy statement recommending a vote to accept AT&T’s acquisition offer violated SEC rules regarding non-GAAP measures. Level 3’s shareholders filed a suit claiming that Level 3’s proxy statement regarding its agreement to merge with CenturyLink contained misleading non-GAAP projections. In both cases, the shareholders claim that the non-GAAP measures used in the proxy statements to convey the financial situation of the mergers were misleading since certain information about how those measures were formed or can be reconciled to GAAP was omitted.

Thus, whenever companies report non-GAAP measures, regardless of the nature of the filing or announcement, companies should ensure that comparable GAAP measures are disclosed and given equal prominence as non-GAAP measures. Companies should also articulate clearly the purpose for the disclosure of non-GAAP measures and how the information provides additional insight about the financial situation of the companies. Furthermore, it is important that enough information about the non-GAAP measures is disclosed so that users of the non-GAAP measures understand how the measures are computed and how they can be reconciled with GAAP measures.

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information purposes and is not intended to be and should not be taken as legal advice.

[1] Chairwoman Mary Jo White, “Keynote Address 2015 AICPA National Conference — ‘Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility,’" Dec. 9, 2015.

[2] Chairwoman Mary Jo White, “Keynote Address International Corporate Governance Network Annual Conference,” June 27, 2016.

[3] Ibid.

[4] Ibid.

[5] SEC, Non-GAAP Financial Measures Compliance & Disclosure Interpretations (C&DIs), last updated May 17, 2016, https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm

[6] Final Rule: Conditions for Use of Non-GAAP Financial Measures, https://www.sec.gov/rules/final/33-8176.htm

[7] Curtis, Asher B., Sarah E. McVay, and Benjamin C. Whipple. "The disclosure of non-GAAP earnings information in the presence of transitory gains." The Accounting Review 89, no. 3 (2013): 933-958.

[8] Derryck Coleman and Olga Usvyatsky, “Trend in Non-GAAP Disclosures,” Audit Analytics, Dec. 1, 2015.

[9] Chair Mary Jo White, “Keynote Address International Corporate Governance Network Annual Conference,” June 27, 2016.

[10] Curtis, Asher B., Sarah E. McVay, and Benjamin C. Whipple. "The disclosure of non-GAAP earnings information in the presence of transitory gains." The Accounting Review 89, no. 3 (2013): 933-958.

[11] Doyle, Jeffrey T., Jared N. Jennings, and Mark T. Soliman. "Do managers define non-GAAP earnings to meet or beat analyst forecasts?" Journal of Accounting and Economics 56, no. 1 (2013): 40-56.

[12] The SEC staff issue comments to companies in connection with their review of the companies’ filings (comment letters). Upon receiving comment letters from the SEC, companies submit responses to address SEC’s comments (Correspondences), where the companies/filers quote and supply a response to each of the SEC’s comments.

[13] SEC Full-Text Search of EDGAR filings, last accessed and searched on Aug. 25, 2016.

[14] Companies’ original disclosures are collected from SEC EDGAR company filings.
