

SEC Updates Guidance on Non-GAAP Financial Measures

On January 11, 2010, the Securities and Exchange Commission (“SEC” or “Commission”) released Compliance and Disclosure Interpretations (“C&DIs”) regarding the use of non-GAAP financial measures, replacing the frequently asked questions released in 2003 (“2003 FAQs”).¹ The C&DIs provide additional guidance and clarification, and encourage registrants to include non-GAAP financial information in public disclosures and SEC filings that are in compliance with Regulation G² and Item 10(e)³ of Regulation S-K. The most significant changes, additions and clarifications are summarized below.

I. Adjustments for Non-recurring, Infrequent or Unusual Items

Item 10(e) prohibits registrants from “[a]djust[ing] a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years.”⁴ The C&DIs states that:

“The prohibition is based on the description of the charge or gain that is being adjusted. It would not be appropriate to state that a charge or gain is non-recurring, infrequent or unusual unless it meets the specified criteria. The fact that a registrant cannot describe a charge or gain as non-recurring, infrequent or unusual, however, does not mean that the registrant cannot adjust for that charge or gain. Registrants can make adjustments they believe are appropriate, subject to Regulation G and the other requirements of Item 10(e) of Regulation S-K.”⁵

II. No Requirement to Use Non-GAAP Measure in Management’s Business

Language in the 2003 FAQs strongly implied that permissible disclosure of non-GAAP financial measures was limited to those measures actually used in the management of the registrant’s business. The C&DIs

¹ See Compliance and Disclosure Interpretations: Non-GAAP Financial Measures (January 11, 2010), available at <http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm> [hereinafter Compliance and Disclosure Interpretations]; Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures (June 13, 2003), available at <http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm> [hereinafter Frequently Asked Questions].

² 17 C.F.R. § 244.100–102. Regulation G requires a registrant that discloses non-GAAP financial measures in public disclosures, both written and oral, to include a presentation of the most directly comparable GAAP financial measures and to reconcile the differences between the non-GAAP financial measures and the most directly comparable GAAP financial measures.

³ 17 C.F.R. § 229.10(e). Item 10(e) presents several requirements, limitations and prohibitions regarding the presentation of non-GAAP financial information in SEC filings. Among the requirements are presentation and reconciliation requirements similar to those found in Regulation G. Other important requirements are that the registrant provide a statement disclosing why management believes the non-GAAP financial information presented is useful to investors and, to the extent material, a statement disclosing the additional purposes, if any, for which the registrant’s management uses the non-GAAP financial measures.

⁴ 17 C.F.R. § 229.10(e)(ii)(B).

⁵ Compliance and Disclosure Interpretations, *supra* note 1, at Question 102.03. The C&DIs also removed burdensome language contained in the 2003 FAQs which discouraged registrants from removing recurring items from non-GAAP performance measures.

not only eliminate such language, but expressly state: “There is no prohibition against disclosing a non-GAAP financial measure that is not used by management in managing its business.”⁶

III. Free Writing Prospectus

The C&DIs state that Item 10(e) applies to a free writing prospectus⁷ included or incorporated by reference into the issuer’s registration statement or included in a filing under the Securities Exchange Act of 1934, as amended.⁸ The 2003 FAQs predated the use of free writing prospectuses.

IV. Full Non-GAAP Income Statements Inappropriate

The C&DIs state that it is generally inappropriate to present a full non-GAAP income statement for purposes of reconciling non-GAAP measures. The SEC’s concern is that this may accord undue prominence to the non-GAAP information.⁹

V. “Net of Tax” Adjustment

The C&DIs permit a registrant to present an adjustment “net of tax” when reconciling a non-GAAP performance measure, provided the tax effect of each reconciliation is disclosed either parenthetically or in a footnote. Alternatively, the registrant may present the tax effect in one line in the reconciliation. The registrant must also disclose how the tax effect was calculated.¹⁰

VI. EBIT and EBITDA

The SEC continues to maintain that, aside from a narrow exception, the only non-GAAP liquidity measures in SEC filings that may exclude charges or liabilities that required or will require cash settlement are EBIT (earnings before interest and taxes) and EBITDA (earnings before interest, taxes, depreciation and amortization).¹¹ The exception, retained in the C&DIs, allows for the use of a non-GAAP liquidity measure other than EBIT and EBITDA in the aforementioned circumstances when, for example, a registrant’s credit agreement contains a material covenant regarding the measure.¹² This is because the MD&A section in such filings must include the disclosure of material items that affect liquidity. While the 2003 FAQs required that the title of such alternative measures “should clearly identify the earnings measure being used and all adjustments,”¹³ the C&DIs

⁶ Compliance and Disclosure Interpretations, *supra* note 1, at Question 102.04.

⁷ A free writing prospectus is any written communication that constitutes an offer to sell securities relating to a registered offering that is used after the registration statement for the offering is filed that does not constitute a statutory prospectus (a prospectus satisfying the requirements of section 10(a) of the Securities Act of 1933, as amended), is not a written communication used in reliance on Rule 167 and Rule 426, and does not fall into the exemption from the definition of prospectus provided under section 2(a)(10)(a) of the Securities Act of 1933, as amended. *See* 17 C.F.R. § 230.405.

⁸ Compliance and Disclosure Interpretations, *supra* note 1, at Question 102.08.

⁹ *See id.* at Question 102.10.

¹⁰ *See id.* at Question 102.11.

¹¹ *See id.* at Question 103.01.

¹² *See id.* at Question 102.09.

¹³ *See* Frequently Asked Questions, *supra* note 1, at Question 14.

simply require that the title “should be clearly distinguished from ‘EBIT’ or ‘EBITDA.’”¹⁴ This appears to be a largely superficial change. Additionally, the C&DIs removed language which dissuaded the presentation of EBIT or EBITDA as a performance measure.

VII. Segment Measures

The C&DIs removed language present in the 2003 FAQs which stated that “it would be difficult to demonstrate that segment measures that are not reported to or used by the chief operating decision maker, or otherwise are not in conformity with [GAAP], are useful for investors.”¹⁵ In doing so, the Commission indicates increased acceptance of non-GAAP segment measures.

The C&DIs also clarify the Commission’s stance on whether the information in a table illustrating the breakdown of revenue by product that does not sum to a revenue amount presented in the registrant’s financial statements constitutes a non-GAAP financial measure. The C&DIs state that the product revenue amounts are not considered non-GAAP financial measures, so long as they are calculated in accordance with GAAP. However, the information is considered a non-GAAP financial measure if the revenue amounts are adjusted.¹⁶

VIII. The Use of Constant Currency

The C&DIs discuss how a registrant with operations in various foreign countries may utilize a constant currency presentation in its MD&A in order to isolate the effects of exchange-rate fluctuations. A registrant may comply with the reconciliation requirements of Regulation G and Item 10(e) by presenting both the historical and constant currency amounts, describing the process for calculating the constant currency amounts and describing the basis of presentation.¹⁷ The 2003 FAQs did not address constant currency presentations.

IX. Foreign Private Issuers and “Expressly Permitted” Non-GAAP Financial Measures

The Note to Item 10(e) allows a foreign private issuer to include in its filings non-GAAP financial measures that Item 10(e)(1)(ii) would otherwise prohibit if, among other things, the home-country standard setter for the GAAP used in the registrant’s primary financial statements has either “required or expressly permitted” the use of the non-GAAP financial measures in such filings. The 2003 FAQs noted that a measure is “expressly permitted” if the home-country standard setter clearly and specifically identified the measure as acceptable. This resulted in significant confusion as to the meaning of “expressly permitted” because foreign standard setters do not commonly provide express authorization of accounting measures that are not specified in the applicable accounting standards. To resolve this confusion, the C&DIs state that a foreign private issuer can also demonstrate the concept of “expressly permitted” by showing “explicit acceptance of a presentation by the primary securities regulator in the foreign private issuer’s home country jurisdiction or market.”¹⁸ Explicit acceptance includes “(1) published views of the regulator or members of the regulator’s staff or (2) a letter from

¹⁴ See Compliance and Disclosure Interpretations, *supra* note 1, at Question 103.01.

¹⁵ Compare *id.* at Question 104.03 with Frequently Asked Questions, *supra* note 1, at Question 20.

¹⁶ See Compliance and Disclosure Interpretations, *supra* note 1, at Question 104.05.

¹⁷ See *id.* at Question 104.06.

¹⁸ *Id.* at Question 106.01.

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the regulator or its staff to the foreign private issuer indicating the acceptance of the presentation — which would be provided to the Commission’s staff upon request.”¹⁹

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com.

¹⁹ *Id.*