

Feb 21, 2023

## SEC Updates Guidance on Non-GAAP Financial Measures

## Clarifies the meaning of normal, recurring operating expenses

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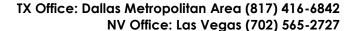
Non-GAAP financial measures have consistently been one of the most frequent comment letter topics from staff of the U.S. Securities and Exchange Commission (SEC or Commission) for decades. While these measures have long been used by SEC registrants (i.e., public companies), such as adjusted earnings, adjusted earnings per share, EBITDA (earnings before interest, taxes, depreciation, and amortization), and free cash flow, it is adjusted EBITDA that especially draws SEC comments. Adjusted EBITDA seeks to remove non-recurring, irregular, and one-time items that may distort EBITDA. Because ample judgement comes into the picture, SEC staff closely monitors these non-GAAP financial measures to ensure that they are disclosed so the comparable GAAP is of equal or greater prominence and are not misleading to investors.

On December 13, 2022, the SEC staff updated its <u>Compliance and Disclosure Interpretations</u> (<u>C&DIs</u>)<sup>1</sup> on non-GAAP financial measures to provide additional clarity and transparency on how the staff applies the guidance. The updates primarily address the nature and presentation of adjustments or measures that may be considered misleading and, therefore, violate Regulation G or Item 10(e) of Regulation S-K.

## The staff revised three existing C&DIs and added two new C&DIs:

- **C&DI 100.01** *revised*: Some stakeholders have historically struggled with how to interpret what is considered a "normal, recurring" operating expense that constitutes an inappropriate adjustment in a non-GAAP performance measure. The staff's updated guidance includes factors that it considers when evaluating an adjustment (e.g., the entity's operations, strategy, industry, regulatory environment, etc.) and clarifies that "occasional" expenses that occur irregularly may constitute recurring expenses. For example, in the retail and restaurant industries, costs associated with opening and closing stores would generally be considered 'recurring' expenses even though they may not occur on a daily or periodic basis.
- **C&DI 100.04** *revised*: The staff objects to non-GAAP financial measures that contain "individually tailored accounting principles." C&DI 100.04 previously referenced the prohibition on "individually tailored accounting principles" primarily in the context of

<sup>&</sup>lt;sup>1</sup> For ease of reference, the Appendix includes tables that compare the updated guidance to the prior guidance and present the new guidance in its entirety.





adjustments that may accelerate revenue recognition. Some interpreted the prior guidance to only apply to revenue-related non-GAAP adjustments. The staff's updated guidance clarifies that an adjustment that "individually tailors" a generally accepted accounting principle applies broadly to both revenue and expenses. The staff provided additional examples of what is considered misleading, which are outlined in the Appendix.

- **C&DI 100.05 new**: The staff frequently comments on non-GAAP measures and adjustments that are not described as "non-GAAP" or are labeled with potentially misleading titles. The new guidance reminds registrants that inappropriate labels are considered violations of Regulation G and provides several examples of labels that do not reflect the underlying nature of the related non-GAAP measures.
- C&DI 100.06 new: This new guidance memorializes the staff's view that misleading disclosures cannot be cured by extensive, detailed disclosures. The staff expects registrants to revise their non-GAAP presentation (by removing the adjustment or measure) in the filing following a staff conclusion that the non-GAAP measure or adjustment is misleading.
- **C&DI 102.10** *revised*: This C&DI was updated, in part, to enhance its readability due to its length. It focuses on providing clarity about presentation that gives "undue prominence" to a non-GAAP measure. GAAP measures should always precede non-GAAP measures, whether they are in the form of dollar amounts, ratios, or percentages. Moreover, additional clarity was provided with respect to the prohibition on the presentation of a non-GAAP income statement (i.e., undue prominence is placed on the non-GAAP results if most line items and subtotals from the income statement appear in the disclosure of non-GAAP financial information).

Here is the prior guidance along with the updated guidance side-by-side:

Question	Prior Guidance	Updated Guidance <sup>2</sup>
100.01	<b>Question:</b> Can certain adjustments, although not explicitly prohibited, result in a non-GAAP measure that is misleading?	Question: Can certain adjustments, although not explicitly prohibited, result in a non-GAAP measure that is misleading?
	Answer: Yes. Certain adjustments may violate Rule 100(b) of Regulation G because they cause the presentation of the non-GAAP measure to be misleading. For example, presenting a performance measure that excludes normal, recurring, cash operating expenses	Answer: Yes. Certain adjustments may violate Rule 100(b) of Regulation G because they cause the presentation of the non-GAAP measure to be misleading. Whether or not an adjustment results in a misleading non-GAAP measure depends on a company's individual facts and circumstances.
	necessary to operate a registrant's business could be misleading. [May 17, 2016]	Presenting a non-GAAP performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business is one example of a measure that could be misleading.

<sup>&</sup>lt;sup>2</sup> Source: https://www.sec.gov/corpfin/non-gaap-financial-measures#section100

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When evaluating what is a normal, operating expense, the staff considers the nature and effect of the non-GAAP adjustment and how it relates to the company's operations, revenue generating activities, business strategy, industry and regulatory environment.

The staff would view an operating expense that occurs repeatedly or occasionally, including at irregular intervals, as recurring. [December 13, 2022]

100.04

Question: A registrant presents a non-GAAP performance measure that is adjusted to accelerate revenue recognized ratably over time in accordance with GAAP as though it earned revenue when customers are billed. Can this measure be presented in documents filed or furnished with the Commission or provided elsewhere, such as on company websites?

Answer: No. Non-GAAP measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could violate Rule 100(b) of Regulation G. Other measures that use individually tailored recognition and measurement methods for financial statement line items other than revenue may also violate Rule 100(b) of Regulation G. [May 17, 2016]

**Question:** Can a non-GAAP measure violate Rule 100(b) of Regulation G if the recognition and measurement principles used to calculate the measure are inconsistent with GAAP?

Answer: Yes. By definition, a non-GAAP measure excludes or includes amounts from the most directly comparable GAAP measure. However, non-GAAP adjustments that have the effect of changing the recognition and measurement principles required to be applied in accordance with GAAP would be considered individually tailored and may cause the presentation of a non-GAAP measure to be misleading. Examples the staff may consider to be misleading include, but are not limited to:

- changing the pattern of recognition, such as including an adjustment in a non-GAAP performance measure to accelerate revenue recognized ratably over time in accordance with GAAP as though revenue was earned when customers were billed:
- presenting a non-GAAP measure
   of revenue that deducts transaction
   costs as if the company acted as
   an agent in the transaction, when
   gross presentation as a principal is
   required by GAAP, or the inverse,
   presenting a measure of revenue
   on a gross basis when net
   presentation is required by GAAP;
   and
- changing the basis of accounting for revenue or expenses in a non-GAAP performance measure from



		an accrual basis in accordance with GAAP to a cash basis. [December 13, 2022]
100.05	N/A	Question: Can a non-GAAP measure be misleading if it, and/or any adjustment made to the GAAP measure, is not appropriately labeled and clearly described?
		Answer: Yes. Non-GAAP measures are not always consistent across, or comparable with, non-GAAP measures disclosed by other companies. Without an appropriate label and clear description, a non-GAAP measure and/or any adjustment made to arrive at that measure could be misleading to investors. The following examples would violate Rule 100(b) of Regulation G:  • Failure to identify and describe a measure as non-GAAP.  • Presenting a non-GAAP measure with a label that does not reflect the nature of the non-GAAP measure, such as:  • a contribution margin that is calculated as GAAP revenue less certain expenses, labeled "net revenue";  • non-GAAP measure labeled the same as a GAAP line item or subtotal even though it is calculated differently than the similarly labeled GAAP measure, such as "Gross Profit" or "Sales"; and  • a non-GAAP measure labeled "pro forma" that is not calculated in a manner consistent with the pro forma requirements in Article 11 of Regulation S-X. [December
100.06	N/A	13, 2022]  Question: Can a non-GAAP measure be misleading, and violate Rule 100(b) of Regulation G, even if it is accompanied by disclosure about the nature and effect of each adjustment made to the most directly comparable GAAP measure?
		Answer: Yes. It is the staff's view that a non-GAAP measure could mislead investors to such a degree that even



102.10

Question: Item 10(e)(1)(i)(A) of Regulation S-K requires that when a registrant presents a non-GAAP measure it must present the most directly comparable GAAP measure with equal or greater prominence. This requirement applies to non-GAAP measures presented in documents filed with the Commission and also earnings releases furnished under Item 2.02 of Form 8-K. Are there examples of disclosures that would cause a non-GAAP measure to be more prominent?

Answer: Yes. Although 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, the staff would consider the following examples of disclosure of non-GAAP measures as more prominent:

- Presenting a full income statement of non-GAAP measures or presenting a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures;
- Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures:
- Presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure;

extensive, detailed disclosure about the nature and effect of each adjustment would not prevent the non-GAAP measure from being materially misleading.
[December 13, 2022]

Question 102.10(a): Item 10(e)(1)(i)(A) of Regulation S-K requires that when a registrant presents a non-GAAP measure it must present the most directly comparable GAAP measure with equal or greater prominence. This requirement applies to non-GAAP measures presented in documents filed with the Commission and also earnings releases furnished under Item 2.02 of Form 8-K. Are there examples of disclosures that would cause a non-GAAP measure to be more prominent?

Answer: Yes. This requirement applies to the presentation of, and any related discussion and analysis of, a non-GAAP measure. 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. The staff would consider the following to be examples of non-GAAP measures that are more prominent than the comparable GAAP measures:

- Presenting an income statement of non-GAAP measures. See Question 102.10(c).
- Presenting a non-GAAP measure before the most directly comparable GAAP measure or omitting the comparable GAAP measure altogether, including in an earnings release headline or caption that includes a non-GAAP measure.
- Presenting a ratio where a non-GAAP financial measure is the numerator and/or denominator without also presenting the ratio calculated using the most directly comparable GAAP measure(s) with equal or greater prominence.
- Presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font, etc.) that



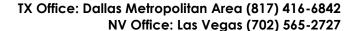
- A non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption);
- Describing a non-GAAP measure as, for example, "record performance" or "exceptional" without at least an equally prominent descriptive characterization of the comparable GAAP measure;
- Providing tabular disclosure of 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;
- Excluding a quantitative reconciliation with respect to a forward-looking non-GAAP measure in reliance on the "unreasonable efforts" exception in Item 10(e)(1)(i)(B) without disclosing that fact and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence; and
- Providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence. [May 17, 2016]

- emphasizes the non-GAAP measure over the comparable GAAP measure.
- Describing a non-GAAP measure as, for example, "record performance" or "exceptional" without at least an equally prominent descriptive characterization of the comparable GAAP measure.
- Presenting charts, tables or graphs of a non-GAAP financial measures without presenting charts, tables or graphs of the comparable GAAP measures with equal or greater prominence, or omitting the comparable GAAP measures altogether.
- Providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence. [December 13, 2022]

Question 102.10(b): Are there examples of disclosures that would cause the non-GAAP reconciliation required by Item 10(e)(1)(i)(B) of Regulation S-K to give undue prominence to a non-GAAP measure?

**Answer:** Yes. The staff would consider the following examples of disclosure of non-GAAP measures as more prominent than the comparable GAAP measures:

- Starting the reconciliation with a non-GAAP measure.
- Presenting a non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures. See Question 102.10(c).
- When presenting a forward-looking non-GAAP measure, a registrant may exclude the quantitative reconciliation if it is relying on the exception provided by Item 10(e)(1)(i)(B) of Regulation S-K. A measure would be considered more prominent than the comparable GAAP measure if it is





presented without disclosing reliance upon the exception, identifying the information that is unavailable, and its probable significance in a location of equal or greater prominence. [December 13, 2022]

Question 102.10(c): The staff considers the presentation of a non-GAAP income statement, alone or as part of the required non-GAAP reconciliation, as giving undue prominence to non-GAAP measures. What is considered to be a non-GAAP income statement?

Answer: The staff considers a non-GAAP income statement to be one that is comprised of non-GAAP measures and includes all or most of the line items and subtotals found in a GAAP income statement. [December 13, 2022]

In conclusion, while non-GAAP financial measure can clearly be beneficial for analysts and investors in understanding company performance, as well as internally used to manage the business, allocate resources, etc.; hefty disclosure requirements apply. Also, it is important to apply disclosure controls and procedures to help ensure that non-GAAP financial measure are accurate, compliant, consistent, reviewed, and supported with quality data. Remember that all public company disclosures through the SEC must have adequate disclosure controls and procedures.

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This is an article from the Governance Issues™ Newsletter, Volume 2023, Number 1, published on February 21, 2023, by Kral Ussery LLC.

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