Cahill

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SEC Staff Updates Interpretations Regarding Non-GAAP Financial Measures

On December 13, 2022, the staff of the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission (the "Commission") issued updated compliance and disclosure interpretations ("C&DIs") to address certain questions regarding the calculation and presentation of financial measures that are not included in US generally accepted accounting principles ("GAAP") and related disclosures. The text of the updated C&DIs can be found here.

Although C&DIs represent only the views of the Staff, are not regulations, and are not binding on the Staff or the Commission, the recent updates, outlined below, should assist reporting companies that utilize non-GAAP financial measures in presenting those measures in a compliant manner.

C&DI 100.01

This C&DI previously addressed the Staff's view that certain adjustments may result in a misleading non-GAAP measure, even if the adjustment is not expressly prohibited. The updated C&DI expands on this view:

- The Staff will consider the "nature and effect" of a non-GAAP adjustment as well as "how it relates to the company's operations, revenue generating activities, business strategy, industry and regulatory environment" when evaluating what is a normal operating expense (the exclusion of which from a non-GAAP measure could be misleading).
- The Staff clarified that an operating expense is "recurring" (and therefore its exclusion from a non-GAAP measure could be misleading) if it occurs "repeatedly or occasionally, including at irregular intervals."

C&DI 100.04

Now broadened, this C&DI states that a non-GAAP measure may violate Rule 100(b) of Regulation G if the recognition and measurement principles used to calculate the measure are inconsistent with GAAP. The updated C&DI provides a non-exhaustive list of examples that the Staff may consider misleading, including:

- changing the pattern of recognition, for example by including in a non-GAAP performance measure an adjustment that accelerates revenue recognition as though revenue was earned when customers were billed when, if GAAP were applied, revenue would be recognized ratably over time;
- presenting a non-GAAP measure of revenue that deducts transaction costs as if the company acted as an agent in the transaction, when GAAP requires presentation on a gross basis as a principal, or presenting a measure of revenue on a gross basis when GAAP requires presentation on a net basis; 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.

C&DI 100.05

This new C&DI discusses how a non-GAAP measure may be misleading to investors if it is not properly labeled and clearly described, because non-GAAP measures are not consistently used and defined across different companies. The C&DI lists the following examples of disclosures that would violate Rule 100(b) of Regulation G:

- failing to identify and describe a measure as non-GAAP; and
- presenting a non-GAAP measure with a label that does not reflect the nature of the non-GAAP measure, such as:
  - using the same label for a non-GAAP measure as a GAAP line item or subtotal when the two are calculated differently; or
  - labelling a non-GAAP item as "pro forma" when it has not been calculated in accordance with the pro forma rules in Article 11 of Regulation S-X.

C&DI 100.06

This new C&DI states that even if a non-GAAP measure is accompanied by "extensive, detailed" disclosure about the nature and effect of each adjustment, it may still be materially misleading to investors. The C&DI does not include any examples.

C&DI 102.10

This C&DI addresses Item 10(e) of Regulation S-K, which requires a company to present the most directly comparable GAAP measure with equal or greater prominence when disclosing a non-GAAP measure. The C&DI has been updated and divided into subsections as follows:

- *C&DI 102.10(a)* clarifies that the equal and greater prominence requirement applies to both the presentation, and any related discussion and analysis, of a non-GAAP measure. This subsection also includes several examples of non-GAAP measures that the Staff considers more prominent than comparable GAAP measures, including:
  - a non-GAAP measure that is presented before the most directly comparable GAAP measure or without including the comparable GAAP measure at all, including in an earnings release headline or caption that includes a non-GAAP measure;
  - a non-GAAP measure that is included in a ratio as the numerator and/or denominator without also including the ratio calculated using the comparable GAAP measure(s) with equal or greater prominence; and
  - non-GAAP measures that are presented in charts, tables or graphs without including charts, tables or graphs of the comparable GAAP measures with equal or greater prominence, or without including the comparable GAAP measures at all.
- *C&DI 102.10(b)* provides additional examples of disclosures that would cause the non-GAAP reconciliation required by Item 10(e) of Regulation S-K to give undue prominence to a non-GAAP measure, including:
  - Although a company may exclude a quantitative reconciliation if it is relying on the exception provided by Item 10(e)(1)(i)(B) of Regulation S-K when presenting a forward-looking non-GAAP measure, the Staff considers such a measure to be more prominent than the comparable GAAP

measure if it is presented without disclosing reliance on the exception, identifying the information that is unavailable, and disclosing its probable significance.

- *C&DI 102.10(c)* concerns presentation of a non-GAAP income statement, whether alone or as part of a required reconciliation, constitutes giving undue prominence to a non-GAAP measure, and clarifies that a non-GAAP income statement is one that includes one or more non-GAAP measures and "all or most" of the line items and subtotals found in a GAAP income statement.

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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 in it, please do not hesitate to call or email authors Geoffrey E. Liebmann (partner) at 212.701.3313 or gliebmann@cahill.com or Samantha Ragonesi (associate) at 212.701.3471 or sragonesi@cahill.com.