

AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

BDO FLASH REPORT

SEC MATTERS



SUBJECT

SEC UPDATES COMPLIANCE AND DISCLOSURE INTERPRETATIONS ON NON-GAAP FINANCIAL MEASURES

DETAILS

On May 17th, the staff of the Securities and Exchange Commission updated its Compliance and Disclosure Interpretations (C&DIs) on non-GAAP financial measures. Non-GAAP measures have recently been highlighted as an area of concern by Chair White and the staff, given registrants' extensive use of them and the potential for confusion they may cause.

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. Specifically, the updates communicate that:

- ▶ Certain adjustments to GAAP measures may be misleading even if they are not expressly prohibited by the SEC's rules. For example, the exclusion of cash operating expenses that are normal and recurring items could be misleading.
- ▶ Non-GAAP measures can be misleading if they are presented inconsistently between periods. While a change between periods is not prohibited, the reason for any change should be clearly described and disclosed. Additionally, registrants may need to consider recasting historical non-GAAP measures to conform to the current period presentation.
- ▶ Non-GAAP measures that exclude non-recurring charges but do not exclude non-recurring gains may be misleading.
- ▶ Revenue measures that are calculated using revenue recognition and measurement methods that are different from those required by GAAP are generally not permitted. The same concept may apply to financial statement line items other than revenue as well.

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- ▶ While registrants may present non-GAAP performance measures on a per share basis, registrants are prohibited from presenting non-GAAP liquidity measures on a per share basis. Whether per share data is permitted depends on whether the non-GAAP measure can be used as a liquidity measure, even if management presents it solely as a performance measure. For this reason, non-GAAP measures such as EBIT and EBITDA may not be presented on a per share basis. Also, registrants should focus on the substance of the non-GAAP measure and not management's characterization of the measure to determine whether presenting the measure on a per share basis is permissible.
- ▶ EBIT and EBITDA should be reconciled to net income (not operating income). Operating income is not the most directly comparable GAAP financial measure because EBIT and EBITDA make adjustments for items that are not included in operating income.
- ▶ Registrants are permitted to present a non-GAAP measure such as "free cash flow"¹ though they should clearly describe how the measure was determined as it does not have a uniform definition across companies. Companies should not imply that the measure represents cash available to fund discretionary expenditures as the definition typically excludes debt-service and other expenditure requirements. Since it is a liquidity measure, free cash flow should not be presented on a per share basis.
- ▶ When reconciling between GAAP measures and non-GAAP measures, the income tax effects of non-GAAP measures should be reflected as a separate adjustment and clearly explained. Reconciling items should not be presented net of tax.
- ▶ Question 102.10 provides several examples that illustrate placing undue prominence on non-GAAP measures presented (which is prohibited by Item 10(e) of Regulation S-K). These examples include, among others:
 - Omitting comparable GAAP measures from an earnings release headline that includes non-GAAP measures;
 - Presenting non-GAAP measures before the directly comparable GAAP measures;
 - Describing a non-GAAP measure as "record performance" without an equally prominent description of the comparable GAAP measure; and
 - Providing a discussion and analysis of the non-GAAP measures without a comparable discussion of the GAAP measures.

Furthermore, for registrants that present "funds from operations" (FFO), as defined by the National Association of Real Estate Investment Trusts (NAREIT), the staff clarified that it accepts NAREIT's definition of FFO in effect as of May 17, 2016 as a performance measure and does not object to its presentation on a per share basis. Additionally, registrants are permitted to present FFO on a basis other than as defined by NAREIT as long as the measure complies with Regulation G or Item 10(e) of Regulation S-K.

The C&DIs are available [here](#) on the SEC's website.

¹ Free cash flow is typically calculated as operating cash flows, less capital expenditures.

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