ROPES & GRAY

ALERT

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SEC Staff Updates Guidance on Disclosure of Non-GAAP Financial Measures

Overview

On December 13, 2022, the staff of the Division of Corporation Finance of the Securities and Exchange Commission (the "SEC") updated its guidance on registrants' disclosure of non GAAP financial measures ("non-GAAP measures") – numerical measures of a registrant's historical or future financial performance, financial position or cash flows that exclude amounts included in, or include amounts excluded from, the most directly comparable measure calculated under the generally accepted accounting principles ("GAAP") used in preparing the registrant's financial statements. These changes to the SEC's published guidance primarily update the prior guidance to reflect interpretations and practices that the SEC has already implemented through its comment process and enforcement actions.

Background

Under the federal securities laws, a registrant that publicly discloses a non-GAAP measure must present the non-GAAP measure with the most directly comparable GAAP measure, as well as a quantitative reconciliation (or, in the case of a forward-looking non-GAAP measure, a qualitative reconciliation to the extent presenting a quantitative one would involve unreasonable efforts) of the differences between the non-GAAP measure and the comparable GAAP measure. When the non-GAAP measure is included in a registrant's registration statement, periodic report or current report filed, or earnings release furnished, with the SEC, the non-GAAP measure must not be presented with greater prominence than the comparable GAAP measure. Furthermore, a publicly disclosed non-GAAP measure, when taken together with any accompanying discussion about the measure, must not be misleading.

The SEC staff's latest guidance, which was issued as an update to its Compliance and Disclosure Interpretations on non-GAAP measures (the "C&DI"), clarifies certain terms used in its prior guidance and provides additional examples of when the SEC staff would view a non GAAP measure as misleading and when they would view a non-GAAP measure as being presented with greater prominence than its comparable GAAP measure.

Specifically, the updated guidance clarifies the meaning of "normal, recurring operating expenses" and "non-GAAP income statement" in the SEC staff's prior guidance (updating Questions 100.01 and 102.10 of the C&DI), provides additional examples of misleading non GAAP measures in the context of prior guidance (updating Question 100.04), provides additional examples of non-GAAP measures presented with greater prominence than their comparable GAAP measure (updating Question 102.10, including by reorganizing it into three subsections), and includes guidance on two entirely new topics (in new Questions 100.05 and 100.06): (i) whether a non-GAAP measure can be misleading if it is not appropriately labeled and clearly described, and (ii) whether a non-GAAP measure that is accompanied by extensive disclosure about the nature and effect of each adjustment could still be misleading.

In recent months, the SEC staff have emphasized the continued focus of the Division of Corporation Finance's Disclosure Review Program on the disclosure of non-GAAP measures by registrants, as well as related enforcement actions in this area. The SEC staff's updated guidance further underscores that this is an area of current focus by the SEC staff that registrants should pay particular attention to.

The Key Takeaways from the Updated Guidance

The following are the key takeaways from the updated guidance.

Misleading Non-GAAP Measures

- The exclusion of normal, recurring, cash operating expenses that are necessary to operate a registrant's business is an example of an adjustment that would make a non GAAP "performance" measure misleading. The updated guidance states that:
  - whether an expense is a normal, operating expense depends on the nature and effect of the non-GAAP adjustment and how it relates to the registrant's operations, revenue-generating activities, business strategy, industry, and regulatory environment; and
  - an operating expense that occurs repeatedly or occasionally, including at irregular intervals, should be treated as a recurring operating expense.
- A non-GAAP measure may be misleading if it is calculated using recognition and measurement principles that are inconsistent with the comparable GAAP measure. For example, the SEC staff may consider the following to be misleading:
  - 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 on a net basis (i.e., deducting transaction costs) when gross presentation is required by GAAP or vice versa; and
  - changing the accounting basis for revenue or expenses from an accrual basis to a cash basis.
- Inappropriately labeled or unclearly described non-GAAP measures and/or related adjustments such as the following would render a non-GAAP measure misleading:
  - A failure to identify and describe a non-GAAP measure as such.
  - Giving a non-GAAP measure a label that is not reflective of the nature of the non GAAP measure. For example:
    - a contribution margin calculated as GAAP revenue less certain expenses, labeled "net revenue";
    - a non-GAAP measure labeled the same as a GAAP measure, even though it is calculated differently than the similarly labeled GAAP measure; 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.
- A non-GAAP measure could still be misleading notwithstanding that it is accompanied by extensive, detailed disclosure about the nature and effect of each adjustment. Although the SEC staff did not give any examples, if a non-GAAP measure is calculated using recognition and measurement principles inconsistent with the comparable GAAP measure or is inappropriately labeled, as discussed above, the SEC would likely consider it to be misleading regardless of the level of detail or explanation accompanying such non-GAAP measure.

Non-GAAP Measures Presented with Greater Prominence

- Examples of non-GAAP measures that would be considered to be more prominent than the comparable GAAP measure include:

- a ratio with a non-GAAP measure as the numerator and/or denominator is presented without the ratio calculated using the most directly comparable GAAP measure being presented with equal or greater prominence; or
- a chart, table or graph of a non-GAAP measure presented without presenting a chart, table or graph of the comparable GAAP measure with equal or greater prominence.

- A non-GAAP reconciliation, as required by the SEC rules, would be viewed as giving undue prominence to a non-GAAP measure if:
  - the reconciliation starts with a non-GAAP measure; or
  - a non-GAAP income statement is presented in connection with the reconciliation.
    - For this purpose, a "non-GAAP income statement" is 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.

It is important to note that the SEC staff has, over the years, issued guidance on the presentation of non-GAAP measures that are in addition to those discussed above, including with respect to misleading non-GAAP measures and non-GAAP measures presented with greater prominence than comparable GAAP measures. The updated guidance noted above reflects only the most recent updates to the SEC staff's prior guidance in this area. In connection with the disclosure of non-GAAP measures in SEC filings and other public disclosures, registrants should review these updates in conjunction with the SEC staff's prior guidance.

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If you would like to follow up regarding any of the matters covered by this Alert, please contact your usual Ropes & Gray attorney.