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# Renewed SEC Focus On Non-GAAP Measures: 1 Year Later

By **Elaine Harwood, Frank Mascari and Laura Simmons, Cornerstone Research**

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In recent years, the use of non-GAAP financial measures[1] has become more widespread, and the magnitude of the differences between non-GAAP and GAAP (generally accepted accounting principles) measures has grown. For example, in fiscal year 2015, non-GAAP earnings per share (EPS) of companies in the Dow Jones Industrial Average were approximately 31 percent higher than EPS reported based on GAAP.[2] Earnings for S&P 500 firms grew nearly 14 percent from 2012 to 2015 based on non-GAAP measures, but were essentially unchanged based on GAAP.[3]


Elaine Harwood

One year ago, on May 17, 2016, the U.S. Securities and Exchange Commission issued interpretive guidance on non-GAAP financial measures, signaling an increased focus on these measures. This article explores the effect of this increased focus on SEC enforcement and litigation and what the future may hold.

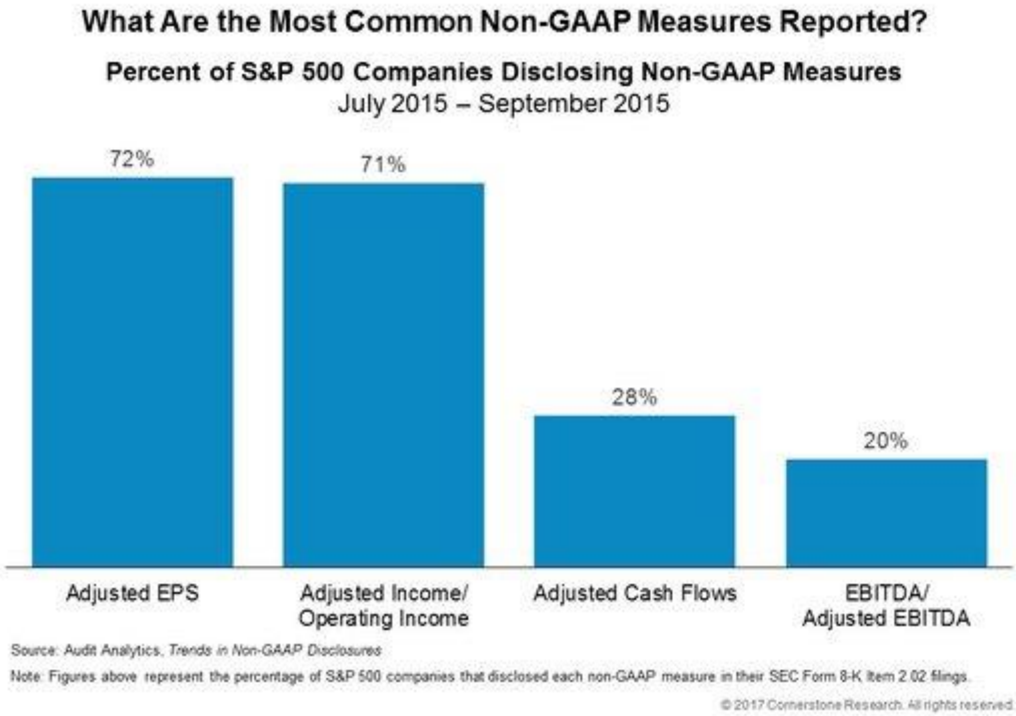

Frank Mascari

**Non-GAAP Measures**

Non-GAAP measures may be presented in registrants' periodic reports, as well as registration statements, as long as they comply with Regulation G and Item 10(e) of Regulation S-K. Guidance related to the use of non-GAAP measures includes that they generally must be reconciled to the most directly comparable GAAP measure, they cannot be presented in a manner that gives them greater prominence than comparable GAAP measures, and they must be accompanied by disclosures as to why management believes they are useful to investors.[4]


Laura Simmons

Non-GAAP measures are commonly reported by public companies. In fact, Audit Analytics reported that 88 percent of S&P 500 companies used at least one non-GAAP measure in their earnings releases between July and September 2015.[5] As shown below, the most common measures were adjusted EPS and adjusted income/operating income, followed by adjusted cash flows and EBITDA/adjusted EBITDA (earnings before interest, tax, depreciation and amortization).




While not the first time attracting attention, non-GAAP measures received renewed focus one year ago with the SEC's issuance of revised compliance and disclosure interpretations (C&DIs) that clarified the SEC's views on non-GAAP measures.[6] The C&DIs addressed a number of concerns regarding the use of non-GAAP measures, including "cherry-picking" adjustments to create the measures, the prominence of non-GAAP measures over GAAP measures, failures to reconcile non-GAAP to GAAP measures, and consistency in presentation of non-GAAP measures between periods.[7]

The SEC continues to emphasize the need for caution with regard to the use of non-GAAP measures. Earlier this month, SEC Chief Accountant Wesley Bricker described that issues concerning non-GAAP financial measures have implications for other measures reported by firms, such as operating metrics, noting that these also are subject to bias in reporting. He further observed that reporting processes associated with non-GAAP metrics may require more effort than GAAP-related processes because the latter benefit from the standard-setting process associated with GAAP while the former do not.[8]

**Regulatory Actions and Private Litigation**

It is well-known that SEC comment letters on non-GAAP measures became highly prevalent following the May 2016 C&DIs.[9] Our research focuses on SEC enforcement actions, as well as private litigation (i.e., securities class actions) involving non-GAAP measures.

Prior to the May 2016 C&DIs, SEC enforcement actions involving non-GAAP financial measures had been rare.[10] However, as of the date of this article, we are aware of three enforcement actions since the

May 2016 C&DIs, two involving individuals and the third involving a public company. Across these three cases, allegations included manipulations of adjusted EBITDA, falsely reporting adjusted funds from operations (AFFO) to meet analyst consensus projections, presenting non-GAAP financial measures with greater prominence than GAAP measures, and failing to reconcile a non-GAAP measure to GAAP.[11] Thus, the SEC's enforcement actions to date allege issues that are consistent with concerns addressed in its C&DIs.

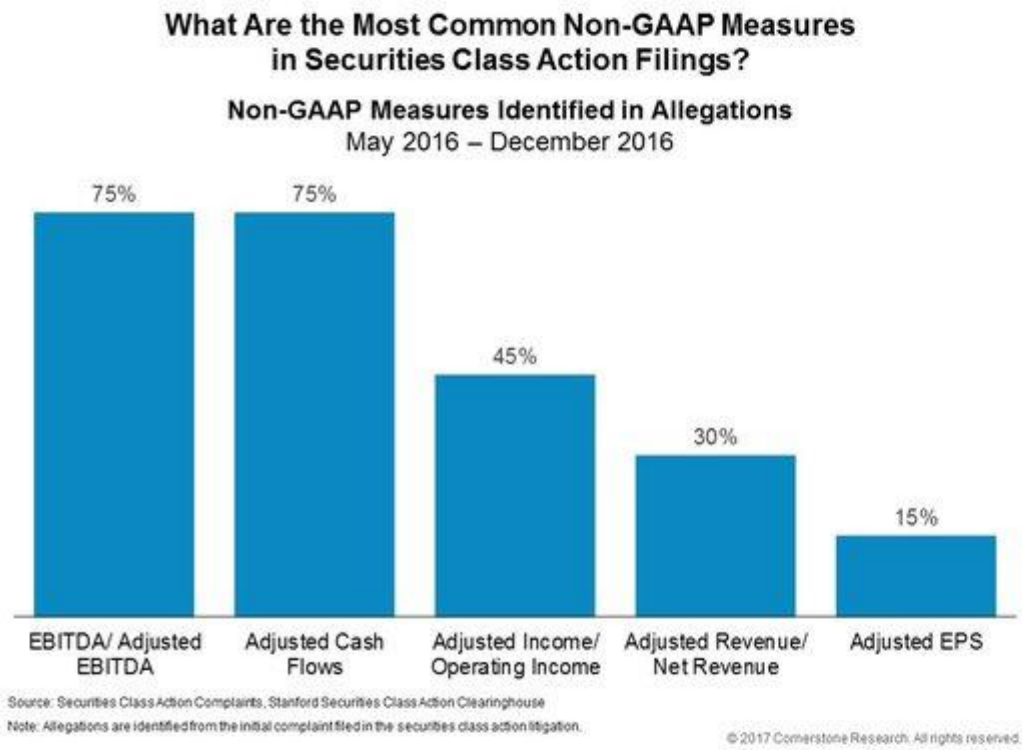
Turning to private litigation, there are not many traditional securities class action filings involving non-GAAP measures.[12] This may not be surprising in light of the lack of disclosure requirements for changing or correcting non-GAAP measures that could trigger a stock price decline that would provide the basis for a shareholder class action. For example, there is no requirement to issue a Form 8-K to correct an error in a previously reported non-GAAP measure.[13]

The inclusion of non-GAAP metrics in proxy statements has been growing dramatically. For example, Audit Analytics reported that in 2009 less than 20 percent of proxy statements included non-GAAP measures, but that by 2016 the frequency of non-GAAP language had increased to almost 60 percent.[14] Accordingly, we researched private litigation involving claims related to the use of non-GAAP measures in conjunction with merger and acquisition transactions.

Overall, an unprecedented number of federal class actions involving M&A transactions were filed in 2016, a significant portion of which involved non-GAAP issues. In particular, our findings indicate that nearly one-third of the M&A lawsuit filings included allegations related to non-GAAP measures — specifically, the lack of a reconciliation of non-GAAP to GAAP measures.[15] The vast majority of the M&A lawsuits involving non-GAAP measures were filed subsequent to the SEC's May 2016 C&DIs, and a number of the complaints cite the SEC's concerns about the use of those measures.

Although plaintiffs allege that companies did not include a reconciliation of projected non-GAAP measures to the most directly comparable GAAP measure as required, the SEC guidance provides an exception to the reconciliation requirement for forward-looking information when the information needed for the reconciliation is not available without "unreasonable efforts."[16] The SEC's C&DIs directly address the use of this exception and require a company that relies on the exception to disclose that fact, as well as to identify the information that is unavailable and its probable significance.[17]

The chart below shows the frequency of specific non-GAAP measures identified in M&A-related litigation. While adjusted EPS was the most prevalent measure reported in earnings releases, it was identified in the smallest proportion of cases for the categories shown for M&A lawsuits. In contrast, EBITDA/adjusted EBITDA and adjusted cash flows were the most prevalent measures involved in M&A case allegations.[18]




**Looking Ahead**

The future of regulatory actions and/or litigation involving non-GAAP measures depends in large part on how firms respond to last year's guidance. Audit Analytics issued a report noting varying degrees of "improvement" across different categories of non-GAAP disclosure issues following the issuance of the C&DIs.[19] For example, there was a substantial reduction in the prominence of non-GAAP measures as presented in the headlines and text of press releases, but smaller changes for other issues. Part of the reason for the variation in responses to the C&DIs is that they involve judgment to interpret. For example, whether an adjustment to arrive at a non-GAAP measure that is not specifically prohibited by SEC guidance could result in a non-GAAP measure that is misleading requires judgment, and the SEC and/or plaintiffs may not agree with management's judgment.[20]

With respect to regulatory actions, the SEC has indicated that it expects to provide more comment letters on non-GAAP disclosures. Those could lead to informal or formal investigations, but we expect that enforcement actions may take a while to surface.

With respect to securities class action filings, some of what the future holds may be connected with SEC actions. For example, traditional securities class actions may increase if, as a result of the comment letter process, the SEC requires disclosure of corrections of non-GAAP measures, and those disclosures trigger stock price declines. In addition, we observed that some of the companies that were sued by shareholders in M&A lawsuits were also subject to a comment letter from the SEC related to their use of non-GAAP measures. The ultimate resolution of the existing private litigation, and the potential filing of more litigation, may depend on the SEC's conclusions as to the appropriateness of firms' non-GAAP disclosures.

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[1] The SEC has defined a non-GAAP measure as a numerical measure of a registrant's historical or future financial performance, financial position or cash flows that adjusts selected amounts to or from the most directly comparable GAAP measure. U.S. Securities and Exchange Commission, Final Rule: Conditions for Use of Non-GAAP Financial Measures, 17 CFR Parts 228, 229, 244, and 249, https://www.sec.gov/rules/final/33-8176.htm.

[2] John Butters, "Did DJIA Companies Report Higher Non-GAAP EPS in FY 2015?" FactSet, March 11, 2016, https://insight.factset.com/2016/03/earningsinsight_03.11.16.

[3] Michael Rapoport and Dave Michaels, "SEC Tightens Crackdown on 'Adjusted' Accounting Measures," Wall Street Journal, May 18, 2016, https://www.wsj.com/articles/sec-tightens-crackdown-on-adjusted-accounting-measures-1463608923.

[4] See U.S. Securities and Exchange Commission, Final Rule: Conditions for Use of Non-GAAP Financial Measures, 17 CFR Parts 228, 229, 244, and 249, https://www.sec.gov/rules/final/33-8176.htm, Item 10(e).

[5] See Olga Usvyatsky and Derryck Coleman, "Trends in Non-GAAP Disclosures," Audit Analytics, Dec. 1, 2015, http://www.auditanalytics.com/blog/trends-in-non-gaap-disclosures/.

[6] U.S. Securities and Exchange Commission, Non-GAAP Financial Measures, Compliance & Disclosure Interpretations, May 17, 2016, https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[7] Id.

[8] Wesley R. Bricker, Chief Accountant, U.S. Securities and Exchange Commission, "Remarks before the 2017 Baruch College Financial Reporting Conference: 'Advancing Our Capital Markets with High-Quality Information,'" May 4, 2017, https://www.sec.gov/news/speech/remarks-2017-baruch-college-financial-reporting-conference-advancing-our-capital. Cara Mannion, "SEC Accounting Chief Tells Cos. To Prepare For Rule Changes," Law360, May 4, 2017, https://www.law360.com/articles/920577/sec-accounting-chief-tells-cos-to-prepare-for-rule-changes.

[9] See, e.g., Shearman & Sterling, Updated Non-GAAP Guidance: The First 150 Comment Letters, Oct. 19, 2016.

[10] See, e.g., Skadden Arps Slate Meagher & Flom LLP, Corporate Finance Alert, July 7, 2016, noting that as of that date, only one SEC enforcement action had been brought under Regulation G (and that it occurred in 2009).

[11] See U.S. Sec. Exch. Comm'n v. Kipp, No. 3:16-cv-00258 (W.D.N.C.); U.S. Sec. Exch. Comm'n v. Block, No. 1:16-cv-07003 (S.D.N.Y.); and In the Matter of MDC Partners Inc., U.S. Sec. Exch. Comm'n, Administrative Proceeding File No. 3-17795.

[12] A traditional securities class action is one that alleges violations of Rule 10b-5, Section 11, and/or Section 12(a)(2).

[13] See Olga Usvyatsky and Derryck Coleman, "Disclosure Requirements of Non-GAAP Error Corrections?," Audit Analytics, Sept. 13, 2016, http://www.auditanalytics.com/blog/disclosure-requirements-of-non-gaap-error-corrections/.

[14] See Olga Usvyatsky and Derryck Coleman, "Use of Non-GAAP in Proxy Statements," Audit Analytics, June 16, 2016, http://www.auditanalytics.com/blog/use-of-non-gaap-in-proxy-statements/. Note that data reflect non-GAAP language found in any section of the proxy, including discussions of executive compensation.

[15] See Cornerstone Research, Accounting Class Action Filings and Settlements — 2016 Review and Analysis, https://www.cornerstone.com/Publications/Reports/2016-Accounting-Class-Action-Filings-and-Settlements.

[16] See U.S. Securities and Exchange Commission, Final Rule: Conditions for Use of Non-GAAP Financial Measures, 17 CFR Parts 228, 229, 244, and 249, https://www.sec.gov/rules/final/33-8176.htm, Item 10(e)(1)(i)(B), which states that whenever one or more non-GAAP financial measures are included in a filing with the commission, the registrant must include "[a] reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historical non-GAAP measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP identified in paragraph (e)(1)(i)(A) of this section."

[17] The C&DIs provide examples of disclosures that would cause a non-GAAP measure to be more prominent, including "[e]xcluding 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." U.S. Securities and Exchange Commission, Non-GAAP Financial Measures, Compliance & Disclosure Interpretations, May 17, 2016, https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm, Question 102.10.

[18] Reflecting the judgment and flexibility associated with non-GAAP financial measures, we note that even for the measures reported in the chart, we observed multiple variations in presentation, as firms defined these metrics in alternative ways. For example, we noted several different definitions of "cash flow," including cash flow from operations, free cash flow, and unlevered free cash flow.

[19] Audit Analytics, Corporate Implementation of SEC's Compliance & Disclosure Interpretations Regarding Non-GAAP Financial Measures, December 2016.

[20] The C&DIs state that 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 necessary to operate a registrant's business could be misleading." U.S. Securities and Exchange Commission, Non-GAAP Financial Measures, Compliance & Disclosure Interpretations, May 17, 2016, https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm, Question 100.01.

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