

SEC Continues To Focus on Non-GAAP Measures: Updated SEC Staff Guidance and Recent Enforcement Action

In recent months, the presentation of non-GAAP financial measures (“non-GAAP measures”)¹ and related disclosure controls and procedures have emerged as a key focus area of the U.S. Securities and Exchange Commission (“SEC”). In late 2022, the staff of the Division of Corporation Finance updated its guidance regarding the disclosure of non-GAAP measures. Importantly, the new and revised Compliance and Disclosure Interpretations (“CDIs”)² provide (1) additional guidance regarding when the SEC staff may consider a non-GAAP measure to be misleading under Rule 100(b) of Regulation G and (2) new examples of when, pursuant to Item 10(e) of Regulation S-K and the requirements of Item 2.02 of Form 8-K, the SEC staff may consider a non-GAAP measure to be presented more prominently than the most directly comparable GAAP measure. On the Enforcement front, last month the SEC announced settled charges against an issuer for making misleading disclosures of non-GAAP measures over several reporting periods and failing to maintain adequate disclosure controls and procedures related to non-GAAP measures.

The updated SEC staff guidance and the recent non-GAAP enforcement action illustrate the SEC’s continued focus on public companies’ use and presentation of non-GAAP measures in SEC filings and other public disclosures. We expect the SEC and its staff to continue to scrutinize public companies’ non-GAAP measures and related disclosures, as well as companies’ disclosure controls and procedures, including those on the use and disclosure of non-GAAP measures.

HISTORICAL BACKGROUND

Adopted by the SEC in 2003 in response to a Sarbanes-Oxley mandate, Regulation G applies to

the public disclosure of material information that includes non-GAAP measures by U.S. and, in limited circumstances, non-U.S. reporting companies. Item 10(e) of Regulation S-K imposes additional requirements on the use and presentation of non-GAAP measures in SEC filings. Compliance with key parts of Item 10(e) is also required in earnings releases pursuant to Item 2.02 of Form 8-K, even though those are “furnished” and not “filed”.³

The SEC staff first published guidance on Regulation G and Item 10(e) of Regulation S-K in 2003, and provided updated guidance in the form of CDIs in 2010 and again in 2016. For the last several years, public companies’ use of non-GAAP measures and

related disclosures has been a significant area of focus for the SEC staff. Non-GAAP measures have been among the most frequent areas of comments that issuers have received on their SEC filings from the staff in the Division of Corporation Finance, and the Division of Enforcement has also continued to focus on non-GAAP disclosures.⁴

UPDATED CDIs

In December 2022, the Division of Corporation Finance updated its non-GAAP CDIs, centralizing and formalizing certain principles that had been previously articulated by the SEC staff in a number of comment letters and speeches related to non-GAAP measures. In light of continued focus in this area, we have included several questions highlighting issues of note for companies, boards and their advisors about the updated guidance:

1. *The SEC staff has consistently stated that non-GAAP measures that exclude normal, recurring cash operating expenses necessary to operate a business may be misleading and violate Rule 100(b) of Regulation G. Did the staff provide any additional guidance on when it may consider such adjustments to be misleading?*

Yes. Revised CDI 100.01 now states that the SEC staff views an operating expense that occurs repeatedly or occasionally, including at irregular intervals, as recurring. The SEC staff also updated the CDI to state that in evaluating what is a normal operating expense the staff will consider “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”. While the revised CDI states that whether or not an adjustment results in a misleading non-GAAP measure “depends on a company’s individual facts and circumstances”, based on recent statements the SEC staff has made in public speaking engagements and comments issued in individual filing reviews, examples of adjustments the staff may question include:

- in industries where stores, restaurants, fitness studios or similar places of business open, close or are relocated in the normal course of business, excluding preopening and start-up costs from the calculation of a non-GAAP measure;
- in the pharmaceutical industry, excluding expenses related to acquired in-process research & development costs in an asset acquisition, or excluding upfront and contingent milestone payments in connection with research & development arrangements from the calculation of a non-GAAP measure;
- in industries such as airline and gaming, excluding rent expense from the calculation of a non-GAAP measure and using non-GAAP measures such as EBITDAR or Adjusted EBITDAR⁵; and
- for companies that engage in frequent M&A activity, excluding acquisition, transformation or similar costs from the calculation of a non-GAAP measure.

Given this updated CDI and the general posture of the SEC staff, the staff may be less likely to accept a company’s rationale for making certain adjustments than in the past. For example, companies should be prepared for questions on any adjustments that could plausibly be considered recurring cash expenses.

2. *In prior guidance, the SEC staff stated that non-GAAP adjustments that have the effect of changing GAAP recognition and measurement principles, such as adjustments that accelerate revenue recognition, would be considered individually tailored accounting principles and may violate Rule 100(b) of Regulation G. Are there any other examples of similar adjustments the SEC staff may view as misleading under Rule 100(b) of Regulation G?*

Yes. Revised CDI 100.04 provides additional examples of adjustments that represent the application of individually tailored accounting principles and may cause a non-GAAP measure to be misleading. These include:

- 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 principal is required by GAAP (or the inverse); and
- changing the basis of accounting for revenue or expense in a non-GAAP measure from an accrual to a cash basis.

In discussing the changes to Question 100.04, the SEC staff noted that “individually tailored” accounting principles that may be inconsistent with Rule 100(b) of Regulation G extend beyond those that affect revenue recognition. In our experience, if the SEC staff suggests that a measure is “individually tailored”, it can be difficult to persuade them otherwise, meaning the expansion of this CDI could be particularly impactful for some issuers.

3. *Did the SEC staff provide any other updates to its views on when it may consider a non-GAAP measure to be misleading pursuant to Rule 100(b) of Regulation G?*

Yes. The answer to new Question 100.05 states that if not appropriately labeled and clearly described, a non-GAAP measure may be misleading. The staff provided the following examples where labeling or a lack thereof may cause a non-GAAP measure to be misleading:

- failure 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:
 - a contribution margin that is calculated as GAAP revenue less certain expenses labeled as “net revenue”;
 - a 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.

Importantly, the answer to new Question 100.06 provides that a non-GAAP measure could mislead investors to such a degree that even extensive, detailed disclosure about the nature and effect of each adjustment would not prevent the non-GAAP measure from being materially misleading. In other words, there are some non-GAAP measures that the staff views as so potentially misleading that no amount of disclosure about the amount and nature of any adjustments could make the non-GAAP measure not misleading. We believe this to be a new staff position. The staff did not provide any examples of such measures and this will likely be a facts and circumstances analysis. This development could make it more challenging for issuers to adopt “close to the line” non-GAAP measures or adjustments while relying on detailed disclosure to render the measures not misleading.

4. *If the SEC staff objects to my non-GAAP measure, are there repercussions?*

Yes. If the staff ultimately objects to a particular adjustment or measure, the SEC staff has made clear in public speaking engagements that it expects the company to correct the presentation of the non-GAAP measure in the next filing or public disclosure that uses that measure, and that companies should take care to similarly adjust any comparable periods presented. This means that there is no “wind down” or transition period during which the measure or adjustment the SEC staff objected to can continue to be disclosed. However, the SEC staff has not so far suggested that it will insist that any objectionable non-GAAP measure must be *immediately* recast (e.g., such as the reissuance of an earlier earnings release disclosing the subject non-GAAP measure or adjustment).

5. *Companies that disclose non-GAAP measures in SEC filings or in earnings releases under Item 2.02 of Form 8-K must present the most directly comparable GAAP measure with equal or greater prominence than the non-GAAP measure. Does this requirement also apply to*

any related discussion and analysis of the non-GAAP measure?

Yes. This has been our advice since the release of new CDIs in 2016, and the answer to new Question 102.10(a) makes clear that the SEC staff considers the “equal or greater prominence” requirement to apply to any related discussion of the non-GAAP measure. This new CDI provides the following new examples of disclosures that would be considered non-GAAP measures that are presented more prominently than the related GAAP measure:

- presenting a ratio using the non-GAAP measure as the numerator and/or denominator without also presenting the ratio calculated using the most directly comparable GAAP measure(s) with equal or greater prominence;⁶ and
- presenting charts, tables or graphs of a non-GAAP measure without presenting charts, tables or graphs of the comparable GAAP measure with equal or greater prominence.

The answer to the revised CDI also makes explicit the SEC staff’s longstanding position that presenting a non-GAAP measure before the most directly comparable GAAP measure would mean that the non-GAAP measure is presented more prominently than the GAAP measure, including in earnings release headlines or captions that include a non-GAAP measure. These updates reflect the staff’s continued focus on issues of equal or greater prominence, and companies should review carefully any earnings release headlines or captions that include non-GAAP measures and ensure that comparable GAAP measures are presented first. We expect these areas to be a particularly fertile ground of future SEC staff comment.

6. Is it permissible to begin the non-GAAP reconciliation required by Item 10(e)(1)(i)(B) with the non-GAAP measure?

No. The answer to new Question 102.10(b) states that the staff would consider beginning the required reconciliation with a non-GAAP measure to be an example of a non-GAAP measure disclosed more prominently than the comparable GAAP measure. The SEC staff also stated that it would consider presenting a non-GAAP income statement when

reconciling non-GAAP measures to the most directly comparable GAAP measure to be another example of non-GAAP measures disclosed more prominently than the comparable GAAP measures.⁷ Finally, the staff would consider a non-GAAP reconciliation to give undue prominence to a non-GAAP measure if a forward-looking non-GAAP measure excludes a quantitative reconciliation without disclosing reliance upon the exception in Item 10(e)(1)(i)(B) of Regulation S-K, identifying the information that is unavailable and its probable significance with equal or greater prominence.

RECENT ENFORCEMENT ACTION

As noted above, in March 2023, the SEC announced it had settled charges against an issuer for making misleading disclosures of non-GAAP measures over several reporting periods. According to the SEC’s order, the issuer had “materially increased its non-GAAP earnings by negligently misclassifying tens of millions of dollars of expenses” as non-GAAP adjustments related to strategic transactions as disclosed in the issuer’s public filings. As a result, the SEC found that the issuer’s non-GAAP net income and non-GAAP diluted EPS disclosure were materially misleading over several periods.

The SEC also charged the issuer with violating Rule 13a-15(a) of the Securities Exchange Act of 1934 (“Exchange Act”) for failure to have adequate disclosures controls and procedures in place with respect to the company’s non-GAAP measures disclosure. In its Order, the SEC specifically noted that the issuer did not have a non-GAAP policy or disclosure controls and procedures specific to the disclosure of non-GAAP measures.

While the recent enforcement action does not directly relate to the topics of the new CDIs, we believe it underscores the theme that the SEC and its staff expect heightened rigor and compliance with the rules around non-GAAP measures. In particular, issuers would be well advised to carefully consider whether they have adequate disclosure controls and procedures related to non-GAAP measures (including a non-GAAP policy) that would have prevented the misclassification that occurred in the

recent case and that would lead to compliance with the new CDIs.

RECOMMENDATIONS

We expect the SEC staff in the Division of Corporation Finance to continue to issue comments and vigorously question companies on the use and presentation of their non-GAAP measures. In particular, since the new CDIs generally represent a formalization of a number of principles previously articulated through comment letters and public speeches, we expect the SEC staff to view issuers as being “on notice” of these principles and emphasize their importance through a campaign of comments and potentially enforcement actions, as applicable.

In light of the recent enforcement action and continued focus by the SEC Enforcement staff on non-GAAP disclosures, it is important that companies act now with respect to their presentation of and controls around non-GAAP measures. Specifically:

- disclosure committees and those responsible for disclosure controls and procedures at the company should familiarize themselves with the new CDIs and pressure test their own disclosures against the new guidance:
 - any company without formal non-GAAP policies (or other disclosure controls and procedures specifically covering the use of non-GAAP measures) should seriously evaluate adopting such policies and work with counsel to adopt appropriate policies and procedures;
- management involved with SEC reporting should review and discuss with their audit committee any updates to non-GAAP policies and procedures or to disclosure controls and procedures necessary to reflect the updated CDIs;
- directors, particularly on audit committees, should ask members of management that report to them about the company’s controls around non-GAAP measures and the steps the company is taking to respond to heightened SEC focus in this arena;

- legal teams and outside counsel should plan to closely review SEC filings, earnings releases and any related public disclosures for compliance with the updated CDIs, even if historical practices around non-GAAP measures have not yet resulted in a comment from the SEC staff; and
- financial and legal teams should work with their auditors and counsel to educate appropriate company personnel on recent SEC guidance and enforcement actions.

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- 1 Both Regulation G and Item 10(e) define non-GAAP measures as numerical measures of a company's historical or future performance, financial position or cash flow that exclude or include amounts or are subject to adjustment that have the effect of including or excluding amounts from the most directly comparable measure calculated in accordance with GAAP.
 - 2 CDIs on non-GAAP measures are available at <https://www.sec.gov/corpfin/non-gaap-financial-measures>. Questions 100.01 and 100.04 have been revised. Questions 100.05 and 100.06 are new and Question 102.10 has been revised and expanded into Questions 102.10(a), (b) and (c).
 - 3 See Final Rule: Conditions for Use of Non-GAAP Financial Measures ("Adopting Release"), Release No. 33-8176, available at https://www.sec.gov/rules/final/33-8176.htm#P45_6165. Although Item 10(e) applies only to SEC filings and earnings releases are typically furnished under Item 2.02 of Form 8-K, Instruction 2 to Item 2.02 of Form 8-K provides that the requirements of Item 10(e)(1)(i)—including presenting the most directly comparable GAAP measure with equal or greater prominence, a statement disclosing the reason why management believes the presentation of the non-GAAP measure provides useful information to investors regarding the registrant's financial condition and results of operations and, to the extent material, a statement disclosing the additional purposes, if any, for which management uses the non-GAAP measure—apply to disclosures under Item 2.02.
 - 4 The Division of Enforcement has actively investigated non-GAAP disclosures for several years, conducting a widely noticed sweep of non-GAAP disclosures in earnings releases in 2016.
 - 5 The staff may not object to disclosure of either measure if the measure is presented as a valuation measure rather than a performance measure; however, the staff will likely only allow the measure to be presented for the current period on the grounds that presenting comparative disclosure makes the measure look like an operating or performance measure rather than a valuation measure.
 - 6 Footnote 27 in the Adopting Release already requires any company that presents a ratio using a non-GAAP measure as the numerator or denominator to also disclose the ratio calculated using the directly comparable GAAP measure(s).
 - 7 In new Question 102.10(c) the staff clarifies its position that it considers a non-GAAP income statement to be one that comprises non-GAAP measures and includes *all or most* of the line items and subtotals found in a GAAP income statement. Prior to these revisions, CDI 102.10 stated that disclosing a *full* income statement of non-GAAP measures would be an example of a non-GAAP measure presented with undue prominence.

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