Minding the

Non-GAAP

The SEC's new guidance on non-GAAP disclosures and Regulation G is prompting IROs to review their earnings releases, but legal experts don't expect a significant impact on most companies.

By David Tobenkin

The U.S. Securities and Exchange Commission's recent guidance on financial measures that do not adhere to Generally Accepted Accounting Principles (GAAP) has IR professionals huddling with colleagues, lawyers, and consultants to assess how to update their disclosures of financial results.

The impact of the SEC's new Compliance & Disclosure Interpretations (C&DIs), which were issued in May, likely will be minimal for public companies that make little use of non-GAAP metrics or use them conservatively. Conversely, companies that have relied heavily on non-GAAP data to tell their financial stories may have to make significant changes to the content of their disclosures, IR professionals and lawyers say.

Companies using non-GAAP data in their disclosures have tended to fall into two camps, says Nicole Russell, vice president of investor relations at Waddell & Reed Financial, Inc. "The first group has used non-GAAP financials in a limited fashion to be able to report and exclude items that are non-meaningful to results, such as items that are not recurring," Russell says. "A second group includes companies in certain sectors that use non-GAAP data on a recurring basis because they believe non-GAAP data, such as for non-cash items, more clearly reflects their operational results. Some industries, for example, may not have a lot of revenues in a given period, such as certain technology and biotech companies, and therefore rely on non-GAAP metrics to show the value of their business, which will likely cause them to have to reexamine their approaches more in response to the guidance."

Several attorneys who advise companies on SEC reporting expect that compliance with the C&DIs will not require major adjustments for most of their clients. "For the most part, our clients will not need to make major substantive changes in filings," says Howard Berkenblit, partner and leader of the capital markets group with the law firm Sullivan & Worcester. "The bigger practical impact will be how to present non-GAAP measures in earnings releases tied to SEC filings and in presentations so that they don't run afoul of the SEC's interpretations. If you use a non-GAAP measure, for example, then to meet the rule about giving GAAP equal or more prominence you would have to precede non-GAAP with GAAP data," Berkenblit said. "But I don't foresee companies making radical changes. Non-GAAP measures are important and legitimate. Most companies are not feeling the need to eliminate them."

Greater Clarity From the SEC

The C&DIs, which include questions and answers on 12 topics, are considered staff guidance and are not a new Commission rule. On the other hand, they were effective immediately, and SEC officials made clear that they expected companies to comply with the guidance beginning with their second-quarter 2016 earnings disclosures, notes Sandra Flow, a partner in the law firm of Cleary Gottlieb Steen & Hamilton LLP.

"What SEC staff has focused on in recent speeches before and after the release of the C&DIs is that they thought companies may have been too focused on non-GAAP measures and that there should be a presumption of starting with GAAP as the basis for presentations," Flow says. "If you want to present non-GAAP data, think 'why am I doing that and how am I doing that.' Step back and make sure you focus first on GAAP, then on why you need to use non-GAAP, and then present the non-GAAP accurately and appropriately."

"What led up to this really is that [the use of] non-GAAP had gotten off track in some respects," Mark Kronforst, chief accountant at the SEC's Division of Corporation Finance, said during a NIRI webinar in July. "For a small number of companies, I think it's gotten pretty far off track and a lot of work needs to be done."

"We think most companies are just fine or just have to make some minor changes," he said. "Over the years, certain parts of the rules have fallen into a little bit of neglect… so a lot of this effort is to refocus people on some of the concepts that already existed."

Some expect that the SEC guidance will remove some gray areas and clarify that some practices are not consistent with Regulation G. One area where the SEC has taken a firmer stand than in the past is Question 103.02, where the staff advised companies not to use EBIT or EBITDA on a per share basis. "That wasn't clear before," Berkenblit says.

The C&DIs have provided more clarity in certain high-profile disclosure areas, such as headlines, says David Calusdian, executive vice president and a partner at Sharon Merrill, an IR consulting firm. "One of the more controversial areas prior to the new guidance was the use of non-GAAP metrics in the headlines of news releases," says Calusdian, who also serves on NIRI's Board of Directors. "It's now quite clear from the guidance that companies cannot solely include non-GAAP measures in earnings release headlines, nor can they make the GAAP measures less prominent than the non-GAAP measures."

The new C&DIs in Question 102.10 provide precise guidelines regarding when non-GAAP financial data would be considered more prominent than GAAP data in headlines, captions, or tables, down to guidance that the use of larger fonts or bold versus plain text would be considered more prominent.

Other new or revised C&DIs, such as Questions 100.02 and 100.03, seek to curtail inconsistencies in the presentation of non-GAAP data such as, for example, presenting non-GAAP measures inconsistently between periods, or excluding or including charges and not excluding or including equivalent gains.

Some of the C&DIs suggest a strong SEC bias against using non-GAAP measures at all. In addition to the staff's directive (in response to Question 103.02) not to use EBIT or EBITDA on a per share basis, the SEC notes in Question 100.04 that use of non-GAAP measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could violate Rule 100(b) of Regulation G.

Some of the C&DIs may present companies with tough calls for disclosures and presentations. "Question 100.04 says don't present performance measures that accelerate revenue over time," Berkenblit says. "We have clients who recognize certain items at the end of the year but made adjustments during the year for things that will be recognized at the end of the year. It's unclear how broad this guidance will be applied and if we will have to proactively make the change or wait."

The SEC's approach to compliance with the C&DIs may vary by topic, Kronforst said during a NIRI webinar. "It is safe to say, at least based on our observations so far, that some of the issues addressed by the guidance are more common than others," he says. "So you'll see more activity. For example, the prominence issues, we expect to be very common, and so we'll probably spend a lot of time there."

"The most pointed questions come when the guidance uses the word 'misleading'. . . The language was carefully and deliberately crafted and it did send a message on some of those [issues] that we felt were problematic," Kronforst says. "Another way to look at the guidance is when you see it worded in a way like that -- that is something that we will focus on very, very closely."

Compliance Challenges

As noted, C&DI compliance challenges may be greatest for IR professionals in industries such as high tech and investment banking with complicated patterns for recognition of revenues and long histories of reliance upon non-GAAP financials to present what they believe are more informative portrayals of financial performance to analysts and investors.

For CSG International, a technology company that supports communications providers, the use of non-GAAP data is an important part of the financial presentation of the company, says Kathleen Marvin, CSG's director of investor relations. "We've been using non-GAAP numbers to describe our business results since 2010. Non-GAAP data allows us to have another way to complement our GAAP numbers to provide analysts, investors, and management information regarding the underlying strengths of our business and relevant considerations. If you exclude non-recurring items, for example, it allows you to see the underlying business, including past trends and what we are looking for in the future. . . Overall, our sector widely uses non-GAAP measures to monitor the company's performance or incentivize management."

Nevertheless, Marvin expects CSG International won't have to make significant adjustments to comply with the C&DIs: "I think that most companies are using this as an opportunity to examine the way they present the numbers, to relook at their press releases and investor presentation decks to make sure there is equal prominence given to GAAP and non-GAAP and to make sure that reconciliation tables provide clarity on the distinctions between non-GAAP and most comparable GAAP measures . . . . We are revisiting and fine-tuning these areas."

Companies that rely heavily on non-GAAP disclosures will need to approach compliance with the C&DIs with adequate deliberation, some experts say.

"Companies in certain industries are more natural users of non-GAAP measures and believe that they need to use them to help investors understand the underlying financial performance of the business to the exclusion of non-cash or unusual events like intangible writeoffs," says Matthew Kaplan, a New York City-based corporate partner at Debevoise & Plimpton and co-head of the firm's capital markets group. "Companies that are highly leveraged frequently utilize non-GAAP measures and typically back out interest expense and debt amortization associated with carrying large leveraged loads. SEC guidance recognizes that certain industries may lend themselves more to the use of non-GAAP and that the use of such metrics may be appropriate. In fact, if companies in an industry use a range of non-GAAP measures, it may be problematic for a company in that industry to not use similar measures to ensure level comparisons. However, to the extent that a company uses non-GAAP measures, they need to be labeled appropriately; you cannot, for example, call a recurring item a non-recurring item and you cannot label a liquidity measure as a performance measure."

Consequences of Non-Compliance

Companies that do not comply with the C&DIs may receive an SEC comment letter, though enforcement actions over egregious violations are possible, Kaplan says. Eventually, those comment letters, which are published, will provide additional guidance on the use of non-GAAP data.

In 2009, the SEC brought its first enforcement action under Regulation G against SafeNet, Inc. and senior executives. The SEC's complaint alleged that SafeNet represented to investors that its non-GAAP earnings results excluded certain non-recurring expenses, when, in fact, SafeNet had misclassified and excluded a significant amount of recurring, operating expenses from its non-GAAP earnings results, in order to meet or exceed quarterly EPS targets. The action was settled, with SafeNet paying a civil penalty of $1 million.

In some cases, companies may be able to cite the impracticality of compliance with the C&DIs, Flow says. "The C&DIs focus on compliance with respect to forward-looking non-GAAP measures and say that if you can't do a reconciliation without undue efforts, you have to say that, give any available reconciling items and explain the probable significance of what is unavailable and do so with equal or greater prominence," Flow says. "In many cases, that may be difficult."

Preparing documentation of why choices regarding the use of non-GAAP data were made may be a wise step, particularly in cases where companies chose to not follow the C&DIs, Berkenblit says. "A memo to the file may be useful in showing why the company thought the way it did, can help show good faith, and ensures that over the passage of time the nuances are not forgotten."

Useful Tool for IR Professionals

The C&DIs could also prove a useful tool in cases where IR professionals face executives who advocate for the overly aggressive disclosure of non-GAAP metrics.

"This is more ammunition for lawyers and IR professionals against business people or others who want to put a spin on results," Berkenblit says. "In the past, when the SEC said this or that or when rules were released, those people would sometimes answer, 'we've been doing it this way for years.' With the SEC's guidance, there are some bright lines that are easier to point to and that allow an IR professional or lawyer to say, 'this may have worked before, but now there is clear guidance and we need to go with that.' "

Russell of Waddell & Reed says the rules provide IR professionals with an opportunity to show their value by helping to guide the presentation of non-GAAP data in a way that is compliant: "I am an advocate to make sure we are able to disclose information that is useful to how the Street thinks and analyzes the company. We need to provide this type of [non-GAAP] information. This is where the IR officers can serve a role to show what is and is not important to the investment community."

Russell says one way for IR professionals to add value is to think ahead about potential operational and financial events that could present challenges in ensuring compliance with the C&DIs. For example, a divestiture at her company would likely pose some challenges because non-GAAP data would likely be used to try to provide clarity to investors about the financial impact, she noted.

Flow says that IR professionals should think broadly and creatively about how they comply with the guidance. An example, Flow says, is examining alternatives to the use of adjusted revenue measures. "The SEC in the guidance [in Question 100.04] came down hard on use of adjusted revenue measures that alter GAAP revenue recognition principles by adding deferred revenues back into GAAP measures to better reflect sales in the period," Flow says. "Many companies created adjusted revenue numbers and the SEC has said it doesn't like that. But if you present just GAAP revenue without adding back deferred revenue and present the deferred revenue line, you can have discussion about the deferred revenue, which is a GAAP item, and talk about additions and subtractions to it and let investors do the math."

The SEC's guidance also illustrates the importance of ensuring consistency in communications, a key responsibility for the IR team. "Other functions, such as legal or accounting, may not know all of the communications," Berkenblit says. "The IR team is in a position to oversee the consistency of the process for the whole. That is an important underlying theme of the SEC [C&DIs]: if you are going to present non-GAAP information, be consistent from period to period and from outlet to outlet, both technically and with respect to the spirit of the theme and the message." IRU

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