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## Rethinking Non-GAAP Financial Measures

*Law360, New York (March 03, 2010)* -- The U.S. Securities and Exchange Commission's Division of Corporation Finance recently revised its Compliance and Disclosure Interpretations relating to the use of non-GAAP financial measures in filings with the SEC and other public disclosures made by reporting companies.

The revised guidance is less restrictive and is expected to encourage greater use and disclosure of non-GAAP financial measures that comply with Regulation G and Item 10(e) of Regulation S-K.

### Background

In 2003, the SEC adopted Regulation G and Item 10(e) of Regulation S-K. When a reporting company publicly discloses material information that includes a non-GAAP financial measure, Regulation G requires the reporting company to accompany that disclosure with the following:

- a presentation of the most directly comparable financial measure calculated and presented in accordance with accounting principles generally accepted in the United States ("GAAP"); and
- a reconciliation of the differences between the non-GAAP financial measure presented and the most directly comparable financial measure or measures calculated and presented in accordance with GAAP.

Regulation G defines a "non-GAAP financial measure" as a numerical measure of a reporting company's historical or future financial performance, financial position, or cash flows that:

- excludes amounts that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the reporting company's financial statements; or
- includes amounts that are excluded from the most directly comparable measure so calculated and presented.

Excluded from the definition of "non-GAAP financial measure" are operating and other statistical measures, as well as ratios and statistical measures that are calculated using exclusively one or both of (1) financial measures calculated in accordance with GAAP, and (2) operating measures or other measures that are not non-GAAP financial measures.

When non-GAAP financial measures are disclosed in filings with the SEC, Item 10(e) of Regulation S-K requires that the filing include a disclosure (with equal or greater prominence) of the most directly comparable GAAP measure as well as a numerical reconciliation of the kind required by Regulation G.

Item 10(e) also requires disclosure of the reasons why management believes the non-GAAP financial measure is useful to investors and, to the extent material, the additional purposes, if any, for which management uses the measure. In addition, Item 10(e) prohibits certain specific practices relating to the disclosure of non-GAAP financial measures in SEC filings.

Following the adoption of Regulation G and Item 10(e) of Regulation S-K, the SEC's Division of Corporation Finance published and codified Compliance and Disclosure Interpretations including the Division's interpretations of the rules and regulations concerning the disclosure of non-GAAP financial measures.

### **Summary of the Revisions to the Interpretive Guidance on Non-GAAP Financial Measures**

In January 2010, the SEC's Division of Corporation Finance revised its guidance relating to the use of non-GAAP financial measures. Presented below is a summary of the significant changes reflected in that revised guidance.

(Several of the interpretations from the prior version of the division's guidance are carried forward unchanged in the revised guidance; those interpretations that have not changed and are not summarized below.)

#### *Measures Not Used by Management*

The revised guidance confirms that there is no prohibition against disclosing a non-GAAP financial measure that is not used by management in managing its business.

#### *Adjusting for Recurring Items*

The revised guidance confirms that non-GAAP financial measures can adjust for recurring items as well as items that are non-recurring, infrequent, or unusual, subject to the requirements of Regulation G and Item 10(e) of Regulation S-K. Hence, the fact that an item cannot be described as non-recurring, infrequent, or unusual does not mean that a non-GAAP financial measure cannot adjust for that item.

#### *EBIT and EBITDA*

The revised guidance confirms that, when disclosed in SEC filings, EBIT and EBITDA must be calculated in the manner set forth in Exchange Act Release No. 47226 (otherwise, the title of the measures must be distinguished from "EBIT" or "EBITDA", such as "Adjusted EBITDA").

The revised guidance also indicates that when either EBIT or EBITDA is presented as a performance measure, those measures must be reconciled to net income as presented in the statement of operations under GAAP.

#### *Non-GAAP Per Share Performance Measurements*

The revised guidance indicates that non-GAAP earnings per share performance measures may be used in filings with the SEC, but that such disclosures must be accompanied by a reconciliation of the measure to GAAP earnings per share. On the other hand, non-GAAP liquidity measures, such as cash flow, should not be disclosed on a per share basis in filings with the SEC.

#### *Segment Information*

The revised guidance confirms that a measure of profit/loss or liquidity on a segment basis would be a non-GAAP financial measure (and, therefore, subject to Regulation G and Item 10(e) of Regulation S-K) unless the measure conforms with Accounting Standards Codification ("ASC") 280.

The revised guidance clarifies that segment measures that are adjusted to include amounts excluded from, or to exclude amount included in, the measure reported to the chief operating decision maker for purposes of making decision about allocating resources to the segment and assessing its performance do not comply with ASC 280.

The revised guidance also clarifies that where a reporting company discloses in its management's discussion and analysis ("MD&A") a discussion of segment profitability determined consistent with ASC 280 (which also requires that a footnote to the company's financial statements provide a reconciliation), the company should include in the segment discussion in the MD&A a complete discussion of the reconciling items that apply to each particular segment discussed.

#### *Revenue by Product*

The revised guidance clarifies that amounts of revenue by product need not be summed to the total revenue amount presented in the reporting company's financial statements and would not be deemed non-GAAP financial measures as long as each such amount is calculated in accordance with GAAP.

#### *Presenting Financial Information in a Constant Currency*

The revised guidance confirms that where a reporting company with operations in various countries presents its financial information on a constant currency basis (e.g., assuming a constant exchange rate between periods for translation), this will be a non-GAAP measure (subject to Regulation G and Item 10(e) of Regulation S-K) and the reconciliation requirements of Regulation G and Item 10(e) may be satisfied by presenting the historical amounts and the constant currency amounts and describing (1) the process to calculate the constant currency amounts and (2) the basis of presentation.

#### *Foreign Private Issuers*

Item 10(e) of Regulation S-K permits a foreign private issuer to include non-GAAP financial measures in its filings with the SEC only if it is required or "expressly permitted" to do so by the standard setter responsible for establishing GAAP used to prepare the company's primary financial statements disclosed in its SEC filings.

The revised guidance clarifies that a non-GAAP financial measure is "expressly permitted" when (1) the measure is clearly and specifically identified as an acceptable measure by such standard setter or (2) the measure is "explicitly accepted" by the primary securities regulator in the foreign private issuer's home country jurisdiction or market.

("Explicit acceptance" must be demonstrated by (1) published views of the regulator or members of the regulator's staff or (2) a letter from the regulator or its staff to the foreign private issuer indicating acceptance of the presentation — which letter must be provided to the SEC staff upon request).

#### *Additional Interpretations*

The revised guidance also adopted the following new interpretations, among others:

- It is generally not appropriate for a reporting company to present a full non-GAAP income statement for purposes of reconciling non-GAAP measures.
  
- A reporting company may present an adjustment "net of tax" when reconciling a non-GAAP performance measure to the most directly comparable GAAP measure.

- Item 10(e) of Regulation S-K does not apply to a filed free writing prospectus unless the free writing prospectus is included in or incorporated by reference into the issuer's registration statement or included in a filing pursuant to the Securities Exchange Act of 1934, as amended. However, a free writing prospectus remains subject to the requirements of Regulation G.

## **Conclusion**

The revised guidance on non-GAAP financial measures reflects a greater willingness on the part of the SEC to permit the use of such measures in SEC filings and other public disclosures, and provides reporting companies with more flexibility to disclose such measures.

As a consequence of this change, we expect that the SEC will be looking for greater consistency in a reporting company's disclosure of material non-GAAP financial measures in SEC filings and other public disclosures.

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