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SEC Staff Comments on Latest Non-GAAP C&DIs Spotlight 'Prominence'

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The SEC's Division of Corporation Finance shook the accounting world in May when it issued new or revised Compliance & Disclosure Interpretations (C&DIs) that augment existing guidance for companies making non-GAAP disclosures. Although SEC staff have just begun to publicly release disclosure review dialogs with companies regarding the new non-GAAP C&DIs, a few areas of concern have emerged—but with special emphasis on the need to give equal or greater prominence to the most directly comparable GAAP measure.

Staff comments often reference Item 10(e) of Regulation S-K, which governs non-GAAP disclosures in SEC filings, and Regulation G, which applies whenever a registrant (or its representatives) publicly discloses material information that includes a non-GAAP financial measure. Regulations S-K and G also contain special provisions for the use of non-GAAP measures by foreign private issuers, disclosures made in the context of proposed business combinations, and for registered investment companies. This article surveyed companies' non-GAAP disclosure review correspondence with SEC staff made public on EDGAR during the period May 17, 2016, the date CorpFin issued the updated C&DIs, and August 19, 2016.

Equal Prominence

New Question 102.10 provides specific examples of when the presentation of a non-GAAP financial measure would be more prominent than the comparable GAAP measure. This C&DI also noted that in many instances the equal or greater prominence requirement of Regulation S-K depends on the specific facts and circumstances.

Companies in the radio and advertising space drew comments on several points. iHeartCommunications, Inc. and Clear Channel Outdoor Holdings, Inc. both used the metric operating income before depreciation and amortization, non-cash compensation expense and other operating income (expense)—net (OIBDAN). iHeartCommunications said it would make numerous revisions to its disclosures after the staff told the company its OIBDAN presentation was amiss under the new C&DIs. Specifically, the company will fix headlines in its earnings release and make tabular changes to give the operating income metric (the comparable GAAP measure) equal prominence. Clear Channel told the SEC staff it will revise its future earnings releases to put operating income ahead of OIBDAN and that it will reconfigure its tabular disclosures so that OIBDAN by segment will appear in a table that follows operating income by segment.

In comments to EQT GP Holdings, LP, which apply equally to the related entity EQT Midstream Partners, LP, the SEC staff noted defects under Regulation G and the new C&DIs regarding the firm's presentation of forward-looking non-GAAP (adjusted EBITDA guidance) and forward-looking GAAP measures. Similar issues plagued disclosures by Amber Road, Inc., which did not include comparable GAAP measures in its presentation of forward-looking non-GAAP measures (*i.e.*, revenue, adjusted operating loss, and adjusted net loss per common share). Amber Road also failed to disclose its reliance on Regulation S-K's "unreasonable efforts" exception for its decision to omit a quantitative reconciliation of forward-looking non-GAAP measures. EQT said it will revise its future earnings releases, while Amber Road said its future filings would begin to comply with the new C&DIs by the end of this past June.

Moreover, the first bullet point of Question 102.10 regarding full non-GAAP income statements drew the SEC's attention. The staff, for example, flagged a Form 8-K exhibit in which United Community Banks, Inc. gave undue prominence to full non-GAAP income statements. The bank agreed to revise its future filings to comply with the new C&DIs. Likewise, Moelis & Company said it would fix a similar issue in its next earnings release by replacing the phrase "Adjusted Pro Forma" with "Adjusted" or "Adjusted (non-GAAP)," by using only "key line items" to lessen the prominence of non-GAAP measures, and by reworking its reconciliation to only disclose line items with non-GAAP adjustments.

The staff also sought revisions from Sterling Bancorp and Lear Corporation, both of which had included references to "core" non-GAAP measures. In Sterling's case, the staff said the "core" references implied they were the company's "most central or essential operations and results." Both companies agreed to make changes in their future filings or earnings releases.

Adjustments for Non-Recurring Charge (Gain)

Question 102.03 confirms that the Regulation S-K ban on adjusting a non-GAAP measure to smooth a non-recurring charge (gain) that is reasonably likely to recur within two years or for which there was a like charge (gain) in the prior two years is based on the description of the charge (gain) being adjusted and not on the nature of the charge (gain). Adjustments are still possible if the company complies with Regulations S-K and G. But the staff also referred readers to Question 100.01, which notes that even if an adjustment is not explicitly banned, it can still be misleading.

Waters Corporation said it would mull the SEC's latest guidance and Item 10(e)(1)(ii)(B) before its next earnings release. The SEC staff had questioned the company's exclusion from its non-GAAP measure of several items it reported in prior years. The company's exclusion from a non-GAAP measure of "normal, recurring, cash operating expenses" also could run afoul of the new C&DI.

Adjustments for Inconsistencies Between Periods

Question 100.02 had asked if a non-GAAP measure can be misleading if it is presented inconsistently between periods. CorpFin staff answered in the affirmative, especially where a current period

charge (gain) is adjusted but like charges (gains) in earlier periods are not. The C&DI also noted that it may be necessary to "recast" earlier measures to ensure conformance with current period measures.

In a letter to Universal Display Corporation, SEC staff also mentioned Question 100.02's reference to Rule 100(b) of Regulation G, which provides that no registrant may publish a non-GAAP measure that, along with the accompanying information and discussion, contains an untrue statement of material fact or an omission. The staff noted Universal had inventory write-downs in two years, but it removed disclosures for only one of those years. Universal said it would take steps to revise its future filings to comply with the C&DI and Regulation G.

Individually Tailored Methods

SEC staff directed a series of letters to Fortress Transportation and Infrastructure Investors LLC regarding the company's adding back of principal payments on finance leases in calculating its non-GAAP adjusted EBITDA. In the first letter, the staff asked Fortress to explain why its managers believe the measure is useful to investors per Item 10(e)(1)(i)(C) of Regulation S-K. Fortress initially replied that adjusted EBITDA helps management spot trends for investors, especially matters that can be addressed in the near term, and that it functions as a performance measure with certain payments added back to help identify business development opportunities.

In a follow-up letter, the staff noted that Fortress's addback of principal payments on finance leases is inconsistent with Question 100.04. That C&DI provides that certain individually tailored non-GAAP measures could be misleading in the context of Rule 100(b) of Regulation G. Fortress answered that it would remove the "addback" component from adjusted EBITDA and offered proposed language to be included in its future filings.

By contrast, Enterprise Products Partners L.P. told the SEC staff that Question 100.04 was inapt regarding its evaluation of segment gross operating margin (adjusted for committed shippers' make-up rights), although the company said it will revise its future filings in response to a related comment about Question 104.04 to adjust total gross operating margin to exclude shippers' make-up rights for presentations outside the scope of Accounting Standards Codification (ASC) 280's requirements for segment reporting.

Earnings Per Share

One of the thornier issues is whether a non-GAAP earnings per share measure is permitted in materials filed with or furnished to the Commission. Question 102.05 would not bar all non-GAAP EPS measures, but SEC staff reviewing materials that contain these measures would look at the substance (not the characterization) of the non-GAAP measure as a performance or liquidity measure. Still, many non-GAAP liquidity measures of cash generated could not be presented on a per share basis.

The C&DI cites the 1973 guidance contained in Accounting Series Release (ASR) No. 142 (also located in the SEC's Codification of Financial Reporting Policies at 202—202.04, albeit with some modifications). ASR No. 142 (CFRP 202.04) ends with a general axiom: "Accordingly, per share

data other than that relating to net income, net assets and dividends should be avoided in reporting financial results." The inquiry prompting the new C&DI had asked about non-GAAP EPS measures in light of ASC 230 (statement of cash flows) and language contained in footnote 11 of SEC Release No. 33-8176 (January 22, 2003), which did not bar all non-GAAP per share measures, but also said that a measure specifically barred by either GAAP or Commission rules cannot be used in materials filed with or furnished to the Commission.

As an example, the staff asked National Retail Properties, Inc. about adjustments that led to its measure of adjusted funds from operations (AFFO) available to common shareholders because the staff thought the metric was a liquidity measure disallowed by the new C&DI. The comment also asked National Retail to rethink its use of AFFO under Question 102.02, which permits a registrant to use a definition of funds from operations (FFO) by an organization other than the National Association of Real Estate Investment Trusts (NAREIT), but subject to limits for using the metric on a per share basis. National Retail agreed to reconsider its AFFO disclosure.

Although not mentioned in the National Retail dialog, Question 102.01 clarifies that the SEC staff accepts the NAREIT definition of FFO as of the date on which the latest non-GAAP C&DIs were issued, that is, May 17, 2016 (see also the reference to "funds from operations per share" in footnote 50 in SEC Release No. 33-8176 (January 22, 2003)). The staff further noted that NAREIT's definition of FFO is an accepted performance measure and that it also would not object to FFO presented on a per share basis.

Tax Effects

Patheon N.V. received a series of comments beginning before publication of the updated C&DIs in which SEC staff asked whether the company's reconciliation estimated the tax effect of only some or of all adjustments related to depreciation and interest expense. The staff also asked for the amount of pre-tax adjustments for which the company applied a zero effective tax rate.

In a follow-up letter, the staff inquired about Question 102.11, which explains that disclosures about the income tax effects on non-GAAP measures differ based on whether the measure is a liquidity measure or a performance measure, and that income taxes should be shown as a separate adjustment and clearly explained.

Patheon replied that it applied a zero effective tax rate to $213 million in pre-tax adjustments for taxing jurisdictions with valuation allowances and the company listed the requested statutory tax rates. Patheon also said certain tax adjustments use current and deferred income tax expense per U.S. GAAP because adjusted net income is treated as a performance measure. Patheon noted that it adhered to ASC 740 and mulled the staffs' question about the possibility of hypothetical income resulting in the reversal of a valuation allowance, but concluded that the adjustments were immaterial with respect to the timing of a valuation reserve reversal.

With respect to Crown Holdings, Inc. and Quanta Services, Inc., the staff asked these companies to better explain their disclosures of the tax effects on non-GAAP measures. In Crown's case, the staff specifically asked for an explanation of how the company calculated the tax effect.