

SEC STAFF FLASHES RED AND YELLOW TRAFFIC LIGHTS ON COMMON NON-GAAP PRACTICES

Dec 16, 2022

The SEC staff recently published [updated interpretations](#) addressing some common non-GAAP practices as either clearly non-acceptable or questionable. Not ground-breaking, as they largely track recent staff comments, these interpretations flash red lights on some persistent practices the staff deems misleading and yellow lights on others that the staff questions as raising potential concerns. As a result, companies should consider sharing some or all of them with personnel in financial reporting and investor relations who may have been slow to adopt “best practices” and need more specific evidence of the SEC’s views.

Red Lights

Failure to provide equal or greater prominence to comparable GAAP measure

The staff updated its guidance in CDI 102.10(a) on the requirement that, when presenting a non-GAAP measure, a registrant provide equal or greater prominence to the most directly comparable GAAP measure. The staff expanded the list of examples where non-GAAP measures would be deemed to have unacceptable prominence, including several problematic practices that still show up in earnings releases from time to time. The examples include:

- Presenting an income statement of non-GAAP measures, i.e., one that is comprised of non-GAAP measures and includes all or most of the line items and subtotals found in a GAAP income statement.
- Presenting a non-GAAP measure before the most directly comparable GAAP measure or omitting the comparable GAAP measure altogether, including in an earnings release headline or caption that includes a non-GAAP measure.
- Presenting a ratio where a non-GAAP financial measure is the numerator and/or denominator without also presenting the ratio calculated using the most directly comparable GAAP measure(s) with equal or greater prominence.

- Presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font, etc.) that emphasizes the non-GAAP measure over the comparable GAAP measure.
- Describing a non-GAAP measure as, for example, “record performance” or “exceptional” without at least an equally prominent descriptive characterization of the comparable GAAP measure.
- Presenting charts, tables or graphs of non-GAAP financial measures without presenting charts, tables or graphs of the comparable GAAP measures with equal or greater prominence, or omitting the comparable GAAP measures altogether.
- Providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence.

Reconciliations that give undue prominence to non-GAAP measure

In new CDI 102.10(b), the staff provides examples of undue prominence in non-GAAP reconciliations:

- Starting the reconciliation with a non-GAAP measure.
- Presenting a non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures.
- When presenting a forward-looking non-GAAP measure, a registrant may exclude the quantitative reconciliation if it is relying on the exception provided by [S-K Item 10\(e\)\(1\)\(i\)\(B\)](#) (excusing reconciliation of forward-looking measures where “unreasonable efforts” would be required). A measure would be considered more prominent than the comparable GAAP measure if it is presented without disclosing reliance upon the exception and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence.

Using non-GAAP adjustments that change GAAP recognition or measurement principles

The staff added two more examples to CDI 100.04 of non-GAAP adjustments that are misleading because they change recognition and measurement principles required to be applied in accordance with GAAP:

- 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 a principal is required by GAAP, or the inverse, presenting a measure of revenue on a gross basis when net presentation is required by GAAP.

- Changing the basis of accounting for revenue or expenses in a non-GAAP performance measure from an accrual basis in accordance with GAAP to a cash basis.

Yellow Lights

Exclusion of cash operating expenses that occur “repeatedly or occasionally, at irregular intervals”

The staff has long prohibited as being misleading adjustments in non-GAAP performance measures that exclude “normal, recurring cash operating expenses” that are necessary for business operations. (CDI 100.01). The staff now expressly states that it views “an operating expense that occurs repeatedly or occasionally, including at irregular intervals, as recurring.”

As terms such as “occasionally” and “irregular intervals” can present interpretative challenges, companies should take care and develop good faith support before excluding from a performance measure any operating expense that has previously occurred, particularly more than once – including documenting that the expenses are not “necessary” to operate the business or are not “recurring” within the meaning of that phrase.

Unclear identification or questionable selection of non-GAAP measures

In new CDI 100.05, the staff addresses misleading practices involving either inappropriate labels or unclear descriptions for non-GAAP measures or for the adjustments made to arrive at the non-GAAP measure – noting that non-GAAP measures are often not consistent across or comparable with those used by other companies. Examples include:

- Failure to identify and describe a measure as non-GAAP.
- 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 “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.

Additionally, in new CDI 100.06, the staff declares 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.” As

the staff fails to provide any further explanation, companies should carefully evaluate any measures that are not widely used or broadly accepted by companies and their analysts.

RELATED CAPABILITIES

- Securities & Corporate Governance

MEET THE TEAM



R. Randall Wang

St. Louis

randy.wang@bclplaw.com

[+1 314 259 2149](tel:+13142592149)

This material is not comprehensive, is for informational purposes only, and is not legal advice. Your use or receipt of this material does not create an attorney-client relationship between us. If you require legal advice, you should consult an attorney regarding your particular circumstances. The choice of a lawyer is an important decision and should not be based solely upon advertisements. This material may be “Attorney Advertising” under the ethics and professional rules of certain jurisdictions. For advertising purposes, St. Louis, Missouri, is designated BCLP’s principal office and Kathrine Dixon (kathrine.dixon@bclplaw.com) as the responsible attorney.