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Technical Line

Navigating the requirements for non-GAAP financial measures

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What you need to know

- The SEC staff has long expressed concerns about the improper use of non-GAAP financial measures and has published guidance addressing its views, most recently in December 2022.
- Companies that receive questions from the SEC staff about non-GAAP measures should be prepared to revise their future filings, earnings releases, earnings guidance and other documents containing the measures, including revising any comparative data. When the SEC staff concludes that a non-GAAP measure is misleading, it expects the registrant to discontinue using the measure or the portion of the measure that is misleading for all periods presented.
- Companies that are considering making changes to their non-GAAP measures or presenting new non-GAAP measures should assess whether such changes would comply with SEC rules and related SEC staff guidance. If it is unclear whether they do, the company should consider how its overall corporate reporting would have to change if the SEC staff were to object to the updated measure or adjustment.
- The use of non-GAAP measures topped our latest list of the most frequent topics in SEC staff comment letters.

Overview

Non-GAAP financial measures provide an alternative source of information and management may disclose them to help investors better understand a company's operating performance, liquidity or financial position. Many companies assert that non-GAAP measures allow investors

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to better understand the information management uses to operate its business. Companies may adjust GAAP measures to exclude, for example, nonoperating gains and losses, restructuring charges, acquisition-related items, stock-based compensation, depreciation and amortization, impairment charges or gains and losses from asset dispositions.

As required by the Sarbanes-Oxley Act of 2002, the SEC adopted the following rules in a 2003 release[1] that addresses public companies' use of certain financial information that is calculated and presented based on methodologies that are not in accordance with GAAP:

- Regulation G, which applies to all public disclosures of non-GAAP measures that are made by a company or on its behalf
- Item 10(e) of Regulation S-K, which includes different requirements for non-GAAP measures filed with the SEC and those that appear in information that is furnished (e.g., earnings releases filed under Item 2.02 of Form 8-K)

The SEC staff has also published Compliance and Disclosure Interpretations (C&DIs) addressing its views on the presentation and disclosure of non-GAAP financial measures, most recently in December 2022. Further, the use of non-GAAP financial measures remains at the top of our list of the most frequent topics in SEC staff comment letters. Our **SEC Reporting Update: *Highlights of trends in 2022 SEC comment letters*** highlights key trends in SEC staff comment letters issued during the year and provides examples of the comments issued by the SEC staff about non-GAAP financial measures.

General requirements

The rules describe the requirements and prohibitions related to the disclosure of non-GAAP financial measures in SEC filings, earnings releases and other communications. The Appendix to this publication summarizes the requirements and prohibitions related to these forms of corporate communication.

Regulation G

Item 100 of Regulation G provides the overarching disclosure requirements that apply when a registrant presents or releases publicly (in writing or orally) any material information that includes a non-GAAP financial measure.

Regulation G applies to any registrant, other than a registered investment company, that has a class of securities registered under Section 12 of the Securities Exchange Act of 1934 or is required to file reports under Section 15(d) of the Securities Exchange Act of 1934. Regulation G does not technically apply to voluntary filers. However, in C&DI Question 107.01, the SEC staff noted that a voluntary filer's failure to comply with the requirements applicable to a Section 15(d)-reporting company, including Regulation G, "can raise significant issues regarding that company's compliance with the anti-fraud provisions of the federal securities laws."

Rule 100(c) of Regulation G notes that its requirements do not apply to foreign private issuers, to the extent that:

- Their securities are listed or quoted outside the US.
- The non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with US GAAP.
- The disclosure is made or included in a written communication that is released outside the US.

When a registrant publicly presents or releases any material information that includes a non-GAAP financial measure, Rule 100(a) requires the presentation of the most directly comparable GAAP financial measure and reconciliation of the differences between the historical or forward-looking non-GAAP measure and its most directly comparable GAAP measure. However, if the non-GAAP financial measure is included in an SEC filing (e.g., Form 10-K), Item 10(e) of Regulation S-K requires additional disclosures and stipulates certain specific prohibitions, as discussed in the next section.

Rule 100(b) states that a non-GAAP financial measure, taken together with accompanying information, may not misstate or omit a material fact necessary to make the presentation not misleading in light of the circumstances in which the presentation is made. Rule 100(b) applies to all communications that contain a non-GAAP financial measure, whether filed or furnished.

Item 10(e) of Regulation S-K

Item 10(e) of Regulation S-K applies to the use of non-GAAP financial measures in SEC filings (e.g., Form 10-K, Form 10-Q, registration statements, proxy statements). Its disclosure requirements and prohibitions apply to all registrants, other than registered investment companies under Section 8 of the Investment Company Act of 1940, that submit filings to the SEC, including voluntary filers and foreign private issuers that file Form 20-F. While the rules do not apply to eligible Canadian issuers that file Form 40-F, these issuers must comply with the applicable Canadian requirements.

The requirements do not apply to non-GAAP financial measures disclosed in certain communications (e.g., solicitations before furnishing a proxy statement) related to a proposed business combination, an entity that would result from a proposed business combination or an entity that is a party to a proposed business combination. However, the exemption does not extend to registration statements under the Securities Act of 1933, proxy statements or tender offer statements.

Definition of a non-GAAP financial measure

As defined in Item 10(e)(2) of Regulation S-K, a non-GAAP financial measure is a numerical measure of a registrant's historical or future financial performance, financial position or cash flows that does either of the following:

- Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of comprehensive income, balance sheet or statement of cash flows (or equivalent statements) of the issuer

- Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable GAAP measure calculated and presented

Some common examples of measures that meet the above definition include earnings before interest and taxes (EBIT); earnings before interest, taxes, depreciation and amortization (EBITDA); adjusted EBITDA; core earnings; and, for real estate investment trusts, funds from operations.

Item 10(e)(4) further specifies that the following are not non-GAAP financial measures:

- Operating and other statistical measures (e.g., unit sales, number of subscribers).

- Ratios or statistical measures calculated using exclusively financial measures calculated in accordance with GAAP (e.g., earnings per share) and/or operating measures or other measures that are not non-GAAP financial measures (e.g., same-store sales when revenue in accordance with GAAP was used in the calculation of the measure).

- Financial measures required to be disclosed by GAAP, SEC rules or a system of regulation of a government or governmental authority or self-regulatory organization that is applicable to the registrant (e.g., capital ratios reported to bank regulators).

How we see it

Determining whether a measure is in the scope of the rules sometimes requires judgment, and the SEC staff may ask registrants to explain the basis for their conclusion that a measure does not meet the definition of a non-GAAP financial measure and therefore is not subject to the presentation and disclosure requirements for non-GAAP financial measures. Registrants should clearly identify metrics and key performance indicators separately from non-GAAP financial measures and follow the appropriate guidance for each (i.e., the Commission's guidance on key performance indicators and metrics and the rules on non-GAAP measures).

Disclosure requirements

Item 10(e)(1)(i) requires certain disclosures when a registrant presents non-GAAP financial measures in SEC filings. The instructions to Item 2.02 of Form 8-K say the requirements also apply to disclosures (furnished or filed) under that item. The following disclosures are required:

- The most directly comparable financial measure calculated in accordance with GAAP must be presented with equal or greater prominence.
- A reconciliation of the differences between the historical or forward-looking non-GAAP measure and its most directly comparable GAAP measure must be provided. For a forward-looking non-GAAP financial measure, the reconciliation must be provided to the extent available without unreasonable efforts.
- A description of the reasons why management believes that the non-GAAP measure provides useful information to investors, as well as, if material, any additional purposes for which management uses the non-GAAP measure. This disclosure is not required if the non-GAAP measure is presented in an SEC filing other than an annual report on Form 10-K or Form 20-F and if up-to-date disclosure was included in the most recent annual report on those forms.

Prohibitions

Item 10(e)(1)(ii) notes the following restrictions apply to any disclosure of a non-GAAP financial measure in an SEC filing:

- A non-GAAP liquidity measure other than EBIT or EBITDA may not exclude charges or liabilities that required or will require cash settlement or that would have required cash settlement absent an ability to settle in another manner.
- A non-GAAP performance measure may not be adjusted to eliminate or "smooth" (i.e., reduce volatility in) items identified as "nonrecurring, infrequent or unusual" when (1) the nature of the charge or gain makes it reasonably likely that the item will recur within two years or (2) there was a similar charge or gain in the prior two years.
- Non-GAAP financial measures may not be presented on the face of the company's GAAP financial statements or in the accompanying notes unless the measure is required or permitted to be presented in the financial statements by the standard setter responsible for establishing the accounting principles used in preparing that issuer's financial statements.
- Non-GAAP financial measures may not be presented on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X.
- An issuer may not use titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.

Item 2.02 of Form 8-K

Item 2.02 of Form 8-K requires disclosure of any public announcement or press release that includes material non-public information about the registrant's results of operations or financial condition for a completed quarterly or annual fiscal period, including releases or announcements that present non-GAAP financial measures. C&DI Question 105.06 confirms that a press release announcing a registrant's results of operations for a just-completed fiscal quarter, including its expected adjusted earnings (a non-GAAP financial measure) for the fiscal period, would be subject to Item 2.02.

Earnings releases furnished on Form 8-K are subject to Regulation G and to the disclosure requirements of Item 10(e)(1)(i) of Regulation S-K. A registrant may satisfy the Item 10(e)(1)(i) disclosure requirements by providing the disclosures in Item 2.02 of Form 8-K or in the earnings release itself. A registrant may also disclose (1) the reasons why management believes that the non-GAAP measure provides useful information to investors and (2) any additional purposes for which management uses the non-GAAP measure in the most recent SEC annual report and update the disclosures, as necessary, no later than the time the Form 8-K is furnished to the SEC.

Earnings releases furnished on Form 8-K are not subject to the Item 10(e)(1)(ii) prohibitions listed in the section above. Although registrants may exclude cash-settled charges or liabilities from non-GAAP financial measures presented in earnings releases, they should still consider the other concepts in these prohibitions (e.g., not using titles or descriptions that are the same as, or confusingly similar to, those of GAAP financial measures) when disclosing non-GAAP measures.

If a registrant elects to file, rather than furnish, its earnings release with the SEC, it must comply with all the provisions in Item 10(e).

SEC staff interpretations

The SEC staff's C&DIs comprise the Division of Corporation Finance's interpretations of the rules on the use of non-GAAP financial measures. In addition, the SEC staff has announced certain interpretations in public forums such as the AICPA & CIMA[2] Conference on Current SEC and PCAOB Developments (the AICPA Conference).

Reconciliation

The SEC staff has provided several interpretations relating to the most directly comparable GAAP measures to which certain non-GAAP measures should be reconciled:

- Non-GAAP per-share performance measures should be reconciled to GAAP earnings per share
- EBIT or EBITDA, if presented as a performance measure, should be reconciled to GAAP net income. In C&DI Question 103.02, the staff states that operating income would not be considered the most directly comparable GAAP financial measure to EBIT or EBITDA because those measures are adjusted for items that are excluded from operating income.
- Contribution margin and other similar non-GAAP measures should be reconciled to GAAP gross margin. We have observed the staff challenge the reconciliation of non-GAAP margin measures to anything but GAAP gross margin even when a GAAP gross margin is not presented on the face of the income statement. A company is expected to derive a GAAP gross margin (i.e., fully loaded gross margin) for purposes of the reconciliation requirements of Item 10(e) of Regulation S-K.
- In C&DI Question 101.05, the SEC staff noted that a non-GAAP financial measure may be reconciled to a pro forma measure presented in accordance with Article 11 of Regulation S-X, instead of a GAAP financial measure, if that is the most directly comparable measure.

Example SEC staff comment: Most directly comparable GAAP measure
We note you present Adjusted Gross Margin as a non-GAAP measure and that you reconcile this measure to operating income. Please revise to reconcile to a fully loaded GAAP gross margin or tell us why you believe operating income is the most directly comparable GAAP measure.

C&DI Question 102.10(b) provides the following examples of disclosures that would cause the reconciliation required by Item 10(e)(1)(i)(B) of Regulation S-K to give undue prominence to a non-GAAP measure:

- Starting the reconciliation with a non-GAAP financial measure
- Presenting a non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures
- Omitting the reconciliation of a forward-looking non-GAAP measure to the most directly comparable GAAP measure without disclosing in a location of equal or greater prominence that the measure cannot be reconciled without unreasonable effort, the information that is unavailable, and its significance

In C&DI Question 102.10(c), the staff states that it considers a non-GAAP income statement to be "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."

Example SEC staff comment: Reconciliation
In discussing your third-quarter results, you present Adjusted EBITDA and Adjusted EBITDA margin and not net income (loss) or net income (loss) margin. Please present the most comparable GAAP measures with equal or greater prominence to your non-GAAP measures. Also, include a quantitative reconciliation with respect to your forward-looking non-GAAP measures or disclose your reliance on the "unreasonable efforts" exception in Item 10(e)(1)(i)(B) of Regulation S-K and identify the specific reconciling items that are unavailable, along with the probable significance, in a location of equal or greater prominence.

Prominence of non-GAAP measures

The SEC staff's views on prominence extend beyond those related to the reconciliation of a non-GAAP measure to the most directly comparable GAAP measure. C&DI Question 102.10(a) provides additional examples of instances in which non-GAAP measures are more prominent than the comparable GAAP measures, including the presentation of:

- An income statement of non-GAAP measures, as defined above and in C&DI Question 102.10(c)
- A non-GAAP measure before or without the presentation of the most directly comparable GAAP measure
- 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 with equal or greater prominence
- A non-GAAP measure in a format (e.g., bold, larger font) or characterization (e.g., "exceptional") that gives more prominence to the non-GAAP measure in relation to the comparable GAAP measure
- Charts, tables or graphs of a non-GAAP measure without the presentation of charts, tables or graphs of the comparable GAAP measure with equal or greater prominence
- Discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location of equal or greater prominence

The 2003 release notes that when a non-GAAP financial measure is used in the numerator and/or denominator of a ratio, the registrant must (1) provide a reconciliation for each non-GAAP financial measure used in the calculation and (2) present the ratio or measure as calculated using the most directly comparable GAAP financial measure(s).

How we see it

A common request from the SEC staff has been that companies reorganize their disclosures so that non-GAAP measures are not shown with greater prominence than the corresponding GAAP measures. We have seen this request when companies disclosed non-GAAP measures before GAAP measures (in addition to presenting non-GAAP measures in bulleted highlights in earnings releases), used a bold font for non-GAAP measures and put more emphasis on non-GAAP measures throughout the disclosure.

Example SEC staff comment: Prominence
We note several instances where you provide an enhanced discussion of the drivers behind changes in certain non-GAAP measures, including free cash flow and adjusted operating segment income, without a corresponding GAAP discussion. Please revise future filings to provide a similar discussion for your GAAP measures with equal or greater prominence.

Appropriateness of adjustments, presentation and disclosures

The C&DIs also provide guidance on measures, presentation and disclosures the SEC staff would consider misleading or inappropriate. While the C&DIs note that whether an adjustment results in a misleading non-GAAP measure depends on the facts and circumstances of the registrant, they include several examples of actions that could cause an adjustment to be misleading and/or presentation and disclosure to be inappropriate, as discussed below.

Misleading adjustments

'Individually tailored' accounting principles

C&DI Question 100.04 acknowledges that, by definition, a non-GAAP measure excludes or includes amounts from the most directly comparable GAAP measure. However, it notes that if an adjustment reflects a change in the required GAAP recognition and measurement principles, such change would result in the application of an "individually tailored" accounting principle, which may cause the presentation of a non-GAAP measure to be misleading. C&DI Question 100.04 includes the following non-exhaustive list of examples of individually tailored accounting principles that the staff may consider to be misleading:

- A change in the pattern of recognition (e.g., acceleration of revenue recognized ratably over time in accordance with GAAP as though revenue was earned when customers were billed)
- The deduction of 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)
- A change in the basis of accounting from an accrual basis in accordance with GAAP to a cash basis

Example SEC staff comment: 'Individually tailored' accounting principle
Your adjustment for tax valuation allowances in your reconciliations of adjusted net income and adjusted diluted EPS appear to result in individually tailored recognition methods. Please revise your presentation to omit these adjustments or tell us why you believe they are appropriate.

The SEC staff has also said it will not object to companies disclosing the various components of measures that are otherwise prohibited as adjustments because they use tailored accounting principles. That is, a company could disclose the components of such measures as key performance indicators (i.e., operating statistics) or GAAP financial measures and apply the Commission's **guidance** for key performance indicators and metrics.

For example, to help investors calculate a revenue metric that removes the effect of deferred revenue and rebates, a company could provide information about bookings and disclose components of GAAP revenue such as rebates, discounts and the change in deferred revenue, among others.

Exclusion of normal, recurring cash operating expenses

C&DI Question 100.01 addresses the staff's view that the exclusion of normal, recurring, cash operating expenses necessary to operate a registrant's business from a non-GAAP measure could be misleading. The C&DI describes how the SEC staff considers whether operating expenses are "normal" and "recurring." The C&DI notes that, in making the determination of whether an operating expense is "normal," the staff considers how the nature and effect of non-GAAP adjustments relate to the company's operations, revenue-generating activities, business strategy and regulatory environment. Further, it states the staff's view that an operating expense that occurs repeatedly or occasionally, including at irregular intervals, is recurring. In comments to registrants, the SEC staff has noted that if certain operating costs are expected to be incurred over periods in excess of one year, they may be considered "normal" and "recurring."

C&DI Question 100.01 says that whether an adjustment results in a misleading non-GAAP financial measure depends on a company's facts and circumstances. Historically, the SEC staff has objected to a variety of adjustments, including:

- Costs to be a public company (e.g., liability insurance for public company directors and officers, investor relation costs, listing fees)
- Store or restaurant opening and closing costs and rent expense
- Upfront and contingent milestone payments in connection with pharmaceutical collaborative and licensing arrangements, or research and development (R&D) arrangements
- Acquired in-process research and development (IPR&D) assets charged to R&D costs in an asset acquisition in the pharmaceutical industry

Example SEC staff comment: Exclusion of normal recurring cash operating expenses
We note your adjustment for public company expenses in the reconciliation of net loss to Adjusted EBITDA. Please clarify whether this adjustment covers transaction expenses related to your initial public offering. If not, to the extent that public company expenses reflect additional headcount to build infrastructure and support the operations of a public company (i.e., public company directors and officers' liability insurance, investor relations and public listing fees, additional legal and accounting fees, and additional independent board members), please remove the related adjustment.

The SEC staff said it would typically view the opening and closing of a retailer's stores (or restaurants in the hospitality industry) as a normal activity. The staff also noted that although a retailer may not open or close stores frequently, the costs associated with openings and closing would also be considered recurring expenses. The staff also said it considers rent expense in the retail industry to be a normal, recurring operating expense.

Example SEC staff comment: Exclusion of normal recurring cash operating expenses
Please tell us how the adjustments for store pre-opening expenses, store closing expenses, and non-recurring costs to arrive at Adjusted EBITDA are in compliance with Question 100.01 of the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures (C&DIs).

How we see it

Depending on its facts and circumstances, a registrant may conclude that an adjustment for store opening or closing costs may be appropriate for an individual store performance measure. For example, a registrant may conclude that opening or closing costs are not normal or recurring in the context of an individual store, since it will incur them only once in its lifecycle.

Although judgment may be necessary, a registrant could also conclude that an adjustment for closing costs could be acceptable in the context of a restructuring. In those cases, the registrant should clearly explain the nature and purpose of the adjustment, including why the costs do not constitute normal, recurring operating expenses.

Although the SEC staff has said that restructuring costs have not typically been found to be "normal" in their assessed fact patterns, it has emphasized that registrants should consider how restructuring relates to the factors noted in C&DI Question 100.01 (i.e., operations, revenue-generating activities, business strategy, industry and regulatory environment) to make that determination. If a registrant has frequent business acquisitions and restructuring costs over successive quarters or years, the SEC staff may ask about the facts and circumstances supporting an adjustment for what could be a recurring cost.

How we see it

We believe adjustments to exclude restructuring costs and acquisition-related costs from non-GAAP measures will generally continue to be allowed. However, registrants will need to exercise judgment, based on their facts and circumstances, to determine whether such adjustments are appropriate. We recommend that registrants continue to monitor developments related to these types of adjustments to non-GAAP measures.

The staff has questioned adjustments for implementation costs related to long-term strategic investments in technology (e.g., replacement of an enterprise resource planning system over several years). Whether these adjustments are appropriate may depend on the registrant's facts and circumstances, including the importance and duration of the investments or projects (e.g., if the project spans several years, that may indicate that the expenses are normal, recurring operating expenses necessary to run the registrant's business).

Boilerplate usefulness and purpose disclosures

Although C&DI Question 102.04 notes that there is no prohibition against disclosing a non-GAAP financial measure that is not used by management in managing the business, Item 10(e)(1)(i) requires registrants to disclose the usefulness of non-GAAP financial measures to investors and, if management uses the disclosed non-GAAP financial measures, how management uses them to the extent material. The SEC staff may ask registrants to clarify and expand on these disclosures if they are boilerplate or too general to help readers understand how they should use a particular measure. If a registrant cannot adequately explain why a measure is useful, the SEC staff may consider that as an indication that the measure may be misleading.

Example SEC staff comment: Usefulness of a non-GAAP measure
We note your disclosure that "adjusted net income" and "adjusted diluted EPS" are useful to investors in assessing year-over-year performance. Please provide a more substantive explanation on the usefulness of these measures. Additionally, your statement on the usefulness of "adjusted diluted EPS" differs from your statement on the usefulness of the measure in your earnings release in Form 8-K. Please revise accordingly.

Inappropriate presentation and disclosure

Inappropriate and/or unclear labeling and descriptions

The SEC staff expects registrants to clearly label and describe in sufficient detail non-GAAP financial measures and related adjustments so investors can understand all material components and distinguish them from GAAP measures.

C&DI Question 100.05 notes that a non-GAAP financial measure (or an adjustment made to a GAAP financial measure) can be misleading if it is not appropriately labeled and clearly described and includes examples of inappropriate labeling practices, such as the failure to identify and describe a measure as non-GAAP and the presentation of a non-GAAP measure with a label that does not reflect its nature (e.g., a measure labeled as "net revenue" that is actually a contribution margin because it subtracts certain expenses from GAAP revenue, a non-GAAP measure labeled as "pro forma" but not calculated in accordance with Article 11 of Regulation S-X).

The SEC staff has noted that a registrant does not need to include the "non-GAAP" label in every instance that that a non-GAAP financial measure is referenced (e.g., "Adjusted EBITDA" does not need to be labeled as "Non-GAAP Adjusted EBITDA"). The registrant may instead include the label in the sub-heading(s) to the section(s) of the document that contain the non-GAAP measures (e.g., a sub-heading labeled "Non-GAAP Financial Results" under Item 7, *Management's Discussion and Analysis of Financial Condition and Results of Operations*, of Form 10-K).

Example SEC staff comment: Inappropriate and/or unclear labeling and descriptions
We note your disclosure of core earnings. This non-GAAP measure includes adjustments for various realized and unrealized gains (losses). In light of these adjustments, please tell us how you determined it was appropriate to title this measure as core earnings.

In C&DI Question 102.07, the SEC staff has emphasized the need for clear definitions and descriptions of measures that do not have a uniform definition and whose title does not describe how they are calculated (e.g., free cash flow). C&DI Question 102.07 refers to "free cash flow" as cash flows from operating activities (as presented in the statement of cash flows under GAAP) less capital expenditures.

Further, in C&DI Question 103.01, the SEC staff has emphasized that registrants should not label as "EBIT" or "EBITDA" non-GAAP measures that are calculated differently from those described in the 2003 release, which defines EBIT as "earnings before interest and taxes" and EBITDA as "earnings before interest, taxes, depreciation, and amortization." C&DI Question 103.01 further specifies that "earnings," in the context of these definitions, means "net income as presented in the statement of operations under GAAP."

How we see it

If a registrant wishes to present an EBIT- or EBITDA-based measure whose calculation differs from the one described in the 2003 release or a free cash flow measure whose calculation differs from the one described in C&DI Question 102.07, it should consider labeling the measures as adjusted EBIT, adjusted EBITDA and adjusted free cash flow.

Although the SEC staff expects registrants to provide clear definitions of their non-GAAP measures and descriptions of the adjustments they contain, C&DI Question 100.06 emphasizes the staff's view that extensive, detailed disclosure cannot be used to cure a misleading non-GAAP financial measure.

Inconsistent presentation between periods and/or treatment of charges and gains

C&DI Question 100.02 states that a non-GAAP measure can be misleading if it is presented inconsistently between periods (e.g., a non-GAAP measure that adjusts a charge or gain in the current period but for which similar charges or gains were not also adjusted in prior periods) without adequate disclosure of the change and explanation of the reasons for the change.

The C&DI also states that, in addition to these disclosures, depending on the significance of a change in how the non-GAAP measure is calculated, it may be necessary to recast the prior-period measures to conform to the current presentation.

Further, C&DI Question 100.03 notes that a non-GAAP measure could be considered misleading if it excludes non-recurring charges but not non-recurring gains that occurred during the same period (i.e., cherry picking). This has been an area of particular focus for adjustments made in response to certain macroeconomic factors (e.g., the COVID-19 pandemic).

Omission or inappropriate presentation of applicable tax effects

C&DI Question 102.11 clarifies that a registrant should appropriately reflect the income tax effects of adjustments made in calculating its non-GAAP measures. This includes potentially reflecting the appropriate tax rate that would apply to adjustments made to calculate a non-GAAP performance measure, considering both the applicable current tax expense and deferred tax expense, which could differ from the registrant's GAAP effective tax rate.

The C&DI says that adjustments to arrive at a non-GAAP measure should not be presented net of tax in the reconciliation to the most comparable GAAP measure. Instead, the reconciling items should be presented gross of taxes, and the tax effect of adjustments should be presented as a separate reconciling item.

Liquidity measures

The SEC staff views a liquidity measure as a non-GAAP measure when it "is different from cash flow or cash flow from operations computed in accordance with GAAP"[3] (i.e., when GAAP cash flow measures are adjusted in any manner to present a different liquidity measure). Free cash flow is a common non-GAAP liquidity measure.

Per-share presentation prohibition

C&DI Question 102.05 emphasizes that non-GAAP liquidity measures cannot be presented on a per-share basis in documents filed or furnished with the SEC. The C&DI notes that per-share data is prohibited if, based on the substance of the non-GAAP measure, it can be used as a liquidity measure, even if management presents it solely as a performance measure.

The SEC staff deems EBIT and EBITDA to be examples of measures that, even if presented as performance measures, could be used as liquidity measures and, therefore, their presentation on a per-share basis is prohibited.[4]

Non-GAAP measures associated with debt covenants

As noted above, Item 10(e) of Regulation S-K prohibits a non-GAAP liquidity measure other than EBIT or EBITDA from excluding charges or liabilities that required cash settlement, will require cash settlement or would have required cash settlement absent an ability to settle in another manner. However, because Item 303 of Regulation S-K requires disclosure of material items affecting liquidity in MD&A, a registrant may be required to disclose measures as calculated in relation to a debt covenant. Since these measures are required to be disclosed by Regulation S-K, they are excluded from the definition of non-GAAP financial measures, and a registrant may present them even if they exclude the charges or liabilities prohibited by Item 10(e) of Regulation S-K.

In C&DI Question 102.09, the SEC staff notes that a registrant may be required to disclose measures associated with debt covenants if management believes that the credit agreement is a material agreement, that the covenant is a material term of the credit agreement and that information about the covenant is material to an investor's understanding of the company's financial condition and/or liquidity. If a registrant discloses a measure associated with a debt covenant, it should consider also disclosing the material terms of the credit agreement (including the covenant), the amount or limit required for compliance with the covenant and the actual or reasonably likely effects of compliance or non-compliance with the covenant on the company's financial condition and liquidity.

Example SEC staff comment: Measures associated with debt covenants
You note that adjusted EBITDA is closely aligned with the material terms of your credit agreement. If you are presenting adjusted EBITDA as a liquidity measure please revise to present it exactly as defined in the credit agreement and provide all the disclosures required by Question 102.09 in the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures, including all the material terms of the credit agreement, the full calculation of the debt covenant measure, the amount or limit required for compliance with the covenant and the actual or reasonably likely effects of compliance or non-compliance with the covenant. The liquidity measure should also be reconciled to operating cash flows. Disclosures related to adjusted EBITDA as a performance measure should be removed.

Free cash flow measures

C&DI Question 102.07 notes that a free cash flow measure that deducts capital expenditures from the GAAP financial measure of cash flows from operating activities would not violate the prohibitions in Item 10(e) of Regulation S-K, even if some of the capital expenditures may have been paid in cash. However, because companies can calculate free cash flow differently, the measure should be clearly described and reconciled to GAAP cash flow from operating activities.

The SEC staff notes that registrants should avoid inappropriate or potentially misleading inferences about the measure's usefulness (e.g., implying that it represents the residual cash flow available for discretionary expenditures, since many companies have mandatory debt service requirements or other non-discretionary expenditures that are not deducted from the measure).

The C&DI also emphasizes that free cash flow is a liquidity measure that, like other liquidity measures described above, must not be presented on a per-share basis.

Other considerations

When a non-GAAP liquidity measure is presented, C&DI Question 102.06 notes that the three major categories of the statement of cash flows (i.e., cash flows from operating, financing and investing activities) should be presented.

Segment information

Item 10(e)(4) of Regulation S-K indicates that financial measures required to be disclosed by GAAP are excluded from the definition of a non-GAAP financial measure. The 2003 release, as emphasized by C&DI Question 104.01, lists "measures of profit or loss [...] for each segment required to be disclosed in accordance with GAAP" as one example of such measures. That is, the measure reported to the chief operating decision maker (CODM) for purposes of making decisions about allocating resources to the segment and assessing its performance and disclosed based on the requirements of Accounting Standards Codification (ASC) 280, *Segment Reporting*, is excluded from the definition of a non-GAAP financial measure.

C&DI Question 104.01 notes that because ASC 280 requires or expressly permits including additional financial information for each segment in the footnotes to the financial statements, that information would be excluded from the definition of non-GAAP financial measure. However:

- C&DI Question 104.02 notes that, if a registrant's MD&A includes a discussion of the measure of segment profit or loss disclosed in accordance with ASC 280, MD&A should also include a discussion of the applicable reconciling items in the reconciliation required by ASC 280. Further, C&DI Question 104.04 notes that the total segment profit or loss presented in the reconciliation required by ASC 280 would be a non-GAAP financial measure if it is presented outside the context of the segment reporting footnote in the consolidated financial statements.
- C&DI Question 104.03 emphasizes that, if the measure of segment profit or loss is adjusted in a manner that renders it different from the measure reported to the CODM for resource allocation and performance assessment purposes (i.e., the measure required by ASC 280), such adjusted measure would be a non-GAAP financial measure subject to the provisions of Regulation G and Item 10(e) of Regulation S-K.

Example SEC staff comment: Segment information
You disclose Adjusted EBITDA on a consolidated and segment basis. Please note that although Segment Adjusted EBITDA is a disclosure required in the notes to the financial statements by ASC 280, your current disclosures on a consolidated basis outside of the segment footnote are non-GAAP measures. Please revise to properly identify all non-GAAP measures and provide all disclosures required by Item 10(e) of Regulation S-K. Please also revise to include a discussion and analysis of all material costs and expenses attributable to your reportable segments that are not included in computing the segment measure of Adjusted EBITDA, for example, depreciation and amortization.

If the CODM uses more than one measure of profit or loss to assess performance and allocate resources, ASC 280 requires the company to report the measure that is most consistent with the measurement principles used to calculate the corresponding amounts in the entity's consolidated financial statements.

For example, if the CODM of a domestic registrant uses both operating income and EBITDA to assess performance and allocate resources, the registrant should disclose operating income as the measure of segment profit, since that measure is most consistent with US GAAP. In this case, EBITDA would be a non-GAAP measure and could not be presented in the financial statements.

The Financial Accounting Standards Board (FASB) has proposed amending ASC 280 to, among other things, permit entities to disclose more than one measure of a segment's profit or loss, as long as at least one of those measures is determined in a way that is most consistent with the measurement principles used to measure the corresponding amounts in the consolidated financial statements. If the proposal is finalized, the guidance would require the company mentioned in the previous paragraph to disclose operating income as its segment profit or loss, and it could elect to disclose EBITDA making it a GAAP measure.

How we see it

The FASB's proposed amendments, if finalized, could change practice because it would allow an entity to disclose more than one measure of segment profit or loss. Registrants should monitor the outcome of the proposal and any changes in SEC staff's views on the relationship of incremental measures of segment profit or loss to non-GAAP financial measures.

Other considerations

Non-GAAP policies and disclosure controls and procedures

Registrants should establish written policies to document how non-GAAP financial measures are defined, calculated and presented. Non-GAAP policies may also document how the inputs to non-GAAP measures and their calculation and presentation are reviewed and approved within the organization, including the applicable disclosure controls and procedures.

When disclosed in SEC filings, non-GAAP measures and the related reconciliations and disclosures fall under a company's disclosure controls and procedures that require certification by the chief executive officer and chief financial officer. The SEC staff has said that companies should implement controls over their preparation and disclosure of non-GAAP measures.

Common types of disclosure controls implemented by companies include establishing policies that clearly describe the adjustments made to calculate a non-GAAP measure, establishing a process for changing how a non-GAAP financial measure is calculated (including reviewing any new non-GAAP adjustments for compliance with the SEC rules and staff interpretations) and enhancing audit committee oversight of the company's disclosure of non-GAAP financial measures.

How we see it

As a leading practice, audit committee and disclosure committee members should understand the company's policies addressing non-GAAP financial measures, the nature of the company's non-GAAP financial measures, the adjustments they include and any judgments management makes in calculating the measures.

Audit committee and disclosure committee members should also understand disclosure controls and procedures applied in the preparation and presentation of non-GAAP financial measures. They may also consider assessing how the measures may differ from those presented by other registrants, particularly the company's peers.

Cohesive disclosures across various corporate communications

When reviewing non-GAAP financial measures, the SEC staff considers information in the filings required by the Securities Act of 1933 or the Securities Exchange Act of 1934, as well as earnings releases, earnings calls, investor presentations and other forms of communication with investors. Registrants often find it challenging to determine which rules apply to the different forms of stakeholder communication and how to provide a cohesive picture of the company across such communications.

For example, the rules on the prominence of non-GAAP measures appear in Item 10(e) of Regulation S-K, which applies to all documents filed with the SEC and earnings releases furnished under Item 2.02 of Form 8-K (including supplemental information included or incorporated into such filings). The prominence rules do not apply to other communications such as investor presentations furnished under Item 7.01 or information a company posts on its website or discusses orally in an earnings call.

As a leading practice, companies should ensure that their non-GAAP financial measures across corporate communications provide investors and other stakeholders with a cohesive explanation of performance.

Timeliness of revising the presentation of non-GAAP disclosures

When the SEC staff concludes that a non-GAAP financial measure is misleading, it expects the registrant to discontinue the use of the measure or the portion of it that is misleading for all periods presented, including revising comparative periods. The SEC staff has emphasized that there is no transition period to address such matters in registrants' filings.

How we see it

Companies that are considering making changes to their non-GAAP financial measures or presenting new non-GAAP measures should assess whether such changes would comply with the SEC rules and related SEC staff guidance. If it is unclear whether they do, the company should consider how its overall corporate reporting would have to change if the staff were to object to a measure or adjustment.

Further, companies that receive questions from the staff about non-GAAP financial measures should be prepared to revise future filings, earnings releases, earnings guidance and other documents containing such measures, including revising any comparative data.

Endnotes:

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[1] 34-47226, *Conditions for Use of Non-GAAP Financial Measures*.
[2] The Chartered Institute of Management Accountants (based in London).
[3] See the 2003 release.
[4] See C&DI Question 103.02.

Appendix: Summary of disclosure requirements and prohibitions

	SEC filings (e.g., Form 10-K, Form 10-Q)	Earnings releases furnished on Item 2.02 of Form 8-K	Other communications (e.g., investor presentations, earnings calls)
Requirements	▸ Presentation, with equal or greater prominence, of the most directly comparable GAAP measure ▸ A quantitative reconciliation to the most directly comparable GAAP measure ▸ A statement disclosing the reasons why management believes the presentation of the non-GAAP measure provides useful information to investors ▸ To the extent material, a statement disclosing the additional purposes, if any, for which management uses the non-GAAP measure	▸ Presentation, with equal or greater prominence, of the most directly comparable GAAP measure ▸ A quantitative reconciliation to the most directly comparable GAAP measure ▸ A statement disclosing the reasons why management believes the presentation of the non-GAAP measure provides useful information to investors ▸ To the extent material, a statement disclosing the additional purposes, if any, for which management uses the non-GAAP measure	▸ Presentation of the most directly comparable GAAP measure ▸ A quantitative reconciliation to the most directly comparable GAAP measure
Prohibitions	▸ Disclosing a non-GAAP financial measure that, taken together with accompanying information, misstates a material fact or omits a material fact necessary to make the presentation not misleading ▸ Excluding from non-GAAP liquidity measures charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner ▸ Adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when it is likely to recur or has occurred over a two-year period ▸ Presenting non-GAAP financial measures on the face of (or notes to) the GAAP or pro forma financial statements ▸ Using titles or descriptions of non-GAAP measures that are the same or confusingly similar to GAAP titles	Making public a non-GAAP financial measure that, taken together with accompanying information, misstates a material fact or omits a material fact necessary to make the presentation not misleading	Making public a non-GAAP financial measure that, taken together with accompanying information, misstates a material fact or omits a material fact necessary to make the presentation not misleading