

**HASKELL & WHITE LLP**  
SEC Roundtable Series



**NON-GAAP FINANCIAL MEASURES ARE BACK!**

April 25, 2012

# Our Agenda

- I. Welcome and introductions
- II. Non-GAAP Financial Measures are Back!
  - How and why SOX curtailed the use of non-GAAP measures
  - What the SEC rules and regulations say regarding the use of non-GAAP measures
  - Why the use of non-GAAP measures has increased in recent years
  - What common pitfalls exist for public companies
- III. Closing and Questions

## Introduction to Haskell & White LLP

- ✓ We are a **middle-market focused** firm powered by 60 client-centered professionals and 9 entrepreneurial partners
- ✓ We practice with the **technical competencies and experience** of larger accounting firms and the **attentiveness and responsiveness** of smaller accounting firms
- ✓ Our primary focus areas include **SEC, Real Estate and M&A**
- ✓ Our SEC clients include both **accelerated and non-accelerated filers**; we serve pre-revenue companies, as well as businesses with revenues in the hundreds of millions
- ✓ In January 2011, we received our second consecutive **“clean” PCAOB inspection report**

## First - What are Non-GAAP Financial Measures

- ✓ The SEC rules define a non-GAAP financial measure as a numerical measure of past or future financial performance, financial position or cash flows that:
  - (i) **excludes** amounts that are included in the most directly comparable GAAP measure; or
  - (ii) **includes** amounts that are excluded from the most directly comparable GAAP measure
  
- ✓ Some common non-GAAP financial measures include:
  - EBITDA, EBIT and FFO
  - a measure of operating income that excludes “non-recurring” items
  - Same store sales; number of subscribers; segment profit are not non-GAAP financial measures

## SOX and Non-GAAP Financial Measures

- ✓ January 2003 – SEC issues final rules regarding financial information that is computed on a basis other than GAAP
- ✓ The SEC’s goal – ensure that investors are not misled by financial information that differs from what is presented in the financials
- ✓ Companies need to make incremental disclosures when presenting non-GAAP financial information
- ✓ Further, companies need to “furnish” ER’s to the SEC on Form 8-K

**Why?**

## SOX and Non-GAAP Financial Measures

- ✓ December 2001 – SEC issues “Cautionary Advice regarding the Use of Pro Forma Financial Information in Earnings Releases”
- ✓ “Pro Forma” has no defined meaning and no uniform characteristics!
- ✓ Reminder that the antifraud provisions of the securities laws apply to pro forma information (even though not filed with the SEC)
- ✓ Commend earnings release guidelines issued by FEI and NIRI
- ✓ January 2002 – SEC settles its first enforcement case involving non-GAAP earnings information in a press release; ticker symbol: THCR



## SOX and Non-GAAP Financial Measures

- ✓ October 1999 - THCR made misleading statements in its Q3 1999 earnings release in order to create the false impression that it exceeded analysts' expectations
- ✓ Disclosed Q3 1999 net income \$14M before a one-time charge of \$81M
- ✓ Failed to disclose that net income included a \$17M one-time gain
- ✓ Disclosed that earnings exceeded analysts' expectations



## SOX and Non-GAAP Financial Measures

The real facts:

- revenues and net income (excluding one-time items) had declined from the comparable prior year period;
- earnings would have not met analysts' expectations had the one-time gain been properly excluded;
- THCR mislead investors by misrepresenting that the increase in revenues and net income over the prior year period resulted from operational improvements that it had implemented





# The SEC and non-GAAP Measures

## SEC Regulations Regarding Use of Non-GAAP Measures

- Brief History
- Overview of Regulation G and Item 10(e) of Regulation S-K
- Regulation G
- Item 10(e)
- Item 2.02 of Form 8-K (Prior Item 12)

# The SEC and non-GAAP Measures

## Brief History

- Pre-Sarbanes-Oxley
  - Use of Non-GAAP Financial Measures
  - Fraud
- Sarbanes-Oxley
  - Section 401(b)
  - Amends Section 13 of the Exchange Act of 1934 and orders SEC to issue rules regarding use of Non-GAAP financial measures
- Regulation G issued in January 2003
- SEC Interpretive Guidance issued in June 2003
- Compliance and Disclosure Interpretations issued in 2010 and 2011

## The SEC and non-GAAP Measures

### Overview of Regulation G and Item 10(e) of Regulation S-K

The SEC regulates the use of non-GAAP measures at two levels:

- 1) Regulation G** is an anti-fraud provision that prohibits the use of non-GAAP financial measures unless that use is not misleading and it requires that the non-GAAP measures be reconciled to the corresponding GAAP measures. Regulation G applies to all communications made by companies.
- 2) Item 10(e) of Regulation S-K** contains more detailed rules and governs the use of non-GAAP measures in SEC filings and it states that a company may not adjust, eliminate or smooth items identified as non-recurring, infrequent or unusual, where the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain in the prior two years.

## The SEC and non-GAAP Measures

### About Regulation G

Regulation G is an anti-fraud provision that prohibits the use of non-GAAP financial measures unless that use is not misleading and it requires that the non-GAAP measures be reconciled to the corresponding GAAP measures. **Regulation G applies to all communications made by companies.**

Regulation G applies to any entity that is required to file reports pursuant to Sections 13(a) or 15(d) of the Exchange Act, other than a registered investment company. Regulation G applies whenever such a registrant, or a person acting on its behalf, discloses publicly or releases publicly **any material information that includes a non-GAAP financial measure.**

# The SEC and non-GAAP Measures

## Key Provisions of Regulation G

General Disclosure Requirement: Regulation G includes a “general disclosure requirement” which requires that a registrant, or a person acting on its behalf, shall not make public a non-GAAP financial measure that, taken together with the information accompanying that measure, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading.

# The SEC and non-GAAP Measures

## Key Provisions of Regulation G

Reconciliation Requirement: Whenever a company that is subject to Regulation G, or a person acting on its behalf, publicly discloses any material information that includes a non-GAAP financial measure, Regulation G requires the registrant to provide the following information as part of the non-GAAP financial measure:

- a presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP; and
- a reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historic measures and quantitative, to the extent available without unreasonable efforts, for prospective measures, 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.

## The SEC and non-GAAP Measures

### Liability Under Regulation G

**Rule 102 of Regulation G** expressly provides that neither the requirements of Regulation G nor a person's compliance or non-compliance with the requirements of Regulation G shall in itself affect any person's liability under Exchange Act Section 10(b) or Rule 10b-5 thereunder.

Disclosure pursuant to Regulation G that is materially deficient may, in addition to violating Regulation G, give rise to a violation of Section 10(b) or Rule 10b-5 thereunder if all the elements for such a violation are present. The SEC holds the view that, under certain circumstances, non-GAAP financial measures could **mislead investors if they obscure the company's GAAP results** and, therefore, could give rise to actions under Rule 10b-5.

# The SEC and non-GAAP Measures

## Liability Under Regulation G

**Section 3(b) of the Sarbanes-Oxley Act** provides that a violation of that Act or the Commission's rules thereunder shall be treated for all purposes as a violation of the Exchange Act. Therefore, if an issuer, or any person acting on its behalf, fails to comply with Regulation G, the issuer and/or the person acting on its behalf could be subject to a Commission enforcement action alleging violations of Regulation G. Additionally, if the facts and circumstances warrant, an action under both Regulation G and Rule 10b-5 can be pursued.



## The SEC and non-GAAP Measures

### Item 10(e) of Regulation S-K

Item 10(e) of Regulation S-K contains more detailed rules and governs the use of non-GAAP measures in SEC filings and it states that a company may not adjust, eliminate or smooth items identified as non-recurring, infrequent or unusual, where the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain in the prior two years.

The Commission amended Item 10 of Regulation S-K as follows:

1. a presentation, with equal or greater prominence, of the most directly comparable financial measure calculated and presented in accordance with GAAP;

## The SEC and non-GAAP Measures

### Item 10(e) of Regulation S-K

2. a reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historical non-GAAP measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP;
3. a statement disclosing the reasons why the registrant's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations; and
4. to the extent material, a statement disclosing the additional purposes, if any, for which the registrant's management uses the non-GAAP financial measure that are not otherwise disclosed.

## The SEC and non-GAAP Measures

### Item 10(e) of Regulation S-K - Prohibitions

- excluding charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP liquidity measures, other than the measures EBIT and EBITDA;
- adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when (1) the nature of the charge or gain is such that it is reasonably likely to recur within two years, or (2) there was a similar charge or gain within the prior two years;

## The SEC and non-GAAP Measures

### Item 10(e) of Regulation S-K - Prohibitions

- presenting non-GAAP financial measures on the face of the registrant's financial statements prepared in accordance with GAAP or in the accompanying notes;
- presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; and
- using titles or descriptions of non-GAAP measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP measures.

**Key Point - The requirements and prohibitions for filed information are more extensive than those of Regulation G.**

## The SEC and non-GAAP Measures

### Item 2.02 (Item 12) of Form 8-K

The Commission amended Form 8-K (old Item 12) to registrants to furnish to the Commission **all releases or announcements disclosing material non-public financial information** about completed annual or quarterly fiscal periods. The new Item does not require that companies issue earnings releases or similar announcements. However, such releases and announcements will trigger the requirements of the new Item.

Under securities law, the terms “**filing**” and “**furnished**” have different meanings.

## Non-GAAP Financial Measures Today

- ✓ Wilson, Sonsini IPO study results
- ✓ Audit Analytics – in 2009, 20% of SEC comment letters questioned non-GAAP measures
- ✓ 2010 and 2011 – SEC’s CorpFin issued new CDIs on non-GAAP measures
- ✓ The new CDIs replace the interpretive guidance in the SEC’s June 2003 FAQs on non-GAAP measures (however, Regulation G and Item 10(e) of Regulation S-K were not amended)

### **Why?**

- ✓ While registrants frequently included non-GAAP measures in press releases, the SEC believed that the restrictive FAQs were making registrants reluctant to include these same measures in SEC filings

## Non-GAAP Financial Measures Today

The **most significant change** made by the SEC in the 2010 and 2011 CDI's -

- ✓ Revised and relaxed guidance on nonrecurring, infrequent or unusual items (FAQs 8 and 9)

CDIs **prohibit describing** such items as nonrecurring, infrequent or unusual when they are reasonably likely to recur within 2 years or there was a similar item within the prior 2 years

CDIs **do not prohibit the adjustment** to the non-GAAP measure; certain onerous disclosure requirements have been eliminated

## Non-GAAP Financial Measures Today

**Other SEC changes** in the 2010 and 2011 CDI's -

- ✓ Clarifies that a registrant is not prohibited from disclosing a non-GAAP measure that is not used by management in managing its business
- ✓ Clarifies that a registrant may present an adjustment “net of tax” when reconciling a non-GAAP measure to the most directly comparable GAAP measure



## Non-GAAP Financial Measures – Common Pitfalls

- ✓ Not aware of the relevant SEC rules –
  - Regulation G
  - Item 10 of Regulation S-K and SEC’s CorpFin CDIs
  - Item 12 of Form 8-K
- ✓ Missed opportunity or a competitive disadvantage because of a perception that non-GAAP measures are too difficult or too risky
- ✓ Backlash over non-GAAP metrics used by Groupon – “we don’t measure ourselves in conventional ways”
  - Gross profit and free-cash flow = okay
  - Adjusted consolidated segment operating income = what?

## Non-GAAP Financial Measures are Back

- ✓ Please complete **evaluation** form
- ✓ Please suggest **future topics**
- ✓ Please use the sign-in sheet for **CPE credit**
- ✓ We'll see you again here in the **Fall 2012** for our next SEC roundtable

**Thank You and Have a Great Day!**