



Telling Your Story – The SEC Offers Advice: *Revised Non-GAAP Interpretations and Other Matters*

The Staff of the Securities and Exchange Commission recently has made clear both that it wants public companies to tell their stories in the ways most meaningful to investors and that it wants those stories to be consistent across the spectrum of disclosure – SEC filings, earnings releases, conference calls and other public statements. On January 11, 2010, the SEC updated the Compliance and Disclosure Interpretations for disclosure of non-GAAP financial measures (the “Non-GAAP C&DIs”).¹

In a number of recent public statements, the Staff from the Division of Corporation Finance has reminded everyone that the Staff reviews company statements outside the context of SEC filings to determine whether a company’s public statements, including the way that the company portrays itself through the use of non-GAAP financial measures, are consistent with disclosure in its SEC filings.

Revisions to Non-GAAP C&DIs

Regulation G, adopted in 2003 in response to the Sarbanes-Oxley Act of 2002, applies whenever a public company discloses or releases publicly any material information that includes a non-GAAP financial measure. A “non-GAAP financial measure” is a numerical measure of a company’s historical or future financial performance, financial position or cash flows that:

- 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 income, balance sheet or statement of cash flows (or equivalent statements) of the company; or
- includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable GAAP measure so calculated and presented.

Under Regulation G, a company is required to include, in the same disclosure or release, (1) a presentation of the most directly comparable GAAP financial measure and (2) a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure.

In addition, when it adopted Regulation G, the SEC amended existing Item 10(e) of Regulation S-K concerning the use of non-GAAP financial measures in filings made with the SEC. The amended rules apply to the same categories of non-GAAP financial measures as Regulation G but contain more detailed and stringent requirements regarding use of such non-GAAP financial measures, including a requirement that the company disclose why investors would find the information useful and, to the extent the information is material and not duplicative, why

¹ See <http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm>.

the company uses the measure. It should be noted that the more stringent requirements of Item 10(e) – and the way in which the SEC Staff has applied these requirements – often discourages companies from disclosing non-GAAP financial measures in SEC filings

The Non-GAAP C&DIs replace the original Frequently Asked Questions issued in 2003 and demonstrate a new flexibility in the Staff's interpretation of the rules that should facilitate including non-GAAP measures in their public disclosures (including in SEC filings), provided that the measures are not misleading and there is sufficient explanation of the measures and an appropriate reconciliation.

The most significant changes reflected in the Non-GAAP C&DIs are:

- **Ability to adjust for recurring items** – Item 10(e) prohibits adjustments that “eliminate or smooth items identified as non-recurring, infrequent or unusual” if the item has occurred in the past two years or is reasonably likely to do so in the next two years. Staff review comments over the years have strongly discouraged adjustments for recurring items even with sufficient surrounding disclosure. The new Non-GAAP C&DIs expressly permit a non-GAAP financial measure that excludes a charge or gain that is recurring, so long as the item is not described as “non-recurring, infrequent or unusual.” (Question 102.03)
- **Use of Measures in Managing Business** – A company may disclose a non-GAAP financial measure even if management does not use that measure in managing the business or for other purposes. In this regard, the Staff notes that Item 10(e)(1)(i)(D) of Regulation S-K states only that, “[t]o the extent material,” there should be a statement disclosing the additional purposes, “if any,” for which the company’s management uses the non-GAAP financial measure. (Question 102.04)
- **Per Share Performance Measures** – While the SEC continues to prohibit per share non-GAAP liquidity measures (such as cash-flow measures) in documents filed or furnished with the SEC, the Staff will not challenge per share performance measures, subject to special guidance for real estate investment trusts (“REITs”). (Question 102.05).
- **REIT FFO** – Since the adoption of Regulation G, the SEC has recognized that special nature and nearly ubiquitous disclosure of “funds from operations” (“FFO”) by REITs. Regulation G and Item 10(e) permit public companies to disclose FFO as determined in accordance with the specific definition of the National Association of Real Estate Investment Trusts (“NAREIT”). However, a number of REITs use an adjusted FFO calculation. The Non-GAAP C&DIs clarify that a company may use an adjusted FFO calculation and may even disclose a per share FFO measure provided that it is used as a performance and not a liquidity measure. However, if adjusted FFO is intended to be a liquidity measure, it may not exclude charges or liabilities that required, or will require, cash settlement. (Questions 102.01 and 102.02).
- **“Free Cash Flow” Measures** – The Non-GAAP C&DIs clarify that Item 10(e) does not prohibit disclosure of a “free cash flow” measure (e.g., cash flows from operating activities less capital expenditures) in filings with the SEC, as long as there is a clear description of its calculation and the company avoids “inappropriate or potentially misleading inferences about its usefulness.” (Question 102.07).
- **Adjusted EBITDA Calculations** – Many companies have customized financial covenants, particularly EBIT (adjusted earnings before interest and taxes) and EBITDA (adjusted earnings before interest, taxes, depreciation and amortization) in their credit agreements. The Non-GAAP C&DI provides that “[t]he prohibition in Item 10(e) notwithstanding,” if management believes that the credit agreement is material, 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, then the company may be required to disclose the measure as calculated by the debt covenant as part of its MD&A.

In disclosing the non-GAAP financial measure in this situation, a company should consider also disclosing the following:

- 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. (Question 102.09).
- **No non-GAAP Income Statements** – Consistent with a position that the Staff has taken in the review process, a new interpretation states that it is generally not appropriate to present a full non-GAAP income statement for the purpose of reconciling non-GAAP measures to the most directly comparable GAAP measures, because the non-GAAP income statement may attach “undue prominence to the non-GAAP information.” (Question 102.10).
 - **Foreign Private Issuer Requirement** – Item 10(e) permits a foreign private issuer to include a non-GAAP financial measure that otherwise would be prohibited by Item 10(e) if, among other things, the non-GAAP financial measure is required or “expressly permitted” by the standard setter responsible for the GAAP used by the foreign private issuer. The Non-GAAP C&DIs clarify that express permission may be demonstrated by the published views of the relevant regulator or a letter directly from the regulator to the foreign private issuer accepting such non-GAAP measure. The foreign private issuer must provide the letter to the SEC's staff upon request. (Question 106.01)
 - **“Net of Tax” Adjustment** – A company may present an adjustment “net of tax” when reconciling a non-GAAP performance measure, provided that the tax effect of each reconciling item is disclosed parenthetically or in a footnote to the reconciliation. Alternatively, the company can present the tax effect in one line in the reconciliation. In all cases, the company should disclose how the tax effect was calculated. (Question 102.11).

In addition to the interpretations discussed above, the Staff also eliminated out-of-date questions and clarified certain questions.

Consistency Across the Disclosure Spectrum

While for many years the Staff has looked outside the four corners of a company's filing when reviewing the disclosure, recent statements have emphasized a renewed focus of the Staff on all forms of communication in the course of the review process. At the recent 37th Annual Securities Regulation Institute in San Diego, Meredith Cross, Director of the Division of Corporation Finance, reminded participants that the Staff listens to earnings calls, reviews press releases and presentations, reviews analysts' coverage and other public statements by companies. The Staff then uses the knowledge learned in this process to inform their comments on the disclosure in the SEC filing that is being reviewed. The Staff will pay special attention to inconsistencies between SEC filings and the other public statements. Ms. Cross indicated that an underlying reason for the revisions to the Non-GAAP C&DIs is to address an increasing disconnect between information included in SEC filings and information communicated to investors through other means. It was observed that Forms 10-K and 10-Q have increasingly become compliance documents that are not communicative. The greater flexibility in the Item 10(e) interpretations is not necessarily designed to encourage more use of Non-GAAP financial measures in SEC filings, but rather should encourage improved, more balanced disclosure in SEC filings.

These recent actions by the SEC Staff continue the ongoing quest by the SEC (since at least as far back as the adoption of Regulation FD in 2000) to push companies into having consistent disclosure throughout the various methods used by companies to disseminate information – presentations, earnings calls, website and SEC filings. Now more than ever, companies will need to be cognizant of any disconnect between what is said on an earnings call or in an analyst presentation and the story that the company is telling in its MD&A.

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