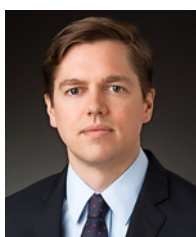


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ACCOUNTING STANDARDS**Recent SEC Guidance on Non-GAAP Financial Measures
May Impact Federal Securities Lawsuits**

BY ALEX J. KAPLAN, JAMES HEYWORTH, AND ELISE YOUNG

Companies often use non-GAAP (Generally Accepted Accounting Principles) measures in financial disclosures to present unique measures or benchmarks, such as EBIT or EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). Recently, however, the use of non-GAAP measures has come under fire from several commentators. Critics argue that non-GAAP accounting can improperly “ma-

nipulate” financial results and otherwise obfuscate company performance. One prominent writer has labeled non-GAAP measures as “fantasy figures” and “make-believe.” Gretchen Morgenson, *Fantasy Math is Helping Companies Spin Losses into Profits*, N.Y. TIMES, April 22, 2015, at BU1.

On May 17, 2016, the U.S. Securities and Exchange Commission (SEC) Division of Corporation Finance published additional guidance on the use of non-GAAP financial measures. As discussed further herein, the SEC’s guidance—issued as Compliance & Disclosure Interpretations (C&DIs), and in the form of questions and answers—concerns Item 10(e) of Regulation S-K, which sets out requirements concerning transparency in the use and publication of non-GAAP measures in SEC filings.

For companies and other parties who must be mindful of disclosure obligations, it remains to be seen how the SEC’s guidance may impact courts’ analysis of claims for alleged violations of federal securities laws based on the use (or alleged abuse) of non-GAAP measures in corporate disclosures. This article addresses the current state of the law and considers how courts may weigh the updated C&DIs in the event of claims that non-GAAP measures present material misstate-

Alex J. Kaplan is a partner and James Heyworth and Elise Young are associates with Sidley Austin LLP in New York. They are members of Sidley’s Securities and Shareholder Litigation group. The views expressed in this article are those of the authors and not necessarily those of Sidley Austin LLP or its clients.

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ments or misrepresentations in violation of securities laws.

Background on Regulation of Non-GAAP Financial Measures: Regulation G and Item 10(e) of Regulation S-K

In early 2003, the SEC issued final rules regarding “Conditions for Use of Non-GAAP Financial Measures.” Release No. 8176 (Jan. 22, 2003). In the final rules, the SEC explained that two regulations cover the use of non-GAAP measures in SEC filings: (1) Regulation G, which applies to entities filing reports under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the “Exchange Act”), and (2) Item 10(e), which applies to entities filing earnings statements on Form 8-K. These regulations have served as the bases on which plaintiffs bring lawsuits alleging a material misrepresentation or omission.

Regulation G

Regulation G applies to entities (other than registered investment companies) filing reports under Sections 13(a) or 15(d) of the Exchange Act, where the registrant publicly discloses or releases material information that includes a non-GAAP financial measure. Regulation G does not apply in all situations; for instance, it does not apply to non-GAAP financial measures that represent projections or forecasts of results of proposed business combination transactions.

When Regulation G applies, it “contains a general disclosure requirement and a specific requirement of a reconciliation of the non-GAAP financial measure to the most directly comparable GAAP financial measure.” Release No. 8176, at *6 (Jan. 22, 2003). The issuing entity is required to satisfy both general disclosure and reconciliation requirements. The general disclosure requirement prohibits registrants from publicizing a non-GAAP financial measure that “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.” *Id.* The specific requirement of reconciliation requires the registrant to present “the most directly comparable” GAAP measure, and reconcile the historical and prospective quantitative differences between the non-GAAP and GAAP financial measure. *Id.*

A registrant that violates Regulation G may be subject to liability under the federal securities laws. Specifically, materially deficient disclosure may give rise to liability under the Exchange Act if, as the SEC has put it, the registrant or any person acting on its behalf “obscure[s] the company’s results.” Release No. 8176, at *7. Further, the Commission itself may pursue an action for violations of Regulation G or Rule 10b-5 where, depending on the circumstances, an issuer or any person acting on its behalf violates Regulation G. *Id.*

Item 10 of Regulation S-K

In Item 10(b) of Regulation S-K, the SEC “encourages the use . . . of management’s projections of future economic performance that have a reasonable basis and are presented in an appropriate format.” Item 10(e) addresses the use of non-GAAP financial measures in SEC filings, and generally applies to all filings and earn-

ings releases pursuant to Item 2.02 of Form 8-K that include non-GAAP financial measures.

Like Regulation G, Item 10(e) contains provisions that require the display of comparable GAAP measures where appropriate: “Whenever one or more non-GAAP financial measures are included in a filing with the Commission,” the registrant must present the comparable GAAP measures “with equal or greater prominence.” 17 C.F.R. § 229.10. In addition, the registrant must reconcile non-GAAP measures with GAAP measures and disclose why a non-GAAP statement is useful to investors about “the registrant’s financial condition and results of operations.” *Id.*

The SEC also has explained that the requirements and prohibitions under Item 10(e) “for filed information are more extensive and detailed than those of Regulation G.” Release No. 8176, at *9 (Jan. 22, 2003). For example, the registrant “must not” “exclude charges or liabilities . . . [requiring] cash settlement . . . from non-GAAP liquidity measures” other than the measures EBIT or EBITDA. Nor may the registrant “adjust a non-GAAP performance measure to eliminate or smooth” items by claiming they are non-recurring, infrequent, or unusual, when “it is reasonably likely to recur within two years or there was a similar charge or gain within the last two years.” *Id.* at *8-9.

The SEC’s Recent Guidance

In May 2016, the SEC published on its website guidance regarding the use of non-GAAP measures. See Non-GAAP Financial Measures (May 17, 2016) (available at <https://www.sec.gov/divisions/corpfin/guidance/nongAAPinterp.htm>). The Commission’s guidance relates to Item 10(e) of Regulation S-K and potential violations of Regulation G, and was issued in the form of C&DIs. The SEC states that this guidance “comprise[s] the Division’s interpretations of the rules and regulations on the use of non-GAAP financial measures.”

The C&DIs do not prohibit the use of non-GAAP measures, but they do suggest a number of requirements for the presentation of such measures. For example, the C&DIs explain that GAAP measures should be disclosed in a fashion that is more prominent than non-GAAP measures, including that the GAAP measure should precede the non-GAAP counterpart, and that “comparable GAAP measures” should be included in an “earnings headline or caption that includes non-GAAP measures.” *Id.* The C&DIs also identify certain potentially misleading uses of non-GAAP measures. For example, the guidance cautions that “presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant’s business could be misleading,” and cautions further that a measure “that adjusts a particular charge or gain in the current period and for which other, similar charges or gains were not also adjusted in prior periods could violate Rule 100(b) of Regulation G unless the change between periods is disclosed and the reasons for it explained.” *Id.* The SEC provides a number of additional guiding points that should be closely examined by all registrants.

Judicial Treatment of Non-GAAP Measures in Federal Securities Cases

Prior to the issuance of the Commission’s recent C&DIs, courts regularly found that it is permissible to

use non-GAAP measures that adhere to Regulation G and Item 10(e). At present, it is unclear whether and how the C&DIs may impact judicial analysis and treatment of non-GAAP measures in federal securities lawsuits. While every case will be circumstances dependent, it is probable that the CD&Is will not lead to any seismic shift in liability analysis, and more likely, the updated guidance will augment interpretations of non-GAAP measures that may constitute misleading statements.

As in any disclosure case, courts have focused on transparency. For example, in *Ironworkers Local 580—Joint Funds v. Linn Energy, LLC*, 29 F. Supp. 3d 400 (S.D.N.Y. 2014), the plaintiffs asserted that the issuer (LINN Energy, LLC) reported distributable cash flow (DCF) and distribution coverage ratio (DCR)—both non-GAAP metrics which are derived from EBITDA—in a way that was false and misleading to shareholders. The plaintiff alleged violations of the Securities Act of 1933 (Sections 11, 12(a), and 15) and the Exchange Act (Sections 10(b) and 20(a)), as well as violations of Regulation G and Item 10(e) of Regulation S-K. The court held that plaintiffs failed to sufficiently plead any misstatement or omission, reasoning that, “at all times, [LINN] told the whole truth and nothing but about how they were calculating adjusted EBITDA, DCF, the distribution coverage ratio, and maintenance capex—all non-GAAP metrics for which there is no ‘right’ formula because, unlike GAAP metrics, they have no uniform definition.” 29 F. Supp. 3d at 426. The court further reasoned that the plaintiffs’ argument about “the ‘proper’ method of calculating DCF makes little sense where, as here, there is no recognized ‘proper’ method of making such calculation.” *Id.* at 427. The court also emphasized that securities laws prohibit “untruths and concealment” of necessary information, and that LINN’s transparent use of non-GAAP measures was appropriate. *Id.* at 428. Notwithstanding the SEC’s recent guidance, the underlying premise of *Ironworkers* likely still holds: “the federal securities laws do not protect the marketplace from flawed business decisions, which is what choosing to calculate a metric in a particular way is where, as here, there is no settled formula.” *Id.*

Similarly instructive is the decision in *In re Netflix, Inc. Sec. Litig.*, No. C 04-2978 WHA, 2005 WL 3096209, 2005 BL 53238 (N.D. Cal. Nov. 18, 2005), where the plaintiffs alleged that defendant Netflix used a misleading calculation of the average subscriber cancellation rate, also called “churn.” The plaintiffs alleged violations of Section 10(b) of the Exchange Act, as well as violations of Regulations G and S-K. The court explained that, given the lack of strict rules governing non-GAAP measures, the plaintiffs did *not* allege that Netflix used “bogus figures to calculate the Netflix

churn rate nor that the calculations were done improperly,” but instead that “other, more common methods would have been more predictive, descriptive and consistent. They claim that the other methods are so superior and the Netflix methods so deeply flawed that using them amounts to fraud.” 2005 WL 3096209, at *9. The court dismissed the claims, finding that Netflix and its management adequately and repeatedly disclosed how the company was calculating its churn rate. The court also reasoned that, whether there was a better way to perform this calculation did not matter so long as the way it was actually done was clear to the investing public. In the context of the plaintiffs’ Regulation G and Regulation S-K claims, the court held that the claims were unavailing because there simply was no false statement or material omission, particularly because the disclosures reconciled EBITDA with earnings calculated according to GAAP, as is required under Regulation G. The court found that “all the inputs into [the] reconciliation were fully and clearly disclosed.” *Id.* at *11. Here again, the court was not persuaded by arguments that there may be a better way to do it, and was focused only on whether the disclosures fully presented how it was calculated.

The Future of non-GAAP Measures in the Private Securities Lawsuit Context

In sum, companies may continue to use non-GAAP measures in public filings, subject to proper and full disclosure concerning how the non-GAAP measures are presented, particularly in concert with and comparison to GAAP measures. The SEC’s recent guidance, therefore, does not prohibit or materially restrict the use of non-GAAP measures, but it may present a more explicit reference point for determining when non-GAAP measures are insufficiently transparent or otherwise misleading. We expect that plaintiffs will cite this guidance when alleging misleading use of non-GAAP measures. For example, if a registrant continues to list non-GAAP measures before GAAP measures in a header or description, it likely will be emphasized by a private plaintiff alleging securities law violations. However, if the company otherwise is transparent about its use of non-GAAP measures and clearly articulates what those measures comprise, it should have strong defenses in the event it faces a lawsuit regarding its disclosure of non-GAAP measures. Time will tell how federal courts interpret and apply the SEC’s increased scrutiny and recent guidance, but in the meantime, where registrants use non-GAAP measures, they should continue to focus on transparency and prominently featuring GAAP measures.