KPMG

SEC guidance

Clarifying non-GAAP financial measures

December 20, 2022

SEC staff issues guidance to clarify how it evaluates non-GAAP financial measures.

Source and applicability

- SEC Compliance and Disclosure Interpretations, Non-GAAP Financial Measures
- SEC registrants

Fast facts, impacts, actions

At the 2022 AICPA & CIMA Conference on Current SEC and PCAOB Developments (AICPA Conference), staff from the SEC's Division of Corporation Finance noted that presentation of non-GAAP financial measures continues to be one of the most frequent topics of comment letters issued to registrants. To provide additional guidance on this important topic, on December 13, 2022, the staff released both new and updated Compliance and Disclosure Interpretations (C&DIs) about how to present these measures in compliance with the rules and regulations on non-GAAP measures.

The complete series of C&DIs on non-GAAP measures relate to the application of two Regulations:

- Reg G, which prohibits non-GAAP measures from being misleading; and
- Reg S-K Item 10(e), which requires a non-GAAP measure to be presented with its most directly comparable GAAP measure.

Reg G C&DIs newly issued or updated	
Excluding **normal, recurring, cash operating expenses** from a non-GAAP measure is misleading if the expenses are necessary to operate the registrant's business. (Question 100.1)	Using a **tailored accounting** principle in place of a GAAP principle in a non-GAAP measure can be misleading. (Question 100.04)
Not providing clear and appropriate **labels and descriptions** of a non-GAAP measure to indicate it is non-GAAP can be misleading. (Question 100.05)	Non-GAAP measures can be so misleading that even extensive, detailed **disclosures cannot rationalize** their presentation. (Question 100.06)
Reg S-K Item 10(e) C&DI updated	
A non-GAAP measure cannot be presented more **prominently** than its most directly comparable GAAP measure. (Question 102.10)	

Background

Over the years, the SEC staff has issued several C&DIs to provide supplemental guidance about how registrants are allowed to use non-GAAP financial measures under Reg G and Item 10(e) of Reg S-K. The SEC first adopted its guidance in 2003 and updated it in 2010, 2016 and 2018.

In December 2022, the SEC staff again updated several of these C&DIs and issued two new questions and responses to address non-GAAP presentation practices it believes do not comply with the Regulations. The new and updated C&DIs follow staff comments acknowledging the growing prevalence of non-GAAP measures. The intent of this guidance is to provide more transparency to preparers in how the staff evaluates non-GAAP measures. The C&DIs include examples and views that the staff has expressed as part of its filing reviews, including areas such as the prominence of presentation and characteristics that can make non-GAAP measures misleading, if presented.

If a registrant is found to have violated the rules and regulations on non-GAAP measures, including the C&DIs, the staff has stated it will expect the prohibited non-GAAP measure to be removed and any misleading adjustments in a non-GAAP measure to be corrected the next time presented. Any adjustments determined to be misleading should also be removed from comparative prior year non-GAAP measures.

Summary of updated and new guidance

Not misleading

The overarching principle under Reg G is that a non-GAAP measure may not be misleading. A non-GAAP measure is considered misleading when, taken together with the information or discussion accompanying that measure, and in light of the circumstances under which it is presented, it contains an untrue statement of a material fact or omits a material fact.

The SEC staff provides specific guidance in the C&DIs of practices that may be misleading.

Normal, recurring, cash operating expenses (Updated Question 100.01)

A non-GAAP measure is considered misleading if it excludes normal, recurring, cash operating expenses necessary to operate a registrant's business. During the AICPA Conference, the SEC staff commented that its focus when evaluating compliance with this C&DI has been on determining what is 'normal' and 'recurring', so it updated the C&DI to clarify what it considers in evaluating these concepts.

Normal	When evaluating what is a normal operating expense, the staff considers the nature and effect of the non-GAAP adjustment and how it relates to the registrant's operations, revenue generating activities, business strategy, industry and regulatory environment.
Recurring	When evaluating what is recurring, the staff views an operating expense that occurs repeatedly or occasionally, including at irregular or infrequent intervals, as recurring.

Example: At the AICPA Conference, the staff stated it would question a retailer presenting a non-GAAP financial measure that adjusted for expenses associated with opening a new store if the new store is part of (1) revenue generation and (2) the retailer's business strategy of opening additional stores and selling more inventory. In other words, store openings are part of the retailer's normal operations and the retailer is likely to be opening stores on some sort of recurring basis, even if at irregular intervals. The staff noted this example could be applied to store closings, and it could be applied not just to retailers but also to restaurant chains.

The staff also clarified that the evaluation of 'normal' and 'recurring' is based on the individual facts and circumstances of a company, and registrants should not assume that they can make similar adjustments as other companies.

Tailored accounting principles (Updated Question 100.04)

Non-GAAP measures that substitute individually tailored recognition and measurement principles for GAAP could violate Reg G.

The staff has observed that many registrants interpreted the previous C&DI to apply only to tailored ***revenue recognition*** policies. As a result, the staff has revised the C&DI to be clear that it applies to any tailored accounting principle. The updated C&DI also provides examples of what the staff would view as an individually tailored accounting principle in this context, including:

- presenting a non-GAAP measure of revenue that deducts transaction costs as if the registrant acted as an agent in the transaction when gross presentation as a principal is required by GAAP (or vice versa); or
- presenting a measure of expense (or revenue) on a cash basis when accrual basis is required by GAAP.

Labels and descriptions (New Question 100.05)

Because non-GAAP measures do not have uniform definitions, they should be appropriately labeled and clearly described, as should any adjustments made to arrive at these measures. This new C&DI provides examples that would violate this principle, such as failure to identify and describe a measure as non-GAAP or using a label that does not reflect the nature of the non-GAAP measure.

The C&DI provides three examples of labels that would be considered misleading because they do not reflect the nature of the non-GAAP measure:

- a non-GAAP measure labeled as net revenue that is calculated as GAAP revenue less certain expenses and is more akin to a contribution margin;
- a non-GAAP measure labeled the same as a GAAP line item or subtotal even though it is calculated differently from the similarly labeled GAAP measure, such as gross profit or sales; and
- a non-GAAP measure labeled as pro forma that is not calculated in a manner consistent with Reg S-X Article 11 requirements.

Misleading measures (New Question 100.06)

The staff issued this new C&DI to memorialize its view that a non-GAAP measure could mislead investors to such a degree that even extensive, detailed disclosure about the nature and effect of adjustments would not prevent the non-GAAP measure from being materially misleading.

Presentation of directly comparable GAAP measure

For each non-GAAP measure, Item 10(e) of Reg S-K requires the presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP.

Prominence (Updated Question 102.10)

A non-GAAP measure must not be presented more prominently than its most directly comparable GAAP measure. The previous C&DI provided a number of examples of when a non-GAAP measure may be presented at equal or greater prominence than its most directly comparable GAAP measure. To improve readability and to better focus the guidance on specific issues related to prominence, the staff split the C&DI into three subparts under C&DI 102.10. The updated C&DIs are now organized to address the following issues.

Scope (Question 102.10(a))	Addresses the scope of what constitutes undue prominence and provides additional and more specific examples. Includes an example of presenting a ratio with a non-GAAP measure for the numerator and/or denominator without also presenting the ratio calculated using the most directly comparable GAAP measure(s) with equal or greater prominence.
Reconciliation (Question 102.10(b))	Provides examples of disclosures that would cause the non-GAAP reconciliation to give undue prominence to a non-GAAP measure. Examples include: • starting the reconciliation with the non-GAAP measure; • presenting a non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures; and • excluding the quantitative reconciliation when presenting a forward-looking non-GAAP measure without disclosing reliance on the exception in Reg S-K Item 10(e)(1)(i)(B) and other specified information.
Non-GAAP income statement (Question 102.10(c))	Explains that the staff considers a non-GAAP income statement to be one that comprises non-GAAP measures and includes all or most of the line items and subtotals found in a GAAP income statement. Previously, the C&DI indicated the guidance applied to only a full non-GAAP income statement, and is now updated to clarify that it need not be a full non-GAAP income statement to violate the requirements.

With these updates, the SEC staff is trying to be more transparent in how it evaluates non-GAAP measures. Therefore, registrants should consider them when preparing their upcoming periodic filings as well as earnings releases filed or furnished with the SEC to avoid receiving comment letters from the SEC.

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