NON-GAAP FINANCIAL MEASURES

Triangulating to Clarity: Individually Tailored Accounting and Non-GAAP Financial Measures

By Michael H. Friedman

In 2016, the Division of Corporation Finance of the Securities and Exchange Commission (SEC) added a curiously-phrased "Question & Answer" to its Compliance & Disclosure Interpretations (C&DIs) for Non-GAAP Financial Measures:

> **Question:** A registrant presents a non-GAAP performance measure that is adjusted to accelerate revenue recognized ratably over time in accordance with GAAP as though it earned revenue when customers are billed. Can this measure be presented in documents filed or furnished with the Commission or provided elsewhere, such as on company websites?
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> **Answer:** No. Non-GAAP measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could violate Rule 100(b) of Regulation G. Other measures that use individually tailored recognition and measurement methods for financial statement line items other than revenue may also violate Rule 100(b) of Regulation G.[1]

On its face, the Staff's answer is perplexing. The Staff's initial answer is a blunt and unqualified "no" but the bluntness quickly softens in the balance of the answer with the equivocal expressions "could violate" and "may also violate," each of which begs the question as to when such tailoring *will* violate. Adding to the perplexity: it's in the nature of *all* non-GAAP financial measures to adjust or exclude (that is, to tailor) one or more items from a GAAP financial measure.

A GAAP financial measure devoid of tailoring is, by definition, a GAAP financial measure. But since not all tailored, or non-GAAP, financial measures are deemed to involve proscribed individual tailoring, then what adjustments or exclusions to a GAAP financial measure convert the measure into a proscribed non-GAAP financial measure because it uses an individually tailored accounting method? One looks in vain for a definition.

One natural (and indeed useful) response to such perplexity would be to proceed inductively and catalogue instances highlighted by the Staff, in its comment letters, of problematic individually tailored recognition and measurement methods. With this catalogue in hand (updated from time to time for new Staff comment letters) one could run any given non-GAAP measure through a screen and thereby filter out non-compliant adjustments or exclusions.

Yet even if the catalogue were comprehensive, the formulaic screening process would not suffice, in and of itself, as a reliable and effective guide to presentations of financial measures in a manner that does not involve proscribed individual tailoring. The "catalogue and screen" methodology provides us with examples of problematic disclosures but sheds only a dim light on why any given disclosure is problematic and, more to the point, why the disclosure is problematic in a special way, that is, in a way that results in an individually tailored accounting method.

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As such, the "catalogue and screen" approach, although useful, does not position us to explain robustly why a given metric, in context and as presented, ought not to be proscribed as individually tailored accounting. What we want is a general principle or intelligible standard, abstracted from our catalogue of examples, that we can apply reliably across a wide range of factual scenarios to shape presentations of non-GAAP financial measures so they will not be construed as proscribed individually tailored accounting methods.

Here, let us pause on the word "individually" and consider whether "individually" carries more weight in our search for a general principle or intelligible standard than, at first glance, meets the eye. Might this adverb help us to discern a guiding principle or to formulate an intelligible standard that will allow us to identify and appropriately handle tailoring of GAAP financial measures in ways that avoid proscribed individual tailoring?

In this light, and as a prelude to the following discussion, consider how senses of the word "individual" resemble senses of "idiosyncratic" and "custom-designed" or similar modifiers that differentiate an individually tailored subject from formulations or presentations of a tailored subject in ways "comparable" to those used by other companies or in ways that may be considered to be "customary."

Also in this light, consider how these resonances of "individual" (as contrasted to, for example, "comparable" or "customary," which connote widespread usage) are amplified by the recognition that the SEC's underlying concern with "individual" tailoring is that such tailoring, unless accompanied by robust and nuanced explanation, may be misleading insofar as it suggests an idiosyncratic (or cherry-picked) view of a preferred method by which to evaluate the company's financial performance or position. And since it is the company itself that is publishing the metric, the company is, in effect, holding out, or endorsing, the metric as relevant to how investors should evaluate the company.

A useful way to approach the question as to what is (or is not) an individually tailored accounting principle for purposes of non-GAAP financial measure presentations is to set aside the view that such measures can be neatly catalogued or defined categorically and, instead, to view the label "individually tailored accounting principle" (or a common variant of the label) as a conclusion that the measure, *as presented*, is misleading or confusing in a special way.

In this light, application of the label is not so much an identification of a particular and problematic measure or method, but a critique of the way in which the measure or method is presented or disclosed. For example, if an exclusion from, or an adjustment to, a non-GAAP financial measure is handled inconsistently across periods, or inconsistently with other comparable items that are not also excluded or adjusted, then such inconsistency may be misleading or confusing. Absent the inconsistency, the deficiency may disappear.

Similarly, if an exclusion or adjustment is made that is neither used by management in the operations of the business nor sought by investors to assist them in their analyses, then the exclusion or adjustment may lack a legitimate purpose. But if the exclusion or adjustment is in fact used by management or investors, and disclosure of these use(s) and reason(s) is provided, then the grounds, so to speak, for applying the "individually tailored" label may disappear, or soften.

Indeed, if one surveys Staff comment letters and responses, one can discern that a leading indicator of an objectionable measure (that is, one that can be called an "individually tailored recognition or measurement method" or an "individually tailored accounting principle") is not the measure, in and of itself, but rather a flawed presentation of the measure.

As stated above, under this view, the labeling of a measure or method as "individually tailored" is not so much a statement as to the nature of the measure or method[2] but, rather, a criticism of the fairness of the presentation of the measure or method in light of the overall objectives of SEC regulation of non-GAAP financial measures.[3] What follows is additional detail in further explanation of the foregoing view.

GAAP as the Starting Point and "Not Misleading" as the Ending Point

GAAP financial statements and measures that derive, without adjustment or exclusion, from GAAP financial statements are the starting point. GAAP presentations, inclusive of explanatory footnotes that are part of the financial statements, are designed to provide a fair depiction of a company's financial performance and financial position and allow for informed judgments as to reasons for past performance, prospects for future performance and comparability of company performance with prior period performance as well comparability of company performance with performance of competitors, peers or other select industry participants.

For a variety of legitimate reasons, company management, investors and analysts commonly find it useful to assess supplemental measures of corporate performance or liquidity. In Section 401(b) of the Sarbanes-Oxley Act of 2002 (SOX), Congress directed the SEC to regulate non-GAAP financial measures (referred to in SOX as pro forma financial information) so that such information is not presented in a misleading way and, in furtherance of this imperative, is accompanied by a reconciliation with the GAAP counterpart.

Thereafter, in 2003, the SEC adopted Regulation G and amendments to Item 10 of Regulation S-K to regulate disclosures of non-GAAP financial measures and, in its adopting Release, the SEC stated: "The rules we adopt today reflect the letter and spirit of the Sarbanes-Oxley Act."[4]

In furtherance of the SEC regulations, the Staff has published CD&Is as to "dos and don'ts" for disclosures of non-GAAP financial measures and has issued multiple comment letters on specific disclosures. The unifying concern underlying the regulations, the CD&Is and the comment letters is with adjustments to GAAP numbers that are presented in a misleading way. The SEC's prescriptive rules are designed to work together to assure that disclosures of adjusted numbers are not misleading.

For example, a company that discloses a non-GAAP financial measure must present the most directly comparable GAAP measure with equal or greater prominence.[5] A company generally may not present adjustments inconsistently between periods. As the Staff has stated: "a non-GAAP 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 . . . Regulation G unless the change between periods is disclosed and the reasons for it explained."[6]

Similarly, it may be misleading if an adjustment is made to a GAAP financial measure without also presenting the income tax effect on the adjustment. In the case of a non-GAAP performance measure, the company "should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. In addition, adjustments to arrive at a non-GAAP measure should not be presented 'net of tax.' Rather, income taxes should be shown as a separate adjustment and clearly explained."[7]

Regarding the issue of individually tailored accounting, one of the most important disclosure points—indeed a point virtually inseparable from whether a given adjustment and presentation will result in a proscribed individually tailored recognition or measurement method—is found in the mandate in Item 10(e)(i)(C) of Regulation S-K, which requires that a precondition to including any non-GAAP financial measure in an SEC filing is a statement that discloses why the company'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."[8]

Pause here, and note that if in fact a non-GAAP financial measure provides useful information to investors, then, except in unusual cases, the information is likely to assist investors in comparing the company to other (peer) companies or in assessing the company in light of metrics the investors view as important. It would be unlikely that a measure that in fact provides such useful information is "individual to" the company. In other words, if a company's disclosure of a non-GAAP financial measure is accompanied by a robust disclosure of the reasons why the disclosure is useful for investors, then the company will have greatly reduced the likelihood that the measure is idiosyncratic, or reflective of cherry-picking or, in the words of the CD&I, individually tailored.[9]

Moreover, if management believes that there is some specific event that calls for disclosure of a non-GAAP financial measure that is not a customary metric in the industry and if management is unable to articulate why investors would find the metric to convey useful information to investors, then the company will face a heavy burden of persuasion as to why the adjustment is being made and whether sufficient compensating disclosures have been made to overcome the presumption that such an adjustment is, on its face, misleading.[10]

Conclusion

The aim of this article has been to sketch out a framework to assist companies in their presentation of non-GAAP financial measures in a manner that reduces the likelihood that such measures will be labelled by the Staff as "individually tailored" methods or measures and to further assist companies in responding effectively to Staff comments that particular measures presented by a company are "individually tailored" and, therefore, objectionable.

Notes

1. Question 100.04 of the CD&Is.
2. Indeed, it would be hard (and, from a regulatory perspective, probably counterproductive) to provide a conceptually pure and complete (generic) definition of such a measure or method since, when we speak of any non-GAAP financial measure, we are necessarily speaking of a variation from a "generally accepted" baseline (that is, GAAP).
3. Of course, as a practical matter, one must look at specific adjustments (apart from the presentation of the adjustments) to understand the underlying sources of Staff concern. For example, if a company presents a metric that in substance accelerates revenue in advance of GAAP requirements linked to delivery of goods or services, then a registrant would face a heavy burden as to why its presentation was not inherently misleading even if the presentation included robust disclosure.
4. Release No. 33-8176 (effective March 28, 2003).
5. *See* 102.10 of the CD&Is.
6. *See* 100.02 of the CD&Is.
7. *See* 102.11 of the CD&Is.
8. Item 10(e)(1)(D) also provides for disclosure, to the extent material, of the additional purposes, if any, for which the company's management uses the non-GAAP financial measure.
9. Note that Regulation G, unlike Item 10(e), does not, by its terms, require disclosure as to why the company's management believes presentation of a non-GAAP financial measure provides useful information to investors. Consistent with the thesis of this article, however, the absence of such disclosure (apart from the general restriction in Regulation G on misleading statements and omissions) may increase the likelihood that a given presentation will be found to be an individually tailored accounting method, particularly if such absence is due to an inability of management to explain why the measure, as presented, provides useful information to investors.
10. The Staff has made clear that certain adjustments, such as adjustments that accelerate revenue recognition, or that smooth out expense recognitions, or that involve proportionate consolidation for equity investees, are unlikely to overcome an adverse comment linked to individual tailoring. The "catalogue and screen" approach is particularly valuable in this context because the precedent examples will alert companies and their advisors as to adjustments that are unlikely to overcome an adverse comment.