DrinkerBiddle

Client Alert

May 3, 2016

Another Warning to Mind the Non-GAAP

By Elizabeth A. Diffley

As we have previously reported, over the past few months, SEC officials and numerous other observers have voiced concern about the pervasive and, perhaps abusive, use of non-GAAP financial measures by public companies. Continuing on that theme, during a panel presentation at the Garrett Corporate and Securities Law Institute held at Northwestern University's Pritzker School of Law, Mark Kronforst, the Chief Accountant of the SEC's Division of Corporation Finance, highlighted the SEC staff's current focus on non-GAAP measures. In his remarks, Mr. Kronforst identified several specific examples that are attracting particular attention and concern.

- *Presenting a financial measure according to principle separate and different from GAAP.* Mr. Kronforst identified as particularly problematic the presentation of a line item in accordance with the required GAAP principle and also presenting a measure of that type according to a different, unrelated principle. As an example, he mentioned a company that sells its products on a subscription basis and recognizes revenue ratably over the course of the subscription period as required by GAAP, but has also presented a separate measure of revenue that would record revenue upfront when the full subscription price is billed to the customer. Mr. Kronforst noted that the SEC's non-GAAP rules and guidance permit the presentation of measures that depart from the GAAP measure by making adjustments to include or exclude certain items, but it does not permit companies to use their own principles to determine and present a financial measure where GAAP has established a standard for determination.

COMMENTARY: Particularly in industries where multi-year subscription periods are common and revenue must be recognized over the course of the subscription period, upward or downward trends in subscription renewals and new business may not be apparent from observing year-over-year revenue fluctuations. As a result, it may be valuable to also present other information, such as billings for the period, to provide insight into trends that will impact future revenues. If they choose to do so, however, companies should take care to present the additional metric separately and to provide discussion and analysis that helps explain what information the metric conveys and how it will impact results. Information about billings should not be presented as an alternative version of revenue or otherwise be used to calculate and present an alternative version of net income.

- *Presenting liquidity measures on a per share basis.* The SEC staff has long taken the position that non-GAAP performance measures may be presented on a per share basis but non-GAAP liquidity measures may not be presented on a per share basis. While the staff has issued comments advising companies to discontinue their use of per share liquidity measures, Mr. Kronforst noted that the staff has generally shown deference to company management's designation of a measure as either a performance measure or a liquidity measure. The staff now plans to analyze those designations more critically and may comment on a company's designation of a measure as a performance measure if it appears to be a liquidity measure in substance.

COMMENTARY: Companies presenting non-GAAP measures on a per share basis should review those measures to confirm they are only doing so for performance measures. In addition, consider reviewing the designation of measures as performance or liquidity measures and be prepared to articulate why any item presented on a per share basis is a performance measure.

- *Non-GAAP tax expense.* Mr. Kronforst also indicated that the staff is considering, when measures are presented on a non-GAAP basis, whether tax rates have been determined appropriately given non-GAAP carve-outs. He noted that this is still a developing area of the staff's analysis and consideration, but that they are looking at whether it may be appropriate, in light of the various adjustments made to the GAAP measures for the non-GAAP presentation, whether companies have appropriately taken into consideration and reflected the impact those adjustments would be expected to have on a company's tax rate.

COMMENTARY: This is a developing area of the staff's analysis and it is not clear if the staff will find problems, but companies should be prepared to respond to comments related to their analysis of the impact of adjustments to GAAP measures on their determination of the relevant effective tax rate.

As always, companies are advised to be thoughtful and rigorous when employing and presenting non-GAAP measures.

Corporate and Securities

Primary Contact

Elizabeth A. Diffley
Partner
Philadelphia
(215) 988-2607
Elizabeth.Diffley@dbr.com