

Key New Guidance on Using Non-GAAP Measures

General

On May 17, 2016, the SEC released new interpretations (the "Interpretations") regarding the use of non-GAAP financial information. The Interpretations significantly limit the use of non-GAAP information in filings and earnings releases and will require changes in the way many companies make such disclosure. The rationale for the Interpretations is a perception that the focus on and proliferation of non-GAAP financial information has largely eclipsed GAAP results in the media and financial markets. The new Interpretations (the complete set of which is available at [link](#)) are effective immediately and particularly relate to the requirement that non-GAAP financial information not be more prominent than GAAP information or misleading. The Interpretations apply to the use of non-GAAP information under both Regulation S-K and Regulation G.

Presentation in Filings and Releases

The Interpretations that are likely to have the biggest effect on current disclosure practices are those that specifically target the concept of the "prominence" of non-GAAP measures in relation to GAAP measures. Longstanding SEC rules require that when an issuer presents a non-GAAP measure, it must present the most directly comparable GAAP measure with equal or greater prominence. The staff believes that adherence to this requirement has eroded over time and now has taken this remedial action. This requirement applies to non-GAAP measures presented in documents "filed" with the Commission, as well as earnings releases "furnished" under Item 2.02 of Form 8-K. Whether a non-GAAP measure is more prominent than the most directly comparable GAAP measure generally depends on the facts and circumstances in which the disclosure is made, but the Interpretations now make it clear that the following disclosures of non-GAAP measures are more prominent and therefore not compliant:

- omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures;
- a non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption);
- presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure;

- describing a non-GAAP measure as, for example, "record performance" or "exceptional" without at least an equally prominent descriptive characterization of the comparable GAAP measure;
- presenting a full income statement of non-GAAP measures or presenting a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures;
- providing tabular disclosure of non-GAAP financial measures without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table;
- excluding a quantitative reconciliation with respect to a forward-looking non-GAAP measure in reliance on the "unreasonable efforts" exception in Item 10(e)(1)(i)(B) without disclosing that fact and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence; and
- providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence.

Misleading Disclosure

The Interpretations also prohibit certain adjustments to GAAP numbers, such as:

- presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a company's business;
- a non-GAAP measure that is presented inconsistently between periods, such as one 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, unless the change between periods is disclosed and the reasons for it explained;
- a non-GAAP measure that is adjusted only for non-recurring charges when there were non-recurring gains that occurred during the same period; and
- a non-GAAP performance measure that substitutes individually tailored revenue recognition and measurement methods for those of GAAP.

Free Cash Flow

Free cash flow is typically calculated as cash flows from operating activities as presented in the statement of cash flows under GAAP, less capital expenditures. The Interpretations clarify that the deduction of capital expenditures from the GAAP financial measure of cash flows from operating activities is permissible. The Interpretations are consistent with the position that free cash flow

does not have a uniform definition or method of calculation. The Interpretations require that a clear description of how free cash flow is calculated, as well as the necessary reconciliation, should accompany the measure where it is used. The Interpretations also emphasize that inappropriate or potentially misleading inferences about the usefulness of the measure must be avoided. For example, free cash flow should not be used in a manner that inappropriately implies that the measure represents the residual cash flow available for discretionary expenditures, since many companies have mandatory debt service requirements or other non-discretionary expenditures that are not deducted from the measure. The Interpretations also reiterate that notes that free cash flow is a liquidity measure and thus is inappropriate to be presented on a per share basis.

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