COMMENTARY

The SEC's Watchful Eye: Ensuring Accuracy in Non-GAAP Financial Disclosures

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Securities Litigation

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Financial statements are one mechanism in which to provide insight into a company's financial health. However, management may not be satisfied that this information clearly reflects their business, including how it is run. Therefore, to supplement financial statements, management may provide another view of their company by disclosing alternative financial measures. This alternative information cannot be used to distort reality and must be presented in accordance with specific rules and guidelines.

All publicly traded companies are required to prepare their financial statements in accordance with generally accepted accounting principles, or "GAAP." GAAP are standardized principles created by the Financial Accounting Standards Board and governed by the U.S. Securities and Exchange Commission (SEC). There may be instances when the information presented in a public company's GAAP-based financial statements and footnotes to the financials are not deemed by Management to represent a complete picture of the company's business and financial performance. Therefore, non-GAAP measures complement what is disclosed in a company's GAAP-based financial statements.

These non-GAAP financial measures are defined by federal regulation as numerical measures of a company's historical or future performance, financial position, or cash flow that exclude or include amounts or are subject to adjustments that have the effect of excluding or including amounts from the most directly comparable measure calculated in accordance with GAAP. Non-GAAP measures often enable management to communicate to stakeholders its perspective on the company's financial performance or business strategy. More specifically, it can value the company, determine executive compensation, and assist in peer comparisons. One commonly used financial metric is earnings before interest, taxes, depreciation, and amortization (EBITDA), which reflects a company's operating profitability and can be used instead of net income. Other frequently used non-GAAP financial measures include adjusted earnings, adjusted earnings per share, adjusted revenues, core earnings, funds from operations and free cash flows.

The purpose of non-GAAP financial measures is not to allow companies to change the narrative of the company's financial performance intentionally. Non-GAAP financial measures must be accurate, faithfully represent the company's financial performance, and cannot be misleading. So, while companies are permitted to present non-GAAP measures, it is of utmost importance that they are not inaccurate or misleading.

Non-GAAP rules are governed by the SEC. These rules can be found in Regulation G and Item 10 of Regulation S-K and Regulation S-B. In accordance with Regulation G, public companies must present a reconciliation identifying the differences between the non-GAAP measure and the most directly comparable GAAP measure. This reconciliation process is relevant for stakeholders to understand what is included and excluded from the non-GAAP measures. The SEC has provided that though certain adjustments are not explicitly prohibited, they could result in a misleading non-GAAP measure. Whether or not an adjustment results in a misleading non-GAAP measure depends on a company's facts and circumstances. As the SEC has explained, "Presenting a non-GAAP performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business is one example of a measure that could be misleading."

Non-GAAP measures can also be misleading if the adjustments are designed to use individually tailored accounting policies that have the effect of changing GAAP recognition and measurement principles. Specifically, the SEC considers non-GAAP financial measures that unwind the impact of a newly adopted accounting principle to be misleading, even when presented to discuss comparability with prior periods. Non-GAAP measures may further be misleading if the company fails to identify and describe the non-GAAP measure and if the non-GAAP measure is presented with a label that does not reflect its nature.

Public companies' use of non-GAAP measures has grown in recent years. For instance, Harvard Business Review presented that as of 2021, over 95% of S&P 500 companies were disclosing non-GAAP earnings. Based on the growth of companies disclosing non-GAAP measures, as well as the SEC's recognition of the potential for non-GAAP measures being misleading and the differences between the amounts reported for non-GAAP and GAAP becoming larger, the SEC has heightened its scrutiny over non-GAAP financial measures.

In December 2022, the SEC issued new and updated guidance providing greater insight into how it considers a non-GAAP measure misleading and recent examples of when it may deem a non-GAAP measure to be presented more prominently than the most directly comparable GAAP measure. The SEC has also emphasized that companies should have controls and processes in place to provide timely information to Management to allow for timely decisions regarding required non-GAAP disclosures.

The SEC's Division of Corporation Finance continues to provide comments to issuers about non-GAAP financial measures, and the SEC's Division of Enforcement continues to investigate the accuracy of such non-GAAP metrics and, when necessary, will enforce charges against a company for providing misleading non-GAAP financial measures. Specifically, in 2023, the SEC charged a several companies for providing misleading non-GAAP measures. For example, DXC Technology Co. was charged with materially misstating its reporting and disclosures of non-GAAP financial performance measures, including its non-GAAP net income and diluted earnings per share, in multiple quarterly and annual SEC filings and earnings releases. As described in the cease-and-desist order, "DXC materially increased its non-GAAP earnings by negligently misclassifying tens of millions of dollars of expenses as transaction, separation, and integration-related (TSI) costs and improperly excluding them in its reporting of non-GAAP measures." Newell Brands Inc. and its CEO were also charged in 2023 for allegedly misleading investors about core sales growth, a non-GAAP financial measure.

While a company may want to disclose non-GAAP measures to present a more complete picture of its business, there are rules that must be followed to ensure that financial information is not misleading. Due to the growth and prominence of such measures by companies, it appears that the SEC Division of Corporation Finance and Division of Enforcement will remain focused on reviewing and evaluating companies' use and presentation of non-GAAP measures.

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