

SEC Maintains Its Focus on Non-GAAP Financial Measures

April 27, 2023

Non-GAAP financial measures remain a significant focus of the U.S. Securities and Exchange Commission (“SEC”). This ongoing focus is exemplified by frequent comment letters issued by the staff of the SEC’s Division of Corporate Finance (the “Staff”), new and updated non-GAAP Compliance and Disclosure Interpretations (“C&DIs”) in December 2022, and enforcement actions, including one settled in March 2023.

Comment Letters on Non-GAAP Measures

Non-GAAP financial measures were a frequent topic in comment letters issued by the Staff during 2022. At the 2022 Association of International Certified Professional Accountants & Chartered Institute of Management Accountants conference, members of the Staff noted that non-GAAP financial measures continue to be an area of concern because the Staff believes that registrants continue to misapply the guidance.¹ The Staff also indicated that non-GAAP financial measures remain one of the most frequent topics of comment letters issued to registrants.² Based on our analysis of publicly available comment letters issued to over 230 issuers in 2022, approximately 15% of comment letters sent by the Staff in 2022 included at least one comment relating to non-GAAP financial measures. Based on this review, we observed that the Staff’s comments on non-GAAP financial measures most frequently include the following topics:

- presenting the most directly comparable GAAP financial measure with equal or greater prominence as the non-GAAP financial measure;

¹ See KPMG, *SEC’s Corp Fin Explains its Priorities and Concerns* (2022), <https://frv.kpmg.us/reference-library/2022/2022-aicpa-cima-conference/secs-corp-fin-explains-its-priorities-and-concerns.html>.

² See KPMG, *Clarifying Non-GAAP Financial Measures* (December 2022), <https://frv.kpmg.us/reference-library/2022/clarifying-non-gaap-financial-measures.html>.

- providing an appropriate reconciliation of the non-GAAP financial measure to the most directly comparable GAAP financial measure;
- disclosing why management believes the non-GAAP financial measure provides useful information to investors and the additional purposes, if any, for which management uses such measure;
- identifying and clearly labeling non-GAAP financial measures; and
- non-GAAP measures that the Staff believes are based on individually tailored accounting principles.

Below are select examples of the Staff's comments on these topics:

- You disclose non-GAAP measures without presenting the comparable GAAP measures with equal or greater prominence. Please ensure any discussion regarding non-GAAP measures is preceded by an equal or more prominent discussion of the comparable GAAP measure.
- We note you present Adjusted Gross Margin as a non-GAAP measure and that you reconcile this measure to operating income. Please revise to reconcile to a fully loaded GAAP gross profit or tell us why you believe operating income is the most directly comparable GAAP measure. Refer to Item 10(e)(1)(i)(B) of Regulation S-K.
- We note that your measures, "adjusted revenues," "adjusted gross profits," "adjusted gross profit margin," "adjusted EBITDA," and "adjusted EBITDA margin" are based on revenues that are adjusted to include amounts that would have been recognized if deferred revenue were not adjusted to fair value at the date of acquisition. This adjustment eliminates the impact of GAAP purchase accounting and substitutes individually tailored recognition and measurement methods. Please tell us how you considered the guidance of Question 100.04 of the Division's Non-GAAP C&DIs and Rule 100(b) of Regulation G when presenting these measures.
- Revise your disclosure to include a statement disclosing the reasons why 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 for each identified non-GAAP financial measure.

SEC Releases Updated Guidance

As we discussed in our [December 14, 2022 Debrief](#), the Staff issued new and revised C&DIs relating to the use of non-GAAP financial measures. In particular, the updated C&DIs provide greater insight into the types of non-GAAP measures the Staff believes are misleading and clarified when a non-GAAP measure may have greater prominence than a GAAP measure. The non-GAAP C&DIs are a valuable resource for compliance with and understanding the SEC's non-GAAP rules.

Misleading non-GAAP Measures

- Adjustments that are not explicitly prohibited may nonetheless cause a non-GAAP measure to be misleading based on the company's individual circumstances. In particular, the C&DIs state that presenting a non-GAAP performance measure that excludes normal, recurring, cash operating expenses that are necessary to the operation of the company's business may be considered misleading based on the nature and effect of the non-GAAP adjustment and how it relates to the company's operations, revenue generating activities, business strategy, industry and regulatory environment. The Staff further clarifies that an expense may be "recurring" even if it occurs occasionally, including at irregular intervals. (Q&A 100.01)
- Adjustments that have the effect of changing the recognition and measurement principles required to be applied in accordance with GAAP may cause a non-GAAP measure to be misleading. (Q&A 100.04)
- A non-GAAP measure lacking an appropriate label and clear description, including failing to describe a measure as non-GAAP or utilizing a label that does not reflect the nature of the non-GAAP measure, such as "pro forma" when it is not calculated in a manner consistent with Article 11 of Regulation S-X, could be misleading. (Q&A 100.05)
- In certain circumstances, a non-GAAP measure could mislead investors to such a degree that even extensive, detailed disclosure about the nature and effect of each adjustment made to the most directly comparable GAAP measure, would not prevent the non-GAAP measure from being materially misleading. (Q&A 100.06)

Prominence of non-GAAP Measures

- Whether a non-GAAP measure is more prominent than the corresponding GAAP measure depends on the facts and circumstances in which the disclosure is made, including a consideration of the related discussion and analysis of the non-GAAP

measure. Disclosures of non-GAAP measures that the Staff would consider more prominent include presenting a ratio where a non-GAAP measure is a numerator and/or denominator, without also presenting a similar ratio using the most directly comparable GAAP measures, and presenting charts, tables or graphs of non-GAAP measures, without such disclosures of GAAP measures being presented with equal or greater prominence. (Q&A 102.10(a))

- A reconciliation may give undue prominence to a non-GAAP measure if it starts with the non-GAAP measure or, if presenting a forward-looking non-GAAP measure, the company does not disclose reliance on the exception to providing a quantitative reconciliation and identify the information that is unavailable and its probable significance in a location of equal or greater prominence. (Q&A 102.10(b))
- A so-called “non-GAAP income statement,” defined as an income statement comprised of non-GAAP measures and that includes all or most of the line items and subtotals found in a GAAP income statement, gives undue prominence to non-GAAP measures. (Q&A 102.10(c))

SEC Brings Enforcement Action for Misleading Non-GAAP Measures

On March 14, 2023, the SEC announced the settlement of charges against DXC Technology Company (“DXC”), an IT services company, relating to the use of allegedly misleading non-GAAP disclosures and the failure to maintain sufficient disclosure controls and procedures.³ DXC agreed to settle SEC charges that it made misleading disclosures about its non-GAAP financial performance in multiple reporting periods from 2018 until early 2020. The SEC alleged that DXC materially increased its reported non-GAAP net income by negligently misclassifying tens of millions of dollars of expenses as non-GAAP adjustments for so-called transaction, separation, and integration-related (“TSI”) costs, which resulted in DXC improperly excluding these costs from its non-GAAP measures of earnings.

The SEC alleged that, throughout the relevant period, DXC failed to accurately describe the scope of expenses included in TSI costs, causing DXC’s non-GAAP net income and non-GAAP diluted EPS in periodic reports and earnings releases to be materially misleading. DXC presented TSI as comprising “one-time” or “non-recurring” expenses. However, the SEC alleged that DXC did not have sufficient non-GAAP policies and procedures or disclosure controls and procedures to ensure that costs classified as TSI were consistent with the company’s description of those costs in its public disclosure.

³ *In the Matter of DXC Technology Company*, Exchange Act Rel. No. 97140 (March 14, 2023), <https://www.sec.gov/litigation/admin/2023/33-11166.pdf>.

DXC agreed to pay an \$8 million penalty relating to violations of the Securities Act, the Exchange Act and Regulation G. DXC also agreed to develop and implement appropriate non-GAAP policies and disclosure controls and procedures.

The SEC's substantial settlement with DXC illustrates the SEC's ongoing enforcement focus on non-GAAP financial measures and highlights the importance of incorporating considerations relating to non-GAAP measures within an issuer's disclosure controls and procedures. The undertakings agreed by DXC in the SEC's order provide a framework for the type of disclosure controls and procedures relating to non-GAAP measures that public companies should consider. These include the development and implementation of policies and disclosure controls and procedures for:

- the disclosure of non-GAAP financial performance such that non-GAAP financial measures, including expenses, are described accurately in periodic filings and public statements, and that non-GAAP disclosures are consistent with the company's actual processes for identifying, reviewing, and approving non-GAAP adjustments, including, but not limited to, costs;
- the disclosure committee, or other relevant committee, to review and document, on a periodic basis, the company's non-GAAP policy to assess consistency with its non-GAAP disclosures and publicly-reported non-GAAP financial performance measures;
- controllership staff who are familiar with SEC reporting requirements and the company's non-GAAP policy and non-GAAP disclosures to approve and document the classification of items included in non-GAAP adjustments; and
- timely reviewing, considering, and addressing negative sub-certification survey comments relating to GAAP and non-GAAP financial results or disclosures.

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To enhance compliance with Regulation G and Item 10(e) of Regulation S-K, issuers should review the newly issued C&DIs and evaluate the potential impact of this guidance on their upcoming earnings releases and periodic reports. Issuers should also review their disclosure controls and procedures relating to how they record, process, summarize and report non-GAAP financial measures, particularly in light of the undertakings included as part of the DXC settlement. We are available to discuss these and any other matters relating to non-GAAP financial measures.

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Please do not hesitate to contact us with any questions.

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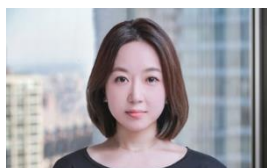
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