Non-GAAP Financial Measures: Current Trends and SEC Guidance

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Who needs to think about non-GAAP financial measures?

- **Public reporting companies** - Companies that file periodic and current reports with the SEC must comply with Regulation G in *all* public statements that contain material information and a non-GAAP financial measure.

- **Any other company filing documents with the SEC** – Generally, all filings with the SEC (including registration statements) must comply with Item 10(e) of Reg. S-K.

- **All other companies involved in securities transactions** – Federal and state anti-fraud principles apply to *all* securities transactions; adherence to non-GAAP rules is one way to inoculate against allegations of misleading financial presentations.
Why think about non-GAAP financial measures now?

- New formal SEC guidance in May 2016.
- Heightened SEC emphasis on compliance.
  - Prominent focus of public statements from SEC Chair, Chief Acct., Director of Division of Corp. Finance and Deputy Chief Acct.
  - Increased SEC comments on non-GAAP deficiencies in SEC filings.
  - Enforcement action brought in January 2017 due to, among other things, failure to comply with non-GAAP requirements of Reg. G and Item 10(e) of Reg. S-K.
What is a non-GAAP financial measure?

- **Basic definition** - “a numerical measure of financial performance, financial position or cash flows that excludes (or includes) amounts that are otherwise included in (or excluded from) the most directly comparable measure calculated and presented in the financial statements under GAAP.” Regulation G; Item 10(e) of Reg. S-K.

- **Common examples in banking sector**
  - “Core” / “operating” / “adjusted” net income (excluding, e.g., merger-related expenses, etc.).
  - Net interest income on a fully-taxable equivalent basis.
  - Tangible common equity and related measures.
What is a non-GAAP financial measure? (cont.)

• **Ratios** - If the calculation of a percentage or ratio uses a non-GAAP financial measure, the percentage or ratio is also a non-GAAP financial measure (e.g., adjusted earnings per share).

• **Projections** - Forward-looking projections are non-GAAP financial measures if their preparation otherwise causes them to meet the basic definition.
What is *not* a non-GAAP financial measure?

- **Operating or statistical measures** that are not financial measures and do not have a GAAP counterpart.
  - Number of branches.
  - Number of mortgage originations (by number, not dollar value).
  - Employee headcount.

- **Financial measures required to be disclosed** by GAAP, the SEC or another regulatory requirement.
  - Guide 3 disclosures.
  - Regulatory capital disclosures.

- **Disclosures relating to proposed M&A activity** and the parties thereto if contained in a communication subject to the SEC’s rules on M&A communications.
When does Regulation G apply and what does it require?

- When a reporting company, or a person acting on its behalf, publicly discloses (in writing or orally) material information that includes a non-GAAP financial measure, Regulation G requires:
  - a presentation of *the most directly comparable GAAP financial measure* and
  - *a reconciliation* of the non-GAAP financial measure to the most directly comparable GAAP financial measure.

- For oral presentations, a company can comply by posting the required GAAP information on its website and disclosing its location during the presentation. Current SEC guidance suggests such material should be archived for *at least 12 months*.

- Regulation G also prohibits public companies from disseminating false or misleading non-GAAP financial measures or presenting non-GAAP financial measures in a manner that would mislead investors or obscure the company’s GAAP results.
When a non-GAAP financial measure is included in an SEC filing, Item 10(e) of Regulation S-K requires:

- A presentation, with **equal or greater prominence**, of the **most directly comparable GAAP financial measure**;

- **A reconciliation** of the non-GAAP financial measure to the most directly comparable GAAP financial measure.

- A statement disclosing why management believes the non-GAAP financial measure provides **useful information for investors**, and

- To the extent material, a **statement of additional purposes** for which management uses the non-GAAP financial measure (if any).
What does Item 10(e) of Reg. S-K prohibit?

- Item 10(e) prohibits:
  - non-GAAP measures of liquidity that exclude items requiring cash settlement, other than EBIT and EBITDA;
  - the use of titles or descriptions for non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures; and
  - the adjustment of non-GAAP measures of performance to eliminate items characterized as “non-recurring, unusual or infrequent” when (i) a similar charge or gain is reasonably likely to recur within two years or (ii) there was a similar charge or gain within the prior two years.
    - A company can eliminate recurring items, but cannot characterize them as non-recurring when doing so.
    - E.g., serial acquirers excluding merger-related expenses as “one-time items” or similar.
New 2016 SEC guidance regarding use of non-GAAP financial measures

• In May 2016, the SEC’s Division of Corporation Finance further updated its prior guidance from 2003 and 2010 by issuing 4 new Compliance & Disclosure Interpretations and substantially revising several existing C&DIs.
  
  – The new guidance does not contradict idea that companies may provide non-GAAP financial information in SEC filings.
  
  – The new guidance does provide greater detail as to what constitutes fair presentation of GAAP information, misleading non-GAAP financial measures and adequate explanation of non-GAAP adjustments.
Key Points of New Guidance

• Certain non-GAAP adjustments may be misleading even if not explicitly prohibited (e.g., a non-GAAP performance measure that excludes normal, recurring cash operating expenses).

• Non-GAAP financial measures may be misleading if presented inconsistently between periods.

• A non-GAAP financial measure may be misleading if it excludes non-recurring charges, but not non-recurring gains.

• Non-GAAP financial measures that substitute individually tailored revenue recognition and measurement methods for GAAP methods may be misleading (e.g., recognizing revenue when customers billed, rather than over time).

• Much greater detail regarding what constitutes impermissibly “greater prominence” for a non-GAAP financial measure.
Prior to and since the new guidance, the SEC staff has intensified its monitoring of reporting companies’ use of non-GAAP financial measures and has indicated its willingness to act through enforcement, if necessary.

- In June 2016 speech, former SEC Chair Mary Jo White reiterated the SEC staff’s concern about misleading non-GAAP financial measures and the use of such measures by reporting companies that extends “too far and beyond what is intended and allowed by [SEC] rules.”
- Former Chairperson White indicated that the SEC Staff is prepared to initiate enforcement actions if necessary.
- We understand that in 2016 the SEC’s Division of Enforcement sent inquiries/document requests to some reporting companies regarding potential violations of Item 10(e) of Regulation S-K in earnings releases that predate the issuance of the C&DIs.
Increased SEC comments

- In 2015, the SEC issued at least 400 comments related to non-GAAP financial measure disclosures.
- Since the issuance of the new guidance in May 2016, the SEC has made public over 200 additional comments related to non-GAAP financial measure disclosures.
Breakdown of SEC comments – “equal or greater prominence”

- Included in approximately 37% of recent SEC non-GAAP financial measure comments.

  - The Bank of N.T. Butterfield & Son Limited - Registration Statement - “We note your charts presenting your “Core Net Income to Common” and “Core Earnings per Common Share Fully Diluted” on pages 3 and 81. We also note your charts presenting “Core ROATCE” on pages 10 and 88. These presentations appear to give undue prominence to these non-GAAP measures as they are not balanced with the presentation of your comparable GAAP measures for the periods presented. Refer to Question 102.10 of the Non-GAAP Compliance and Disclosure Interpretations, available on our website at http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm, and revise your presentation accordingly.”

  - Sterling Bancorp - Earnings Release – “It appears you prominently present non-GAAP financial measures in this section and you disclose non-GAAP financial measure before or without disclosing the most directly comparable GAAP financial measures throughout the exhibit which is inconsistent with the updated Compliance and Disclosure Interpretations issued on May 17, 2016. Please review this guidance when preparing your next earnings release.”
Breakdown of SEC comments – “equal or greater prominence” (cont.)

• Practical tip for compliance – avoid the following:
  - Presenting the non-GAAP financial measure before its GAAP counterpart (including in a headline or caption).
  - Providing a more eye-catching description to a non-GAAP financial measure (e.g., “record performance”) without a similar description of the GAAP counterpart.
  - Tabular or graphical disclosure of a non-GAAP financial measure, but not its GAAP counterpart.
  - Providing discussion and analysis of a non-GAAP financial measure without discussion and analysis – similar in scope and physical placement – of the GAAP counterpart.
  - Presenting a full non-GAAP “income statement.”
  - Foregoing a quantitative reconciliation with respect to a forward-looking non-GAAP financial measure in reliance on the “unreasonable efforts” exception without equally prominent disclosure of such reliance.
Breakdown of SEC comments – lack of reconciliation

- Included in approximately 34% of recent SEC non-GAAP financial measure comments.

  - The Victory Bancorp, Inc. – Offering Statement – “We note your response to prior comment 9 in our letter dated May 20, 2015. We do not see a reconciliation from the following non-GAAP measures to the most directly comparable GAAP financial measures as mentioned in footnote (1) on page 24 under Capitalization: (i) Tangible equity to tangible assets’ to ‘equity to total assets and (ii) Tangible book value per share’ to ‘book value per share’. Please revise your next amendment to include the reconciliations as required by Item 10(e) of Regulation S-K.”

  - Flagstar Bancorp, Inc. – Form 10-K – “Notwithstanding the comment above, we note that you reconcile your non-GAAP operating measures by presenting a non-GAAP income statement on page 114. Please tell us why you believe this presentation does not attach undue prominence to the non-GAAP information. Refer to Item 10(e) of Regulation S-K and Non-GAAP Financial Measures Compliance and Disclosure Interpretation No. 102.10.”

  - National Commerce Corporation – Registration Statement – “We note your presentation of tangible common equity. This financial measure appears to be non-GAAP as defined by Regulation G and Item 10(e) of Regulation S-K. To the extent you plan to provide this non-GAAP ratio, please revise to: (a) clearly label this financial measure as non-GAAP each time it is presented; (b) provide a reconciliation to the most directly comparable financial measure presented in accordance with GAAP for all periods presented; and (c) disclose the reasons why you believe this presentation provides useful information to investors and specify how management uses this measure, if applicable. Refer to Item 10(e)(1) of Regulation S-K.”
Breakdown of SEC comments – lack of reconciliation (cont.)

• Practical tip for compliance – always provide the reconciliations.
  – Fully reconcile the non-GAAP figure to its GAAP counterpart by showing each component line item to the reconciliation.
  – Very commonly, all non-GAAP reconciliations and other disclosures will be in one location in a document under a heading like “Information about Non-GAAP Financial Measures.”
  – As a best practice, instances of non-GAAP financial measures outside of this central location should:
    • Identify non-GAAP financial measures as such; and
    • Provide a cross-reference to the complete non-GAAP disclosures.
Breakdown of SEC comments – explanation of why the non-GAAP financial measure is useful information

• Included in approximately 30% of recent SEC non-GAAP financial measure comments.

  - **Flagstar Bancorp, Inc. – Form 10-K** – “We note your disclosure of non-GAAP measures that represent your results on a "core operating" basis. Please revise future filings to clearly identify and define each non-GAAP measure separately. To the extent you continue to use the term "core operating" in the titles of these measures, please explain why you believe that these titles are appropriate and your basis for each adjustment to the most directly comparable GAAP measures. Discuss why you do not consider the adjusted items to be part of your core operations and why you believe the measures provide additional clarity in assessing your results on a run-rate basis. Please provide us with your proposed disclosure. See Item 10(e) of Regulation SK for reference.”

  - **National Commerce Corporation – Registration Statement** – “We note your presentation of tangible common equity. This financial measure appears to be non-GAAP as defined by Regulation G and Item 10(e) of Regulation S-K. To the extent you plan to provide this non-GAAP ratio, please revise to: (a) clearly label this financial measure as non-GAAP each time it is presented; (b) provide a reconciliation to the most directly comparable financial measure presented in accordance with GAAP for all periods presented; and (c) disclose the reasons why you believe this presentation provides useful information to investors and specify how management uses this measure, if applicable. Refer to Item 10(e)(1) of Regulation S-K.”
Breakdown of SEC comments – explanation of why the non-GAAP financial measure is useful information (cont.)

• Practical tips for compliance.
  – Avoid conclusory statements – e.g., “The Company believes that Core Operating Income provides useful information to investors because it provides meaningful data about the Company’s core operations.”
  – Avoid only saying “analysts / investors / industry peers use the non-GAAP financial measure.”
    • E.g., “The Company believes that tangible book value provides useful information to investors because it is a non-GAAP financial measure widely used by analysts and investors to assess financial institutions.”
    • The SEC would likely want an explanation, from management’s point of view, of why the measure is widely used, not just a statement that it is.
  – The SEC may ask for disclosure regarding the weaknesses or limitations of a non-GAAP financial measure.
  – Consider Audit Committee and/or Board involvement in selection of non-GAAP measures.
Other common issues with non-GAAP disclosures

• Potentially misleading or confusing names for non-GAAP financial measures.
  – Community One Bancorp – Form 10-K – “We note your use of “core earnings”, “core noninterest income” and “core noninterest expense” in various areas of your filing. Please note that the use of the word “core” implies you are referring to your most central or essential operations and results. Removal of credit-related costs from pre-tax operating profit to arrive at “core” earnings implies that credit losses are not an inherent part of your core operations. We believe it would be appropriate to use a more descriptive title to describe the non-GAAP measure, perhaps by eliminating the use of the word "core" in the title. Please revise future filings accordingly.”

• Opportunistically changing the definition of a non-GAAP financial measure from period to period.
  – Companies should not change the definition of a non-GAAP financial measure from period-to-period to “cherry pick” the most favorable presentation.
  – Companies should disclose changes and the reasons for them.
  – Significant changes may require companies to recast prior period measures for comparability.
Other common issues with non-GAAP disclosures (cont.)

- Improper characterization of an excluded amount as “non-
  recurring, infrequent or unusual” if it is reasonably likely to recur
  within two years, or there was a similar charge or gain within the
  two prior years.
  - For bank holding companies, often comes up in the context of serial acquisitions
    and related expenses.
  - Pacific Premier Bancorp, Inc. – Form 10-Q - “You disclose Non-GAAP adjustments
    to remove merger-related expenses from net income, diluted earnings per share
    and return on average assets. In this regard, we note that you have completed
    seven bank acquisitions since 2010. You also disclose that you will continue to
    pursue acquisitions that meet your criteria. It appears that acquisition of
    businesses has, and will continue to be, a key strategy to achieve growth and the
    removal of these Non-GAAP adjustments may be inconsistent with the updated
    Compliance and Disclosure Interpretations issued on May 17, 2016. Please review
    this guidance when preparing your next Form 10-K report and your next earnings
    release.”
Other common issues with non-GAAP disclosures (cont.)

• Excluding “one time” charges, but not “one time” gains.
  – Cannot “cherry pick.”
  – If the rationale for the exclusion of a charge in a given period applies equally to exclusion of a gain, both should be excluded.

• Not clearly articulating tax adjustments to non-GAAP financial measures.
  – A non-GAAP adjustment should not be presented “net of tax,” but instead, the tax effect should be presented as a separate adjustment and clearly explained.
Breakdown of issuer changes to non-GAAP disclosures

- 36% - re-ordered presentation to present GAAP figure before non-GAAP figure.
- 29% - replaced non-GAAP figure with GAAP figure.
- 29% - supplemented or modified reconciliation.
- 18% - supplemented non-GAAP disclosures with GAAP disclosures.
- 15% - omitted non-GAAP figures from CEO quotes.

Source: Debevoise & Plimpton analysis of 100 earnings releases issued by Fortune 500 companies from May 17, 2016 through September 1, 2016.
Breakdown of issuer changes to non-GAAP disclosures (cont.)

- 10% - omitted non-GAAP figure from earnings release or replaced with comparable GAAP figure.
- 10% - added disclosure that an omitted reconciliation was unavailable without “unreasonable effort.”
- 9% - moved non-GAAP disclosure to less prominent location.
- 9% - removed forward-looking guidance on a non-GAAP figure.
- 7% - added a previously omitted reconciliation.

Source: Debevoise & Plimpton analysis of 100 earnings releases issued by Fortune 500 companies from May 17, 2016 through September 1, 2016.
Responding to an SEC comment

1. Provide a comprehensive response – The SEC likely will not accept a conclusory answer.

2. Review published comment letters

3. Pick your battles – A company has little chance of pushing back against an “equal or greater prominence” comment. A company has a better chance of explaining company-specific expense exclusions and similar issues.

4. Provide sample language – For certainty that a comment will not re-surface, consider vetting specific language for future filings (e.g., explanation of a non-GAAP financial measures usefulness).

5. Keep your promises – Ensure that future SEC filings continue to implement disclosure changes agreed upon with the SEC.