

## Heads Up

### In This Issue:

- Background
- Summary
- Appendix

## SEC Issues Compliance and Disclosure Interpretations on Non-GAAP Measures.

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### Background

On January 11 and 15, 2010, the SEC's Division of Corporation Finance issued new [Compliance and Disclosure Interpretations \(C&DIs\)](#) on the use of non-GAAP financial measures. The new guidance provides registrants with more flexibility to disclose non-GAAP measures in filings with the SEC. The C&DIs replace the interpretative guidance in the SEC staff's "Frequently Asked Questions Regarding the Use of Non-GAAP Measures" (the "FAQs"), which was issued in June 2003, but the rules on non-GAAP financial measures (Regulation G and Item 10(e) of Regulation S-K) were not amended. The C&DIs include some new and revised interpretations and exclude certain transition issues that had been covered in the FAQs. Note that the SEC staff also intends to update the SEC Financial Reporting Manual section on non-GAAP measures.

Many of the changes reflected in the C&DIs are the result of a recent SEC staff review of its interpretations of non-GAAP measures. In December 2009, the SEC staff commented at the AICPA Conference on SEC and PCAOB Developments (the "2009 AICPA Conference") that the purpose of its review was to ensure that non-GAAP guidance was not being read "in a fashion that causes companies to keep key information out of their filings, which they are otherwise using to tell investors their story [through communications such as earnings calls and press releases] and which they believe is the most meaningful indicator of how they are doing."

While registrants frequently include non-GAAP financial measures in press releases, many have been reluctant to include these same measures in filed documents because of restrictions in the now rescinded FAQs. At the 2009 AICPA Conference, Ms. Meredith Cross, director in the SEC's Division of Corporation Finance, noted that registrants may also be omitting non-GAAP measures from their filings because of concerns about future SEC staff comments. She indicated, however, that she was not suggesting that registrants go back to some of the practices that existed before Regulation G was issued and that "led to the crackdown on non-GAAP measures." Also speaking at the 2009 AICPA Conference, Mr. Mark Kronforst, deputy chief accountant in the SEC's Division of Corporation Finance, stated that the new guidance would stress that the disclosures related to non-GAAP measures need to continue to include explanations that are clear, understandable, and specific to the registrant and its industry.

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## Summary

In line with the SEC staff's remarks at the 2009 AICPA Conference, the staff made some key changes. For example, it (1) revised the guidance on nonrecurring, infrequent, or unusual items in FAQs 8 and 9 and replaced it with C&DI 102.03 and (2) revised the guidance on the meaning of the concept "expressly permitted" in FAQ 28 and replaced it with C&DI 106.01.

C&DI 102.03 states the following:

**Question:** Item 10(e) of Regulation S-K prohibits adjusting a non-GAAP financial performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years. Is this prohibition based on the description of the charge or gain, or is it based on the nature of the charge or gain?

**Answer:** The prohibition is based on the description of the charge or gain that is being adjusted. It would not be appropriate to state that a charge or gain is non-recurring, infrequent or unusual unless it meets the specified criteria. The fact that a registrant cannot describe a charge or gain as non-recurring, infrequent or unusual, however, does not mean that the registrant cannot adjust for that charge or gain. Registrants can make adjustments they believe are appropriate, subject to Regulation G and the other requirements of Item 10(e) of Regulation S-K.

The following example illustrates the guidance in C&DI 102.03. Registrant A incurs an impairment charge in 2009 that it believes is an appropriate adjustment to a non-GAAP financial performance measure. Management believes that it is reasonably likely that this impairment charge will recur within two years. Management may make the adjustment to the non-GAAP financial performance measure for the impairment charge (subject to Regulation G and the other requirements in Item 10(e)), but it cannot describe the charge as nonrecurring, infrequent, or unusual because it does not meet the specified criteria.

Note that C&DI 102.03 also removes other disclosure requirements that were in FAQ 8, such as the economic substance behind management's decision to use such a measure.

C&DI 106.01 states the following:

**Question:** The Note to Item 10(e) of Regulation S-K permits a foreign private issuer to include in its filings a non-GAAP financial measure that otherwise would be prohibited by Item 10(e)(1)(ii) if, among other things, the non-GAAP financial measure is required or expressly permitted by the standard setter that is responsible for establishing the GAAP used in the company's primary financial statements included in its filing with the Commission. What does "expressly permitted" mean?

**Answer:** A measure is "expressly permitted" if the particular measure is clearly and specifically identified as an acceptable measure by the standard setter that is responsible for establishing the GAAP used in the company's primary financial statements included in its filing with the Commission.

The concept of "expressly permitted" can also be demonstrated with explicit acceptance of a presentation by the primary securities regulator in the foreign private issuer's home country jurisdiction or market. Explicit acceptance by the regulator would include (1) published views of the regulator or members of the regulator's staff or (2) a letter from the regulator or its staff to the foreign private issuer indicating the acceptance of the presentation — which would be provided to the Commission's staff upon request.

**Editor's Note:** C&DI 106.01 refers to Item 10(e), which permits measures that are required or expressly permitted by a standard setter. FAQ 28 defined expressly permitted as being specifically identified by a standard setter as an acceptable measure. In practice, however, few measures are specifically identified in standards, although the measure may be permitted or required by a home-country regulator. C&DI 106.01 clarifies that a measure that is explicitly accepted by the primary securities regulator meets this definition.

In addition to the items noted above, other noteworthy changes include the addition of four C&DIs on topics that had not been addressed in the FAQs. The following are highlights of two of the new C&DIs:

- C&DI 102.04 clarifies that a registrant is not prohibited from “disclosing a non-GAAP financial measure that is not used by management in managing its business.”
- C&DI 102.11 clarifies that "a registrant may present an adjustment 'net of tax' when reconciling a non-GAAP performance measure to the most directly comparable GAAP measure" provided that it makes certain disclosures.

As noted above, the rules on non-GAAP financial measures (Regulation G and Item 10(e)) were not amended; accordingly, registrants should continue to make the disclosures required by Item 10(e).

For summaries of certain changes the C&DIs made to guidance in the former FAQs, as well as cross-references to the former FAQs, see the [Appendix](#).

## Appendix

The table below summarizes certain changes the C&DIs made to the guidance in former FAQs on the use of non-GAAP financial measures. Although the C&DIs replace the FAQs, the rules on non-GAAP financial measures (Regulation G and Item 10(e) of Regulation S-K) were not amended.

C&DI	Former FAQ	Changes to Former FAQ
<b>Section 101. Business Combination Transactions</b>		
101.01	6 <sup>1</sup>	Editorial changes. This C&DI addresses (1) the exemption for non-GAAP measures related to business combinations and (2) the use of pro forma measures for reconciliation purposes in a separate C&DI.
101.02		
<b>Section 102. Item 10(e) of Regulation S-K</b>		
102.01	7	Expands guidance to explicitly indicate that the staff accepts the January 1, 2000, National Association of Real Estate Investment Trusts (NAREIT) definition of “funds from operations” (FFO) as a performance measure and accordingly, that it may be presented on a per share basis.
102.02	7	Clarifies that a registrant may present FFO on a basis other than what is defined by NAREIT provided the adjustments comply with Item 10(e). Also notes that an adjusted measure that is a performance measure may be presented on a per share basis, but not if it is a liquidity measure.
102.03	8 and 9	Clarifies the prohibition in Item 10(e) related to adjustments made to a non-GAAP financial performance measure, noting that the prohibition is based on the description of the charge or gain rather than its nature. Registrants may make adjustments they believe are appropriate, subject to Regulation G and Item 10(e). Removes additional disclosure requirements that were in FAQ 8.
102.04 (new)	N/A	Indicates that a registrant is not prohibited from “disclosing a non-GAAP financial measure that is not used by management in managing its business.” Therefore, a registrant may still comply with Item 10(e) of Regulation S-K even if it does not use the non-GAAP measure in managing its business or for other purposes.  Clarifies that Item 10(e) only requires a statement of the additional purposes, “if any,” for which the registrant’s management uses the measure, “to the extent material.”
102.05	11	Updates references regarding the use of non-GAAP per share financial measures. Also indicates that non-GAAP per share performance measures should be reconciled to earnings per share; non-GAAP liquidity measures should not be presented on a per share basis.
102.06	12	Editorial changes. This C&DI addresses the presentation of statement of cash flow amounts when a non-GAAP liquidity measure is presented.
102.07	13	Removes sentence in FAQ 13 regarding disclosure of “all material limitations” of the non-GAAP measure, “free cash flow.”
102.08 (new)	N/A	Indicates that “Item 10(e) of Regulation S-K does not apply to a filed free writing prospectus unless the free writing prospectus is included in or incorporated by reference into the issuer’s registration statement or included in an Exchange Act filing.” <sup>2</sup>
102.09	10	Editorial changes. This C&DI addresses the use of the non-GAAP financial measure “Adjusted EBITDA” when such measure is a material covenant in a debt agreement.
102.10 (new)	N/A	Indicates that it is generally not appropriate to present a full non-GAAP income statement for reconciling non-GAAP measures to the most directly comparable GAAP measure. <sup>3</sup>
102.11 (new)	N/A	Clarifies that a registrant may present an adjustment “net of tax” when reconciling a non-GAAP performance measure to the most directly comparable GAAP measure as long as the tax effect of each reconciling item is disclosed parenthetically or in a footnote to the reconciliation; alternatively, the registrant may present the tax effect in one line item in the reconciliation. A registrant must also disclose how the tax effect was calculated.
<b>Section 103. EBIT and EBITDA</b>		
103.01	14	Addresses the use of measures other than EBIT and EBITDA, noting their titles should be distinguished from “EBIT” or “EBITDA” (e.g., Adjusted EBITDA). Removed sentence in FAQ 14 indicating that the title should “clearly identify the earnings measure being used and all adjustments.”  Clarifies that such “adjusted” measures are not exempt from the prohibition in Item 10(e), except when used in a material covenant to a debt agreement (see C&DI 102.09).
103.02	15	Eliminates the discussion that a registrant needs to justify the use of EBIT or EBITDA as a performance measure and the reference to FAQ 8 (now C&DI 102.03) regarding excluding recurring charges.

<sup>1</sup> FAQs 1–5 and FAQ 30 addressed transition issues and were not covered in the C&DIs.

<sup>2</sup> Note that this issue was previously addressed by the SEC in its “Securities Offering Reform Questions and Answers” document.

<sup>3</sup> Note that this issue was addressed by the SEC in a speech at the 2006 AICPA Conference on SEC and PCAOB Developments. For more information, see Deloitte’s [December 21, 2006, Heads Up](#).

C&DI	Former FAQ	Changes to Former FAQ
<b>Section 104. Segment Information</b>		
104.01	18	Editorial changes. This C&DI notes that segment information required to be disclosed by GAAP is not a non-GAAP financial measure.
104.02	19	Addresses when a registrant includes a discussion of segment profitability in its MD&A.
104.03	20	Removes the statement that it would be difficult to demonstrate that segment measures that are not reported to or used by the chief operating decision maker, or are not in conformity with GAAP, are useful for investors.
104.04	21	Editorial changes. This C&DI addresses the use of total segment profit or loss measures in any context other than ASC 280 <sup>4</sup> (formerly Statement 131 <sup>5</sup> ).
104.05	16	Clarifies that if a registrant presents a table that breaks down revenues by products in accordance with ASC 280 but does not provide a sum to the revenue amount presented in the registrant's financial statements, such amounts are not a non-GAAP measure (unless such revenue amounts are adjusted in some manner).
104.06	17	Provides guidance regarding the presentation of financial information in constant currency and addresses how to comply with the reconciliation requirements to isolate the effect of exchange rate differences.
<b>Section 105. Item 2.02 of Form 8-K<sup>6</sup></b>		
105.01–105.07	22–27 <sup>7</sup>	These revisions appear to be editorial changes; however, registrants should consider consultation with their SEC legal counsel.
<b>Section 106. Foreign Private Issuers</b>		
106.01	28	Clarifies the meaning of “expressly permitted” in the context of a non-GAAP financial measure that is required or expressly permitted by a standard setter.
106.02	29	These revisions appear to be editorial changes; however, registrants should consider consultation with their SEC legal counsel. This C&DI addresses whether foreign private issuers can incorporate portions of a press release that do not include non-GAAP financial measures.
106.03	31	These revisions appear to be editorial changes; however, registrants should consider consultation with their SEC legal counsel. This C&DI addresses situations in which Item 10 (e) applies to a Form 6-K that contains non-GAAP measures that is incorporated into a registration statement.
106.04	32	No changes.
<b>Section 107. Voluntary Filers</b>		
107.01	33	Editorial changes. This C&DI addresses whether Regulation G and Item 10(e) apply to a registrant that is a voluntary filer.

<sup>4</sup> For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the FASB Accounting Standards Codification."

<sup>5</sup> FASB Statement No. 131, *Disclosures About Segments of an Enterprise and Related Information*.

<sup>6</sup> Item 2.02 of Form 8-K requires a registrant to furnish a Form 8-K within four business days of any public announcement or release disclosing material non-public information regarding its results of operations or financial condition for an annual or quarterly fiscal period.

<sup>7</sup> C&DI 105.04 was issued on January 11, 2010, and withdrawn on January 15, 2010. C&DI 105.07 was issued on January 15, 2010, and replaced this C&DI.

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