

Client Alert

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Adjusted EBITDA Is Out of the Shadows as Staff Updates Non-GAAP Interpretations

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The Staff of the Division of Corporation Finance of the Securities and Exchange Commission (SEC) recently updated its guidance regarding the use of non-GAAP financial measures in SEC filings and other public disclosures.¹ The updated guidance, contained in newly issued compliance and disclosure interpretations (C&DI), supersedes the Staff's prior guidance on this topic issued in 2003 shortly after the SEC adopted Regulation G and Item 10(e) of Regulation S-K governing the use of non-GAAP financial measures.²

In its updated guidance, the Staff has moderated some of its prior positions relating to use of non-GAAP measures, particularly those relating to Adjusted EBITDA and add-backs of recurring items. The net result is that SEC filers will have much more flexibility to use non-GAAP measures, like Adjusted EBITDA, in press releases and SEC filings.

The C&DIs represent a general relaxation of the Staff's prior — and at times somewhat skeptical — attitude toward the use of non-GAAP financial measures. But there is no free lunch: the Staff is informally making clear that they expect issuers to present non-GAAP financial measures consistently in all of their public disclosures, whether filed or not. The Staff's apparent goal is to eliminate differences between the

financial metrics disclosed in earnings releases and analyst meetings and those included in official SEC filings. In other words, if it's in the earnings release, a Staff comment to put it in the next form 10-K or 10-Q as well may be on the way.

This *Client Alert* highlights the significant differences between the prior guidance and the updated guidance. We also summarize our understanding of the Staff's informal views on this topic and suggest a template for disclosure of Adjusted EBITDA as a performance measure in SEC filings and press releases.

Background

Regulation G and Item 10(e) of Regulation S-K

Section 401(b) of the Sarbanes-Oxley Act of 2002 required the SEC to issue rules limiting the use of "non-GAAP financial measures." In response, the SEC adopted Regulation G, applicable to public disclosures *other than SEC filings*, and Item 10(e) of Regulation S-K, applicable to disclosures *in SEC filings*.³

Non-GAAP Financial Measures

Regulation G and Item 10(e) define a "non-GAAP financial measure" as a numerical measure of financial performance, financial positions 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 generally accepted accounting principles (GAAP). Examples include EBITDA, Adjusted EBITDA, free cash flow, organic sales growth and funds from operations (FFO).

Non-GAAP financial measures are often presented in securities offering documents as measures of performance (and, in some cases, as measures of liquidity) and are often used in covenants to measure financial performance or to approximate cash generated from operations that would be available to pay interest on debt.

Regulation G

Regulation G applies whenever an SEC registrant, or a person acting on its behalf, “publicly discloses material information” that includes a non-GAAP financial measure. Regulation G requires that public disclosures of non-GAAP financial measures be accompanied by:

- a presentation of the most directly comparable financial measure calculated in accordance with GAAP; and
- a quantitative reconciliation of the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure.

In addition, Regulation G prohibits an SEC registrant from making any non-GAAP financial measure public if it contains a material misstatement or omits to include information needed to make the included measure not misleading.

Item 10(e) of Regulation S-K

Item 10(e) applies to non-GAAP financial measures included in SEC filings. In addition to the requirements of Regulation G, Item 10(e) requires:

- a presentation, with equal or greater prominence, of 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 the additional purposes for which management uses the non-GAAP financial measure (if any).

Item 10(e) prohibits:

- non-GAAP measures of *liquidity* that exclude items requiring cash settlement, other than EBIT and EBITDA;
- the adjustment of non-GAAP measures of *performance* to eliminate or smooth items characterized as “non-recurring, unusual or infrequent” when a similar charge or gain occurred within the previous two years or the nature of the charge or gain makes it reasonably likely to recur within two years; and
- 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.

Updated Staff Guidance Compared to Prior Guidance

Changes from Prior Guidance

(1) Adjusting for Recurring Items Is Permitted. The new guidance makes clear that companies are free under Item 10(e) to present non-GAAP performance measures that exclude the impact of recurring items, so long as the recurring items are not labeled as non-recurring. This is perhaps the single most important change from the prior guidance.

The prior guidance contained significant restrictions limiting the circumstances under which a company could eliminate the impact of a recurring item in calculating a non-GAAP performance measure.⁴ In many cases, these restrictions had the practical effect of excluding from SEC filings any non-GAAP performance measure that adjusted for recurring items.

The prior guidance required companies to “meet the burden of demonstrating the usefulness of any [non-GAAP] measure that excludes recurring items,” especially for non-GAAP performance measures. In contrast, the updated guidance simply states:

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. (C&DI 102.03)

Thus, the new guidance allows an SEC registrant to freely present a non-GAAP financial performance measure (such as Adjusted EBITDA) that eliminates the impact of recurring items as long as the company clearly discloses and explains the reasons for eliminating the recurring items in the non-GAAP financial measure.

(2) Measures Not Used by Management Are Permitted. The new guidance makes clear that companies are free to present non-GAAP financial measures in their public disclosures and SEC filings even where management does not use the non-GAAP financial measure in managing its business. The new guidance provides:

Item 10(e)(1)(i)(D) of Regulation S-K states only that, “[t]o the extent material,” there should be a statement disclosing the additional purposes, “if any,” for which the registrant’s management uses the non-GAAP financial measure. There is no prohibition against disclosing a non-GAAP financial measure that is not used by management in managing its business. (C&DI 102.04)

While Item 10(e) never explicitly required that a company actually use a non-GAAP financial measure in

managing its business in order to be able to disclose the measure, prior to the release of the new guidance, practitioners generally treated it as a requirement. However, even under the new guidance, Item 10(e) does require, among other things, a statement disclosing why management believes the non-GAAP financial measure provides useful information for investors and, to the extent material, a statement of the additional purposes for which management uses the non-GAAP financial measure, if any.

(3) Adjusted EBITDA Is Out of the Doghouse. The Staff explicitly acknowledged that many companies present Adjusted EBITDA in their SEC filings and public disclosures and that, subject to compliance with the requirements of Item 10(e), they are permitted to do so. In C&DI 103.01, the Staff acknowledged that many companies calculate certain measures differently than those described as EBIT and EBITDA, which is acceptable so long as the title of the non-GAAP financial measure is changed, for example, to Adjusted EBITDA.

New Interpretations

The new guidance includes a number of helpful clarifications:

(1) Free-Writing Prospectuses Are Subject to Item 10(e). The Staff confirmed that Item 10(e) applies to free-writing prospectuses included in or incorporated by reference into a registration statement or other filing under the Exchange Act, but does not apply to other free-writing prospectuses.⁵ (C&DI 102.08)

(2) Full Non-GAAP Income Statement Is Discouraged. The Staff stated that, for purposes of reconciling non-GAAP financial measures, it is generally not appropriate to present a full non-GAAP income statement, since doing so may attach undue prominence to the non-GAAP information. (C&DI 102.10)

(3) Net of Tax Reconciliations. The Staff affirmed that, when reconciling a non-GAAP *performance* measure, a company may present an adjustment “net of tax” so long as it discloses both the tax effect of each reconciling item (parenthetically or in a footnote) and how the tax effect was calculated. (C&DI 102.11)

(4) Foreign Private Issuers — Item 10(e). Item 10(e) contains an exemption for a foreign private issuer (FPI) if, among other things, the non-GAAP financial measure is required or expressly permitted by the standard-setter that establishes the local GAAP used in the FPI’s primary financial statements. The updated guidance provides more clarity on what is meant by “expressly permitted,” which should make it easier for FPIs to use the Item 10(e) exemption to disclose non-GAAP financial measures under certain circumstances. FPIs may now show that a non-GAAP financial measure is “expressly permitted” under home country rules through “explicit acceptance of a presentation,” such as a (i) published regulatory position or (ii) letter from the regulator to the issuer. (C&DI 106.01)

(5) Foreign Private Issuers — Incorporation of Reports on Form 6-K into Securities Act Registration Statement. The updated guidance makes clear that an FPI that furnishes a press release on Form 6-K including non-GAAP financial measures may incorporate into a Securities Act registration statement only those portions of the furnished press release that *do not* include the non-GAAP financial measures. The guidance points out that Form 6-Ks are not incorporated by reference automatically into a Securities Act registration statement, and that in order to incorporate a Form 6-K by reference an FPI must specifically provide for incorporation in the registration statement *and* in the subsequent Form 6-K itself (see Item 6(c) of Form F-3). (C&DI 106.02)

(6) Foreign Private Issuers — Regulation G Exemption and Item 10(e). Rule 100(c) exempts an FPI from complying with Regulation G if its securities are listed or quoted outside the United States; the non-GAAP financial measure being used is not derived from or based on a measure calculated and presented in accordance with US GAAP; and the disclosure is made outside the United States. The updated guidance notes that an FPI that takes advantage of Rule 100(c) and then furnishes non-Regulation G-compliant information in a report on Form 6-K must still comply with Item 10(e) with respect to that information if it chooses to incorporate the Form 6-K into a Securities Act registration statement (with certain exceptions for Canadian companies). (C&DI 106.03)

(7) Constant-Currency Presentations. The updated guidance gives companies much more flexibility to present financial information in a constant currency to eliminate the effects of currency fluctuations on their financial results. The updated guidance makes clear that, while such measures are subject to Regulation G and Item 10(e), a company can present these measures and still comply with Item 10(e) by presenting the historical results together with disclosure on how to calculate the constant currency amounts and the basis for presentation. (C&DI 104.06)

(8) Funds From Operations. The Staff clarified that FFO may be presented on a basis other than as defined and clarified by the National Association of Real Estate Investment Trusts as of January 1, 2000; provided that any adjustments made to FFO from the basis defined by the National Real Estate Investment Trusts comply with Item 10(e) for a performance measure or liquidity measure, as applicable. (C&DI 102.02)

(9) Product Revenues. The updated guidance no longer requires that

amounts of revenue by product be set forth in a table aggregating to “total revenue” as reflected in the financial statements, as had been required under the prior guidance, so long as the revenue amounts for each product are calculated in accordance with GAAP. (C&DI 104.05)

Same Old Same Old

Otherwise, the song remains the same. Except as noted above, most aspects of the prior guidance have been repeated in the updated guidance. Key surviving items include:

- Companies cannot describe an adjustment as “non-recurring, infrequent or unusual” if it occurred within the last two years or is reasonably likely to recur within two years. (C&DI 102.03)
- To the extent material, companies must disclose any purpose for which management uses the non-GAAP financial measure. (C&DI 102.04)
- EBIT and EBITDA are limited to precise definitions (starting with net income and adding back only interest and taxes and, if applicable, depreciation and amortization). Other adjustments are allowed, but the resultant measure must be called Adjusted EBITDA. (C&DI 103.01)
- Per-share non-GAAP performance measures, including FFO for REITs, are permitted, subject to Item 10(e) compliance. (C&DI 102.01 & 102.03)

No Free Lunch

The C&DIs represent a welcome change, and we believe reflect a more general relaxation of the Staff’s prior — and at times somewhat skeptical — attitude toward the use of non-GAAP financial measures, particularly in reports or registration statements filed with the SEC. So far, so good.

But this relaxation comes at a price. In particular, the Staff has informally noted to us that they expect issuers to

present non-GAAP financial measures consistently in their public disclosures, whether filed or not.

What does this mean? Take the case of a public company that has historically made disclosures of non-GAAP financial measures in an earnings release furnished under Item 2.02 of Form 8-K. That disclosure complied with Regulation G, of course. But in many (if not most) instances, the disclosure did not comply fully with Item 10(e). For that reason, among others, the non-GAAP disclosures contained in those earnings releases were not included by the company in the corresponding periodic report it filed with the SEC.

Under the Staff’s new approach, a company that bifurcates its disclosure of non-GAAP financial measures in this way may well receive a comment inquiring about the difference between its public disclosures and those filed with the SEC. We understand the Staff thereby hopes to limit (if not end) what they view as the practice of “shadow disclosure” of non-GAAP financial measures in earnings releases and other public disclosures, without including those non-GAAP measures in filings on Form 10-K or 10-Q. In short, the days of two disclosure regimes for non-GAAP financial measures — one for press releases and similar purposes, and another for SEC filings — may be drawing to a close.

A Proposed Template for Disclosure

The updated guidance will reduce the amount of time we all spend discussing disclosures of non-GAAP measures. The Staff’s focus going forward will be on full disclosure of how non-GAAP measures were prepared rather than on rigid rules denying particular categories of adjustments. Given that Adjusted EBITDA is the most prevalent non-GAAP performance measure, we are proposing a format for disclosure of Adjusted EBITDA as a measure

of performance in press releases and SEC filings. See Annex A to this *Client Alert*. Our proposed template will need to be tailored to suit the facts of any particular company's situation, of course, but we hope that it will be a starting point for every company seeking to present Adjusted EBITDA as a measure of its performance. As always, balance is important. Even under the new guidance, adjustments should be a two-way street. Recurring and non-recurring items should be excluded on a principled basis, regardless of whether they increase or decrease Adjusted EBITDA.

Conclusion

The text of Regulation G and Item 10(e) have not been changed. However, given that the Staff has moderated some of its prior interpretations — in particular, regarding Adjusted EBITDA and exclusions of recurring items — companies will have much more flexibility in disclosing non-GAAP financial measures in press releases and SEC filings. We will continue to monitor public company disclosures on this point.

Endnotes

¹ Compliance & Disclosure Interpretations: Non-GAAP Financial Measures (Jan. 15, 2010), available at www.sec.gov/divisions/corpfin/guidance/nongAAPinterp.htm.

² "Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures" (June 13, 2003), available at www.sec.gov/divisions/corpfin/faqs/nongAAPfaq.htm.

³ Section 401(b) of the Sarbanes-Oxley Act directed the SEC to adopt rules concerning the public disclosure or release of "pro forma financial information" by public companies. The SEC adopted the term "non-GAAP financial measures" to identify the types of information targeted by Section 401(b), rather than the language of the Act to avoid confusion with existing SEC rules on pro forma financial information (such as Article 11 of Regulation S-X).

⁴ See FAQs 8 and 9 of the prior guidance.

⁵ Nevertheless, free-writing prospectuses are still required to comply with Regulation G. The prior guidance did not address this issue because it predated the SEC's Securities Offering Reform (Dec. 2005), which introduced free-writing prospectuses.

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Annex A

Adjusted EBITDA as a Performance Measure

Consider this template for a company that wants to include a presentation of Adjusted EBITDA as a performance measure in a press release, offering circular or SEC filing.

	Fiscal Year			[] months ended [],		Twelve months ended
						[],
	2007	2008	2009	2009	2010	2010
	(dollars in millions)					
<u>Other Data</u>						
Adjusted EBITDA ⁽¹⁾						

(1) We present Adjusted EBITDA as a supplemental measure of our performance. We define Adjusted EBITDA as net income (loss) [from continuing operations] plus (i) interest expense, [net,] (ii) provision for taxes and (iii) depreciation and amortization, as further adjusted to eliminate the impact of certain items that we do not consider indicative of our ongoing operating performance. These further adjustments are itemized below. You are encouraged to evaluate these adjustments and the reasons we consider them appropriate for supplemental analysis. In evaluating Adjusted EBITDA, you should be aware that in the future we may incur expenses that are the same as or similar to some of the adjustments in this presentation. Our presentation of Adjusted EBITDA should not be construed as an inference that our future results will be unaffected by unusual or non-recurring items.

Set forth below is a reconciliation of Adjusted EBITDA to net income (loss):

	Fiscal Year			[] months ended [],		Twelve months ended
						[],
	2007	2008	2009	2009	2010	2010
	(dollars in millions)					
Net income (loss)						
Adjustments:						
Interest expense[, net]						
Provision for taxes						
Depreciation and amortization						
Non-cash equity-based compensation expense						
Goodwill impairment charges ^(x)						
Other non-cash charges ^(x)						
Adjustment A ^(x)						
Adjustment B ^(x)						
Adjustment C ^(x)						
[Income (loss) from discontinued operations]						
Adjusted EBITDA	\$	\$	\$	\$	\$	\$

^(x) Represents [add explanation as necessary].

We present Adjusted EBITDA because we believe it assists investors and analysts in comparing our performance across reporting periods on a consistent basis by excluding items that we do not believe are indicative of our core operating performance. In addition, we use Adjusted EBITDA: [(i) as a factor in evaluating management's performance when determining incentive compensation, (ii) to evaluate the effectiveness of our business strategies and (iii) because our credit agreement and our indenture use measures similar to Adjusted EBITDA to measure our compliance with certain covenants.]

Adjusted EBITDA has limitations as an analytical tool. Some of these limitations are:

- Adjusted EBITDA does not reflect our cash expenditures, or future requirements, for capital expenditures or contractual commitments;
- Adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;
- Adjusted EBITDA does not reflect the significant interest expense, or the cash requirements necessary to service interest or principal payments, on our debts;
- although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and Adjusted EBITDA does not reflect any cash requirements for such replacements;
- non-cash compensation is and will remain a key element of our overall long-term incentive compensation package, although we exclude it as an expense when evaluating our ongoing operating performance for a particular period;
- Adjusted EBITDA does not reflect the impact of certain cash charges resulting from matters we consider not to be indicative of our ongoing operations; and
- other companies in our industry may calculate Adjusted EBITDA differently than we do, limiting its usefulness as a comparative measure.

Because of these limitations, Adjusted EBITDA should not be considered in isolation or as a substitute for performance measures calculated in accordance with GAAP. We compensate for these limitations by relying primarily on our GAAP results and using Adjusted EBITDA only supplementally.

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