Reporting and Disclosures Using Non-GAAP Financial Measures

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Public companies provide information to investors and other market participants in many different ways, including SEC filings (e.g., annual and quarterly reports), company websites, earnings releases, investor calls, and analyst presentations. Such companies frequently use non-GAAP financial measures to communicate such important information to the public. As a result, there is a large volume of non-GAAP financial information circulating outside the SEC filing system, even though the SEC does not discourage companies from disclosing important non-GAAP information in their SEC filings—particularly when nondisclosure could lead to an inconsistency in how a company portrays its business in its SEC filings versus communications outside the SEC filing system.

Generally, a non-GAAP financial measure is a measure of historical or future financial performance, financial position, or cash flow that excludes items included in the most directly comparable GAAP measure or that includes items excluded from the most directly comparable GAAP measure. Commonly used financial non-GAAP measures include earnings before interest and taxes (EBIT); earnings before interest, taxes, depreciation, and amortization (EBITDA); free cash flow; and earnings per share (EPS) that exclude stock compensation or certain other charges.

The authors reviewed 25 companies that had initial public offerings (IPO) in 2011, filed their first Forms 10-K in 2012, and disclosed non-GAAP financial measures. This discussion focuses on the non-GAAP reporting practices of those companies and how they provided transparency and disclosures in their non-GAAP presentations. CPAs should keep in mind some of the best practices for non-GAAP reporting—based upon the SEC's Regulation G, "Conditions for Use of Non-GAAP Financial Measures"—examined in the following sections.

SEC Guidance for Non-GAAP Reporting

The SEC regulates the disclosure of non-GAAP financial measures under Regulation G and Regulation S-K, designed to protect investors from being misled by non-GAAP disclosures.

Regulation G. As directed by the Sarbanes-Oxley Act of 2002 (SOX), the SEC adopted new rules and amendments to address public company disclosures of certain financial information that is calculated and presented on the basis of methodologies other than GAAP. One such rule was Regulation G, effective March 28, 2003. Regulation G applies whenever a company publicly discloses material information that includes a non-GAAP financial measure. It requires the company to include a presentation of the most directly comparable GAAP financial measure and a reconciliation of it to the non-GAAP financial measure.

Regulation S-K. Item 10(e) of Regulation S-K, on the other hand, only regulates non-GAAP financial measures included in SEC filings. Under Item 10(e)(1)(i), the following information should accompany a company's disclosure of non-GAAP financial measures:

- A presentation of GAAP measures, with equal or greater prominence as non-GAAP financial measures
- A reconciliation of non-GAAP measures to GAAP presentations (by schedule or another clearly understood method)
- A statement disclosing the reasons why management believes that presentation of the non-GAAP financial measure provides useful information to investors
- To the extent it is material, a statement disclosing the additional purposes for non-GAAP measure disclosures, if any.

In addition, Item 10(e) prohibits the following when disclosing non-GAAP financial measures:

- Excluding charges that require cash settlement from non-GAAP liquidity measures, other than EBIT and EBITDA presentations—for example, free cash flow should not be used in a manner that could imply that the non-GAAP measure represents the residual cash flow available for discretionary expenditures by the company, because the company may have mandatory debt service requirements or other nondiscretionary expenditures that are not deducted from the free cash flow measure

■ Eliminating or smoothing items identified as nonrecurring, infrequent, or unusual when the nature of the charge or gain is reasonably likely to recur within two years or a similar charge or gain has occurred within the two prior years

■ Presenting non-GAAP financial measures on the face of GAAP financial statements or in the accompanying notes

■ Presenting non-GAAP financial measures on the face of any pro forma financial information required by Article 11 of Regulation S-X, which requires pro forma presentation in certain circumstances (e.g., a significant business combination or disposition of a significant portion of a business)

■ Using titles or descriptions of non-GAAP financial measures that are the same as or similar to those used in GAAP measures.

SEC Frequently Asked Questions (FAQ). In its July 8, 2011, Compliance & Disclosure Interpretations (C&DI) on non-GAAP financial measures, the SEC provided additional guidance regarding non-GAAP reporting (http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm). The C&DI clarified several issues, including the following:

■ If a company presents EBIT or EBITDA as its performance measures, it should reconcile these measures to net income, as presented in the statement of operations under GAAP (Q&A 103.02).

■ It would not be appropriate to state that a charge or gain is nonrecurring, infrequent, or unusual, unless it meets the specified criteria; however, a company's inability to describe a charge or gain as nonrecurring, infrequent, or unusual does not mean that the company cannot adjust for that charge or gain (Q&A 102.03). Companies can make adjustments they believe are appropriate—subject to Regulation G and the other requirements of Item 10(e) of Regulation S-K—and provide their justification.

■ Certain non-GAAP per-share performance measures might be meaningful; however, such financial measures must also include a reconciliation to GAAP EPS and must comply with other Item 10(e) requirements (Q&A 102.05).

■ It is not appropriate to present a full non-GAAP income statement for purposes of reconciling non-GAAP measures to the most directly comparable GAAP measures, because such a presentation might attach undue prominence to the non-GAAP information (Q&A 102.10).

■ A company can present an adjustment net of tax when reconciling a non-GAAP performance measure to the most directly comparable GAAP measure (Q&A 102.11). Alternatively, the company can present the tax effect in one line of the reconciliation. Regardless of the presentation's format, companies should disclose how the tax effect was calculated.

Analysis of the Data

As previously mentioned, the authors reviewed the financial information of companies that had their IPOs in 2011 and filed their first annual reports in 2012. The objective was to focus on those companies that had the opportunity to design and implement their non-GAAP reporting and disclosure policies under the 2011 SEC guidance. The authors sampled 97 registrants: 13 were foreign companies, and the remaining 84 were publicly held U.S. companies. Of the U.S. companies, 25 (approximately 30%) had non-GAAP presentations; these are analyzed in the sections below with respect to certain items.

Non-GAAP presentations. The SEC believes that non-GAAP measures often provide important insight into a company's business; thus, it encourages companies to include relevant non-GAAP measures in their SEC fillings (rather than only disclosing them outside the SEC filing system). Of the 25 companies reviewed, 21 reported non-GAAP information in their Forms 10-K, 10-Q, and 8-K earnings releases, as well as on their websites. The remaining 4 companies reported non-GAAP information only in their Forms 8-K and on their websites.

Non-GAAP disclosures. Item 10(e) prohibits presenting non-GAAP financial measures on the face of the GAAP financial statements or in the accompanying notes. The authors found that companies generally complied with this guidance. Most disclosed non-GAAP information in their management discussion and analysis (MD&A) of Forms 10-K and 10-Q, Item 6 (Selected Financial Data) of Form 10-K, or the business section of Forms 10-K. Only one company disclosed its non-GAAP measures in the segment-reporting note as part of the measures that the chief operating decision maker routinely reviews.

Antidilutive shares. During the 2010 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff cautioned that, when calculating non-GAAP EPS measures, companies should appropriately recalculate the amount of diluted shares used in the denominator. For example, in situations where a company has a GAAP net loss but discloses a non-GAAP net income measure, it should consider whether it needs to recalculate the number of shares used in the non-GAAP EPS calculation to include any shares previously determined to be antidilutive in the GAAP EPS calculation. Only one company in the sample fell into this category; it properly included previously determined antidilutive shares for a GAAP loss as dilutive shares for non-GAAP net income and EPS reporting purposes.

Stock compensation awards. Stock compensation was a popular exclusion among the companies surveyed. Of the 25 companies that reported non-GAAP data, 23 (92%) reported stock compensation. Of those, 19 (83%) excluded stock compensation for non-GAAP reporting purposes.

The authors believe that the SEC staff's guidance cautioning companies to ensure that they appropriately recalculate the number of diluted shares used in the denominator of EPS also applies to the exclusion of stock compensation for a non-GAAP EPS calculation. In this sample, 11 companies excluded stock compensation, and the number of shares was dilutive for non-GAAP EPS calculation purposes. Of these companies, 3 (27%) adjusted the denominator of EPS for stock compensation in addition to the numerator exclusion. The remaining 8 (73%) used the same denominator for GAAP and non-GAAP EPS reporting.

Accounting Standards Codification (ASC) Topic 260, "Earnings Per Share," requires that all awards be included in the computation of diluted EPS, as long as the effect is dilutive. Stock compensation awards impact not only stock compensation expense (included in the numerator of EPS), but also the denominator of diluted EPS, as part of the Treasury stock method (TSM) of computing the average stock compensation costs for future services that have not been recognized.

The authors believe that if a company chooses to exclude stock compensation for non-GAAP reporting purposes from the numerator of non-GAAP EPS, the corresponding number of shares in the denominator should also be excluded if they are dilutive; without the share exclusion, the presentation would be confusing and inconsistent. As noted earlier, only 27% of the companies surveyed adhered to this interpretation of the guidance.

Non-GAAP presentation justification. SEC Regulation S-K, Item 10(e), requires a statement disclosing the reasons why a company's management believes that presentation of the non-GAAP financial measure provides useful information to investors. The companies analyzed in this sample provided such a statement; in most cases, however, the disclosures were mostly generic statements. The authors believe that the SEC expects more robust explanations as justification for presenting non-GAAP measures.

Non-GAAP reconciliations. Item 10(e) requires a presentation, with equal or greater prominence, of the most directly comparable GAAP financial measure or measures. It also requires a reconciliation of the differences between the non-GAAP financial measures disclosed with the most directly comparable GAAP financial measures.

The authors noted that the companies in the sample were generally compliant with this guidance and provided for equal or less prominent presentation of non-GAAP data, as well as for non-GAAP to GAAP reconciliations. For example, some companies presented EBITDA or adjusted EBITDA as performance measures and reconciled them to net income as presented in their statement of operations or income in their SEC filings. With respect to websites and investor relations literature, however, the authors did not find proper reconciliations in all instances. Eight (32% of the sample) investor presentations did not include proper reconciliations for disclosed non-GAAP financial information. In a few cases, companies presented non-GAAP information with greater prominence.

Exclusions. In the selected sample of 25 companies that reported non-GAAP measurements, only 1 (4%) reported EBITDA; 16 (64%) reported adjusted EBITDA. The remaining 8 companies (32%) simply reported exclusions from income, without any reference to EBITDA or adjusted EBITDA. Most of the companies that recorded stock compensation and adjusted EBITDA presented stock compensation as an adjustment to EBITDA. In addition to stock compensation, other common adjustments were expenses related to mergers and acquisitions, impairment charges, IPO-related charges, and a gain or loss on disposal of assets.

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The most common item among the 8 companies that reported exclusions from income without any reference to EBITDA was stock compensation, followed by depreciation and amortization; expenses related to mergers and acquisitions; and changes in the fair values of certain warrants and derivatives that, according to GAAP, must be reflected in the statement of operations. The authors also noted exclusions that may not qualify as non-GAAP exclusions under Item 10(e). For example, some companies excluded bad debts and foreign currency losses as part of their non-GAAP measure presentations. In the authors' opinion, such expenses are integral to the operations of a business, and their exclusion cannot be justified for non-GAAP presentations under the SEC guidance. Q&A 102.03 considers these expenses as recurring, frequent, and usual in business. The authors did not note any justification for the exclusion of such expenses in the related management disclosures.

Exclusions at gross or net of taxes. The SEC requires that a company present exclusions either net of tax or present the tax effect in one line of the reconciliation. Nevertheless, companies should disclose how the tax effect was calculated (Q&A 102.11). For example, if a company excludes stock compensation, it should make that exclusion net of the related income tax effect or adjust the tax expense; otherwise, the non-GAAP presentation would not be comparable to other companies presenting the same non-GAAP exclusion and, thus, would be misleading.

In this category, 4 companies had exclusions and reported income tax expenses or benefits. Half reflected these exclusions net of taxes or adjusted the tax amount as an alternative. The other 2 companies did not follow this guidance; they reported exclusions at the gross amount and did not adjust the tax amount accordingly.

The companies that presented EBIT, EBITDA, adjusted EBIT, or adjusted EBITDA were exceptions to the above guidance. Because these companies have already excluded income taxes in their non-GAAP presentations, there would be no benefit in adjusting the income tax effects or presenting the excluded expenses net of taxes. The authors did not note any adequate disclosures discussing how the tax adjustments for exclusions had been calculated.

Auditors' Assurance

In August 2013, the PCAOB issued Release 2013-005, "Proposed Auditing Standards—The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; the Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards" (http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf).

In this release, the PCAOB offered a proposal regarding the auditor's responsibility for other information (such as non-GAAP measures) in certain documents filed with the SEC that contain audited financial statements. This proposed standard establishes requirements regarding the auditor's responsibilities with respect to information other than financial statements.

The proposal states that during the PCAOB's outreach activities, some investors expressed an interest in auditors' knowledge of certain matters that do not fall within the scope of an audit, such as non-GAAP reporting. As drafted, the proposed standard identifies the auditor's responsibilities for other information (non-GAAP measures) in certain documents (Forms 10-K, 10-Q, 8-K) containing audited financial statements, as well as certain types of information that are outside the financial statements but are included or incorporated by reference in annual reports filed under the Securities Exchange Act of 1934. The PCAOB has proposed that the responsibilities of auditors in such matters are as follows:

> The auditor must evaluate whether the information [e.g., non-GAAP information] contains (1) a material inconsistency; (2) a material misstatement of fact; or (3) both.

If auditors determine that the other information contains any of the above, they should request management to revise it. If management does not appropriately revise the other information, auditors should communicate the matter to the audit committee. If the audit committee does not revise the other information, auditors can state this fact in their reports or can decide to withdraw from the engagement (depending upon the circumstances).

PCAOB Board member Jay Hanson indicated in a speech on August 13, 2013—

> The proposed standard does expand the auditor's responsibilities from "read" and "consider" as required under current AU sec. 550, to "evaluate" whether the other information contains (1) a material inconsistency with amounts or information, or the manner of its presentation, in the audited financial statements and/or (2) a material misstatement of fact. The auditor's responsibilities are limited, however, to basing this evaluation on relevant audit evidence obtained, and conclusions reached during the audit. In other words, if the auditor, through the performance of the financial statement audit or audit of internal controls, did not gather information or evidence against which to evaluate the consistency or truthfulness of the "other information," the auditor need not go further. (http://pcaobus.org/News/Speech/Pages/08132013_Hanson.aspx)

Thus, under the proposed standard, auditors have no obligation to perform additional procedures to corroborate the non-GAAP information in a company's press release. If auditors do not find any material inconsistencies or material misstatements, they do not need to specifically address the issue. There have not been any more recent regulatory developments regarding the auditors' assurance on non-GAAP information, and none of the companies within the scope of this survey provided any level of auditors' assurance regarding their non-GAAP presentations.

Recent Developments

On December 10, 2013, the *Wall Street Journal* reported that recent hot technology IPOs have brought more focus to accounting issues and, as a result, the SEC task force has probed use of non-GAAP metrics (Michael Rapoport, "SEC Task Force Probes Use of Non-GAAP Metrics"). David Woodcock, chairman of the SEC's new financial reporting and audit task force confirmed that it was looking at non-GAAP measures.

When speaking at the AICPA National Conference, Woodcock did not mention any specific companies that the task force might be looking at, but his comments indicated that the SEC is looking at these metrics with an eye toward possible enforcement cases. According to the *Wall Street Journal*, Mr. Woodcock, in an interview after his speech, indicated that the SEC task force is particularly interested in cases of mislabeled information—for example, some companies use certain common and well-defined terms to reference their specific performance measures. Technology companies have often used such nonstandard performance measures, which exclude certain expenses (e.g., interest, taxes, depreciation, amortization, and stock compensation) to reflect non-GAAP profit instead of a GAAP loss. Mislabeled information has drawn more attention in recent weeks because several high profile IPO high technology companies have used such non-GAAP measures in their financial statements.

Room for Improvement

It appears that some companies remain reluctant to reflect non-GAAP measurements in their Forms 10-K and 10-Q, despite SEC guidance encouraging them to include relevant non-GAAP measures in all of their SEC fillings. In addition, some companies do not adjust the denominator of EPS for the exclusion of stock compensation, and other companies do not properly adjust the exclusions for the effects of income taxes. These two examples create a lack of consistency and comparability among registrants who report non-GAAP measures.

In the authors' analysis, companies generally did not provide robust disclosures of the reasons why they presented non-GAAP measures or the nature of their exclusions (i.e., why they are useful and how they should be used). Most of the disclosures were generic explanations lacking any real justification of the non-GAAP presentation. Furthermore, there was not adequate disclosure discussing how the tax adjustments for exclusions had been calculated.

Companies were generally compliant with the SEC guidance regarding the fundamental presentation of their non-GAAP measures in their SEC filings; however, some of the websites and investors' communications did not provide for proper reconciliations for non-GAAP measures, and their presentations did not ensure that non-GAAP presentations were not given undue prominence. In several instances, companies cited non-GAAP measures that excluded normal expenses necessary to operate a business (such as bad debt expenses and foreign currency losses). ❑

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