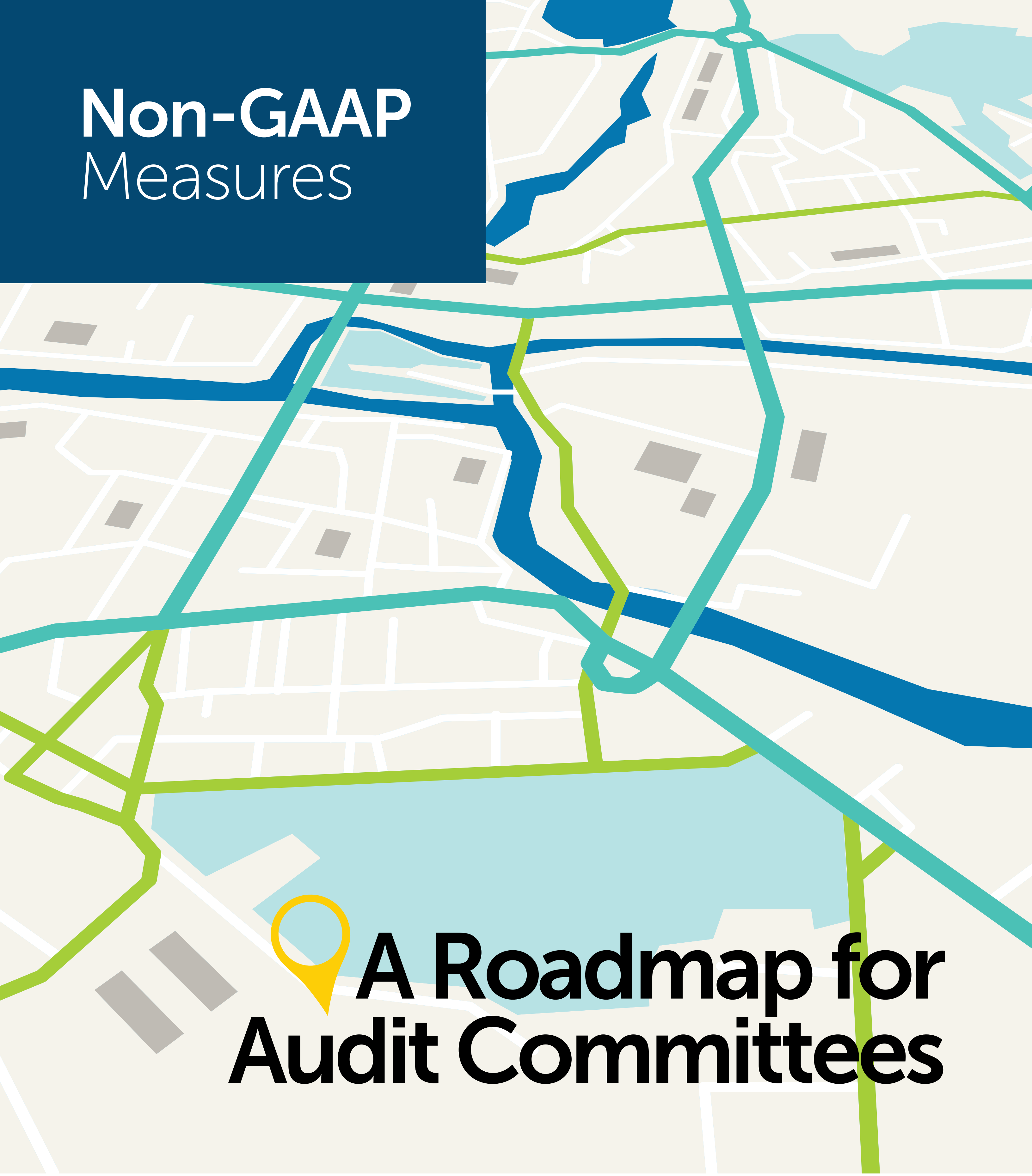
Non-GAAP Measures



A Roadmap for Audit Committees

CENTER FOR AUDIT QUALITY

MARCH 2018

Contents

Introduction

Investors have confidence in financial statements in part because of their consistency, reliability, relevance, and comparability. US Generally Accepted Accounting Principles (GAAP) provide the framework that supports these characteristics; however, investors also value certain non-GAAP financial measures and believe that, when presented appropriately, non-GAAP financial measures can provide additional insight into a company's results of operations, financial position, or liquidity.

Although long the subject of debate—even controversy—the use of non-GAAP financial measures has been a top focus of securities regulators over the years. The US Securities and Exchange Commission (SEC) staff issued guidance specific to the presentation of non-GAAP financial measures in filings and other company communications to investors.[1] Non-GAAP financial measures are explicitly defined by SEC regulations, and not all non-GAAP measures presented by companies will meet the SEC definition of a non-GAAP financial measure.[2] At the December 2017 AICPA Conference on Current SEC and PCAOB Developments, SEC staff members indicated that the SEC was seeing improvements in the presentation of non-GAAP financial measures but urged companies to continue their improvement efforts.[3]

Non-GAAP measures that are transparent, calculated consistently, and comparable to measures disclosed by other companies can help provide users with useful information.[4] Consistent with its mission to convene and collaborate with stakeholders to advance the discussion of critical issues, the Center for Audit Quality (CAQ) has fostered dialogue around this critical topic.[5] This publication summarizes common themes that emerged from a series of 2017 roundtable discussions regarding the presentation and use of non-GAAP measures—and the opportunities to enhance trust and confidence in this information.

GAAP, Non-GAAP, and KPIs: Distinctions That Matter

In this publication, we will use the term *non-GAAP measures* to refer to both non-GAAP financial measures as defined by the SEC and key performance indicators (KPIs) collectively. KPIs can be data points—such as number of stores or customers—or metrics calculated using GAAP amounts and a data point, such as sales per square foot.

The distinctions among GAAP measures, non-GAAP financial measures, and KPIs are important because each type has a different level of subjectivity, and different rules govern each type of measure.

While KPIs are not considered non-GAAP financial measures and are not directly subject to the rules and interpretations discussed in this report, SEC staff has indicated that companies should provide certain disclosures about them, many of which are similar to those a company would provide for non-GAAP financial measures.

We hope that the following "roadmap" will support audit committees in advancing their oversight of and involvement with non-GAAP measures. We also hope that enhancing audit committee oversight and involvement will lead to more transparency and consistency and that it will promote a greater understanding of all stakeholders' roles relative to non-GAAP measures.

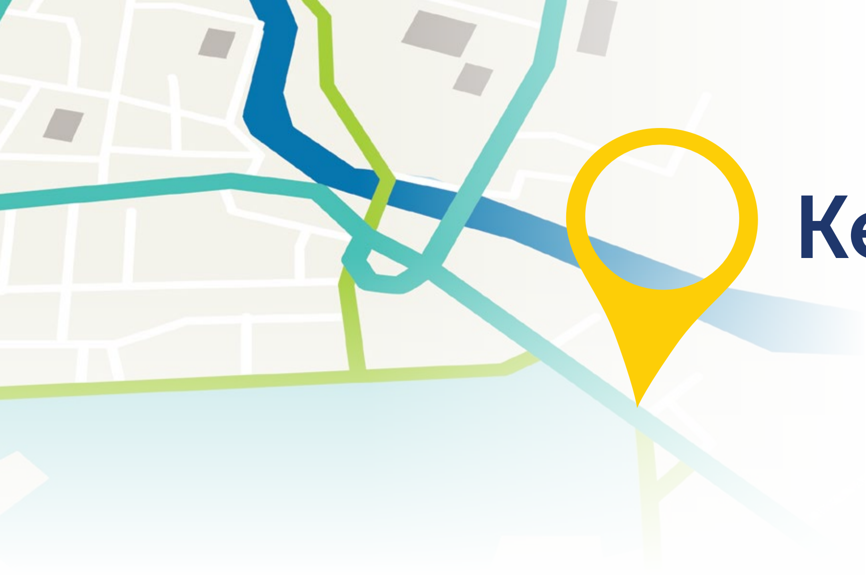
1 In May 2016, the SEC staff updated its compliance and disclosure interpretations (C&DIs).

2 SEC Item 10(e)(2) of Regulation S-K, 17 C.F.R. 229.10(e)(2) and Item 101 of Regulation G, 17 C.F.R. 244.101 define a non-GAAP financial measure as a numerical measure of a registrant's historical or future financial performance, financial position, or cash flow that (1) excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet, or statement of cash flows (or equivalent statements) of the issuer; or (2) includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented. The SEC rules applicable to non-GAAP disclosures include Regulation G and Item 10(e) of Regulation S-K.

3 BDO Center for Corporate Governance and Financial Reporting, *2017 Audit Committee Round-Up; Focal Points, Tools & Resources*, 14.

4 In June 2016, the CAQ released *Questions on Non-GAAP Measures: A Tool for Audit Committees.*

5 In December 2016, the CAQ released *Non-GAAP Financial Measures: Continuing the Conversation*.



Key Themes from the CAQ's 2017 Roundtables

In 2017, the CAQ hosted three roundtable discussions to explore the perspectives of various stakeholders on non-GAAP financial measures. While the focus of the roundtables were those metrics that meet the SEC's definition of a non-GAAP financial measure, attendees also discussed similar concepts related to KPIs.[6]

Each roundtable was attended by approximately 20 to 25 individuals including audit committee members, management, investors, securities lawyers, and public company auditors.[7] Because the presentation and use of non-GAAP measures can vary from industry to industry, each roundtable focused on a specific industry: pharmaceutical, real estate, and technology. This format acknowledged that different non-GAAP measures are more prevalent or meaningful depending on the industry.

With a variety of stakeholders present—including those who prepare, oversee, and use non-GAAP measures—the roundtables explored:

- why management discloses non-GAAP measures;
- how management approaches preparing and presenting non-GAAP measures;
- how audit committees oversee that process;
- how investors and others use non-GAAP measures; and
- what, if anything, could be done to enhance trust and confidence in non-GAAP measures.

From these roundtables, broad, shared themes coalesced regarding why the information is presented and how non-GAAP measures are used. It was clear that audit committees across sectors engage in discussions about non-GAAP measures with company management and, to some extent, with their external auditors. More importantly, the challenges non-GAAP measures present—and the opportunities for ways to approach improving trust and confidence in these measures—were also consistent across industries.

WHY COMPANIES PRESENT NON-GAAP MEASURES

Participants were asked to share their views on what drives the presentation and use of non-GAAP measures. Although participants cited a variety of drivers for presenting and using non-GAAP measures, common themes emerged from the discussion:

- **Demand from investment analysts**: Participants shared that requests from investment analysts are often a primary reason company management chooses to present a non-GAAP measure. Investment analysts find that non-GAAP measures help them better understand the company's underlying business performance or forecast the company's long-term value in their proprietary models.
- **Desire to tell the company's story**: Participants also acknowledged, however, that company management does not present non-GAAP measures solely for investment analysts; rather, management views the use of non-GAAP measures as a tool to help tell a

6 See CAQ, *Questions on Non-GAAP Measures: A Tool for Audit Committees*, 12, and CAQ, *Non-GAAP Financial Measures: Continuing the Conversation* for a discussion of GAAP, non-GAAP, and KPIs.

7 See the appendix for a list of participants at each roundtable.

company's story and provide users of the information with insight into how management evaluates company performance internally. In some cases, non-GAAP measures are also an input into how the company compensates employees for company performance.

WHY GAAP IS A BASELINE

Roundtable participants discussed whether the presentation and the use of non-GAAP measures are an indication that changes should be made to GAAP. The following were key points of agreement:

- Participants shared that while they find non-GAAP measures to be useful, they still view the GAAP information as the "bedrock" or "starting point" for the financial information that companies present. GAAP, they said, provides a useful baseline that offers comparability from one company to the next.
- Some participants expressed their belief that some improvements in GAAP reporting could reduce the number of non-GAAP measures companies present.

CHALLENGES RELATED TO NON-GAAP MEASURES

Participants acknowledged that non-GAAP measures present challenges to certain stakeholders in the financial reporting supply chain.

- **Investors** are challenged by the lack of consistency in the calculation of non-GAAP measures from one company to the next; such irregularity makes it difficult for non-GAAP measures to be compared across companies—even within the same industry. It also can be a challenge for end-users to know whether the performance reported by the press is a GAAP measure or a non-GAAP measure.
- **Management** representatives indicated that they spend a significant amount of time (1) discussing what information to include in or exclude from non-GAAP measures they present, and (2) making sure the information is presented fairly and disclosed transparently.
- **Audit committees** noted that their challenges related to non-GAAP measures tend to be an extension of management's challenges. Audit committees want to understand the reason the company is presenting the measure, and the roles and responsibilities of those involved with the information, including company personnel (e.g., finance and internal audit) and the external auditor. Further, they want to know how the company's non-GAAP measures compare with the information presented by peer companies.

Participants shared that while they find non-GAAP measures to be useful, they still view the GAAP information as the "bedrock" or "starting point" for the financial information that companies present.

- Participants also noted that some companies use non-GAAP measures as an **input into determining incentive compensation**. In these instances, it is even more important that audit committees or compensation committees be closely involved with non-GAAP measures to mitigate potential risks related to the metrics that affect compensation.

STANDARDIZATION OF NON-GAAP MEASURES

Currently, the real estate industry makes use of a supplemental standardized non-GAAP measure: funds from operations (FFO). The FFO measure, which was defined by Nareit,[8] is in widespread use and is recognized by the SEC.[9] Nevertheless, representatives from management in all roundtables indicated that standardization may limit their ability to tell their companies' story, and there did not seem to be strong support for standardization from other sectors, although the real estate investment trust (REIT) industry has benefited from standardizing certain measures. While investors would like more consistency from company to company, they noted that they

8 Nareit is the worldwide representative voice for REITs and for publicly traded real estate companies with an interest in US real estate and capital markets.

9 The SEC has recognized Nareit FFO as a standardized non-GAAP measure for the real estate industry in footnote 50 to the Exchange Act Release No. 47226, *Conditions for Use of Non-GAAP Financial Measures*. The SEC reaffirmed this position in Question 102.01 of SEC Compliance and Disclosure Interpretations on non-GAAP measures.

recognize that standardization is likely not possible and advocated for more transparent disclosure instead of standardization.

IMPORTANCE OF NON-GAAP AS A COMMUNICATION TOOL

Participants shared that management uses non-GAAP measures as a form of communication. These measures often help companies communicate their overall company strategy. Participants noted that company management does not want to be misleading in its communications and would not want its presentation of non-GAAP measures to give the appearance of "cherry picking" or "earnings management." Consequently, company management spends a significant amount of time discussing, among themselves and with the audit committee non-GAAP measures that are being presented by the company; in some cases, management spends more time discussing non-GAAP measures than GAAP measures. Several company management representatives noted that they had set up policies, procedures, and controls to support preparing and presenting non-GAAP measures.

Some participants acknowledged that companies present certain non-GAAP measures because investment analysts ask for them or because investment analysts covering that industry have general expectations that they will be presented. However, other participants noted they had stopped presenting certain expected metrics or adjustments because they do not believe those metrics or adjustments reflect how they evaluate their company's performance. In these instances, company management communicated its rationale for no longer including the information, and subsequently ceased to present that non-GAAP measure or adjustment after a certain number of periods. Participants noted that because of the upfront dialogue between company management and investment analysts, these changes did not affect the investment analysts' assessment of the company.

There was consensus among participants that audit committees can promote rigor related to non-GAAP measures by having a dialogue with company management as well as internal and external auditors.

ADDRESSING JUDGMENT THROUGH DIALOGUE

Participants emphasized the significant judgment involved in determining how to treat a one-time transaction or event in non-GAAP measures, and they agreed that company management and audit committees strive to execute good judgment when making these decisions. To that end, many companies have enhanced the rigor of their presentation and disclosure of these metrics.

There was consensus among participants that audit committees can promote rigor related to non-GAAP measures by having a dialogue with company management as well as internal and external auditors. The purpose of this dialogue would be for the audit committee to set clear expectations regarding the roles and responsibilities—relative to non-GAAP measures—of each member of the financial reporting supply chain. Many of the overarching principles related to the importance of policies, controls, and enhanced oversight by the audit committee apply to non-GAAP measures.

RECOGNIZING THE VITAL ROLE OF AUDIT COMMITTEE OVERSIGHT

The roundtables made apparent that despite the difficulties that non-GAAP measures can create, the benefits of presenting this information far exceed these challenges. Representatives from management unanimously recognized the benefits of increased audit committee oversight and involvement with non-GAAP measures. There was also agreement that a non-GAAP measure that meets the following criteria (in addition to the requirements in applicable SEC rules) is generally useful:

- It is calculated and presented consistently.
- It is transparently disclosed.
- It is comparable to measures disclosed by other companies.

A Non-GAAP Roadmap for Audit Committees

The audit committee has an important responsibility on behalf of company shareholders to oversee the financial reporting process and external audit. Given its role, the audit committee can act as a bridge between management and investors, and it can assess management's reasons for presenting non-GAAP measures and evaluate the sufficiency of the related disclosures. The audit committee can determine whether the measures present a fair and balanced view of the company's performance.

IDENTIFY KEY DISCUSSION TOPICS

Discussions between management and the audit committee could result in the audit committee being more confident that non-GAAP measures present a balanced representation of the company's performance. An audit committee may consider a possible roadmap of topics for discussion, including the following:

- **Putting itself in the investors' shoes** when evaluating if the presented non-GAAP measures and related disclosures align with the company's overall strategy and performance.
- **Engaging with investors directly or through investor relations** to ensure that the presented non-GAAP measures aid investors' understanding of the company's performance.
- **Asking management whether it has an internal policy** that provides guidelines for determining how non-GAAP measures are generated, calculated, and presented, including the rationale for the measures and adjustments that it presents and excludes. If there is no policy, encourage management to create one.
- **Discussing with management how the company makes changes to non-GAAP measures it presents**, and the rationale for why it would or would not make changes.
- **Seeking the perspective of counsel** on non-GAAP measures.
- **Asking the company to compare or benchmark** its non-GAAP measures to those of its peers.
- **Finding out what disclosure controls and procedures are in place** as they relate to the information that is presented and disclosed.
- **Asking the external auditors what their responsibilities are for non-GAAP measures**, and whether that responsibility is different depending on where non-GAAP measures are presented.
- **Asking the external auditors for perspectives** on how non-GAAP measures that the company presents generally compare with those of other companies.
- **Discussing with the external auditors what their views are on the company's non-GAAP measures,** including whether the measures are consistent with the auditors' understanding and knowledge of the company's performance.

UNDERSTAND THE EXTERNAL AUDITOR'S ROLE REGARDING NON-GAAP MEASURES

The external auditor's opinions on the company's financial statements and, when required, the effectiveness of the company's internal control over financial reporting (ICFR) do not cover non-GAAP measures. Non-GAAP measures are often included in other areas of a company's annual and quarterly reports that contain the financial statements. If that is the case, the professional auditing standards indicate that the auditor should read non-GAAP measures presented in certain documents containing the financial statements (such as annual and quarterly reports) and consider whether non-GAAP measures or the manner of their presentation is materially inconsistent with information appearing in the financial statements or a material misstatement of fact.[10]

Though external auditors do not audit non-GAAP measures as part of the financial statement or ICFR audits, audit committees and management may consider leveraging the external auditors as a resource when evaluating non-GAAP measures. Separate from the financial statement and ICFR audits, external auditors may be engaged to perform certain procedures related to non-GAAP measures. Although the procedures the external auditor can perform for non-GAAP measures are limited, they could include testing certain controls related to the preparation and disclosure of non-GAAP measures in accordance with the company's policies, and reporting results to the audit committee. External auditors may be able to address audit committees' concerns related to non-GAAP measures and to increase the trust and confidence in those measures.

Although the procedures the external auditor can perform for non-GAAP measures are limited, they could include testing certain controls related to the preparation and disclosure of non-GAAP measures in accordance with the company's policies, and reporting results to the audit committee.

ADOPT LEADING PRACTICES

Discussions at each roundtable highlighted some leading practices that several companies have instituted to support the presentation of high-quality non-GAAP measures (that is, those that represent a balanced view of the company's performance):

- **Disclosure controls**: Participants generally agreed that non-GAAP measures should be subject to robust disclosure controls. Establishing disclosure controls specific to non-GAAP measures could enable companies to mitigate risks and support sound decision making about their reporting. The disclosure controls should be documented and robust enough to facilitate testing of the controls. Participants emphasized that such disclosure controls could drive more consistency and transparency into preparation and presentation of non-GAAP measures.

- **Non-GAAP policies**: Management representatives shared that they have established policies that provide a set of guidelines to follow when preparing and presenting non-GAAP measures. These policies can help in making decisions on the treatment of new transactions or events within non-GAAP measures that the company presents. Also, having policies in place can help promote consistency in the measures that are presented and the way they are calculated. While not all companies have the same policies, participants cited having non-GAAP policies as a valuable tool to ground discussions and decisions related to non-GAAP measures.

- **Audit committee disclosure**: Few, if any, companies currently disclose their non-GAAP policies. There was no consensus regarding whether disclosure of the company's non-GAAP policies—or simply disclosing that the company has a non-GAAP policy—would be a good practice. However, given the current regulatory environment and the fact that non-GAAP measures are important to investors and are central to their decision making, there could be benefits to an audit committee voluntarily disclosing that the company has non-GAAP policies (but not necessarily the relevant details of those policies). Such disclosure could demonstrate to investors the importance of this information to the audit committee and that policies are in place to support the metrics being consistent, transparent, and comparable.

10 See PCAOB Auditing Standard 2710: Other Information in Documents Containing Audited Financial Statements.

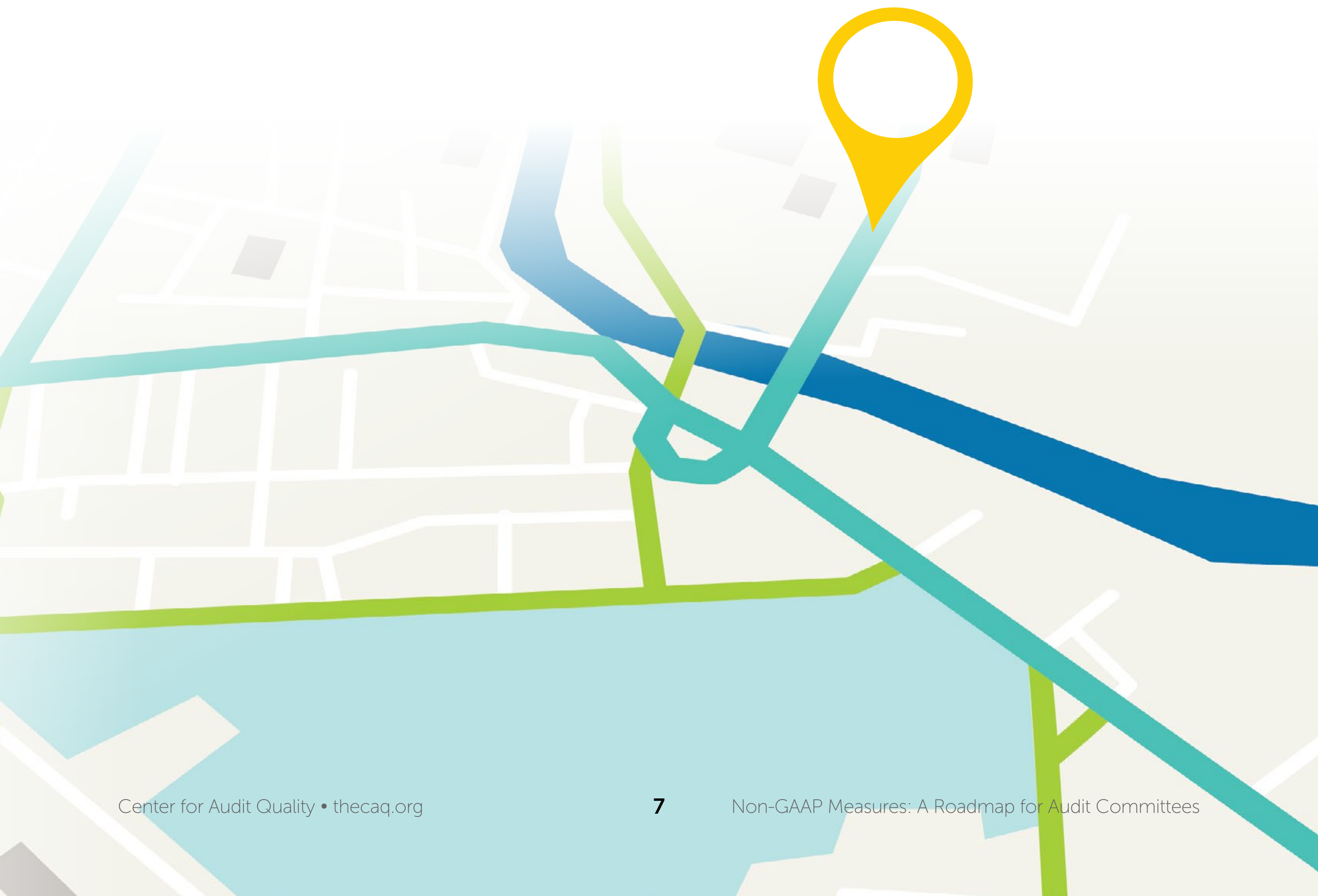
Conclusion

By sharing the themes learned from our non-GAAP roundtables, the CAQ aims to share leading practices and to provide a roadmap to audit committees that will enhance their oversight of and involvement with non-GAAP measures.

While there is no one-size-fits-all approach to improving or maintaining trust and confidence in non-GAAP measures, audit committees nevertheless have an important role to play. Through oversight and ongoing dialogue with other key stakeholders, audit committees can set expectations regarding the roles and responsibilities of management and others as they relate to non-GAAP measures. When circumstances warrant, to increase confidence in non-GAAP measures, audit committees may engage external auditors to perform certain procedures related to these measures. For example, audit committees may have an appetite for increased auditor engagement with non-GAAP measures when they affect compensation; in other instances, audit committees may simply ask their auditors for perspective.

The roundtables have reinforced the CAQ's view that non-GAAP measures that are presented in compliance with the applicable SEC rules and that are transparent, calculated consistently, and comparable across companies can help investors and other users understand a company's results of operations, financial position, or liquidity. Greater awareness and discussion of non-GAAP measures by audit committees will contribute to high-quality reporting that meets the needs of its users.

All stakeholders in the financial reporting process can benefit from understanding how companies approach the preparation and presentation of non-GAAP measures and the external auditor's responsibility related to that information. The CAQ looks forward to continuing to monitor and engage on this important topic with our members in the public company auditing profession and with the multitude of stakeholders who have graciously shared their valuable experience and insight at these roundtables.



Appendix: Roundtable Participants

The CAQ would like to extend a special thank you to **Keith Higgins**, Chair of the Securities and Governance Practice at Ropes & Gray LLP, who served as the moderator for each roundtable and whose counsel and assistance was instrumental to the success of this effort.

The CAQ would like to thank the following individuals who generously shared their time and insight.

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