# Coming to Terms with Short-Termism: Implications for Fraud

## July 7, 2016

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1.5
Skill Specific

# Today's Program

## Goals of the program

- Explore how to improve the balance and identify ways to mitigate the risks of short-termism
- Discuss what successful companies do to reinforce the alignment between seemingly conflicting goals
- Provide actionable recommendations that each supply chain member can implement in their organizations

# Panelists

**Douglas Chia**
Executive Director
The Conference Board Governance Center

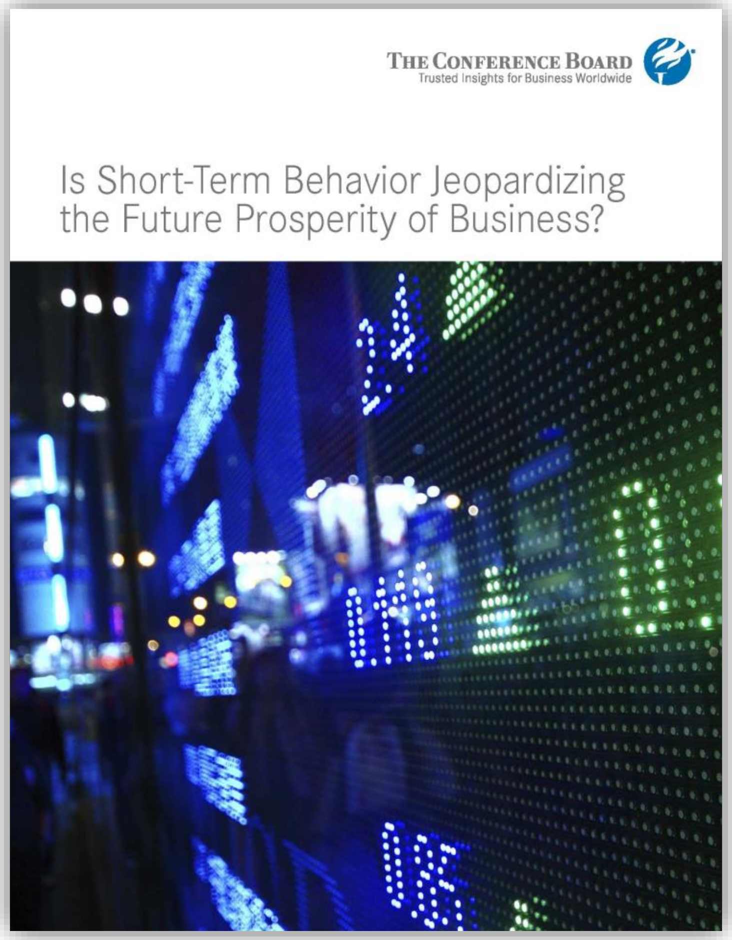
**Karen Horn**
Chairman
National Association of Corporate Directors

**Bill McCracken**
President
Executive Consulting Group

**Jose Rodriguez**
Partner
KPMG LLP

# Moderator

**Cindy Fornelli**
Executive Director
Center for Audit Quality


THE CONFERENCE BOARD
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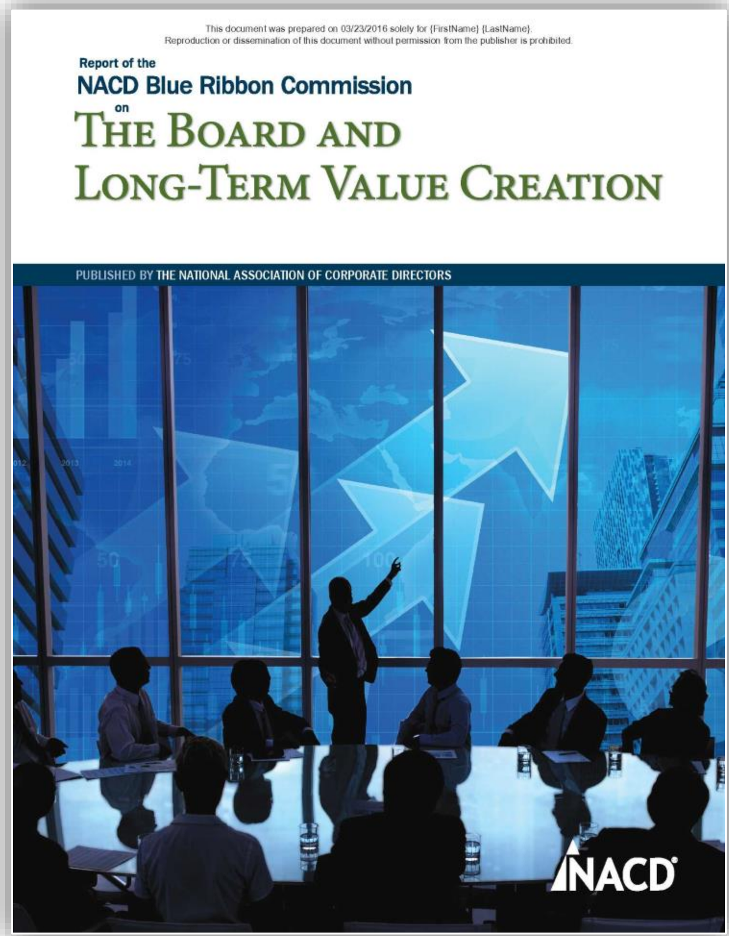
Is Short-Term Behavior Jeopardizing the Future Prosperity of Business?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on
THE BOARD AND LONG-TERM VALUE CREATION
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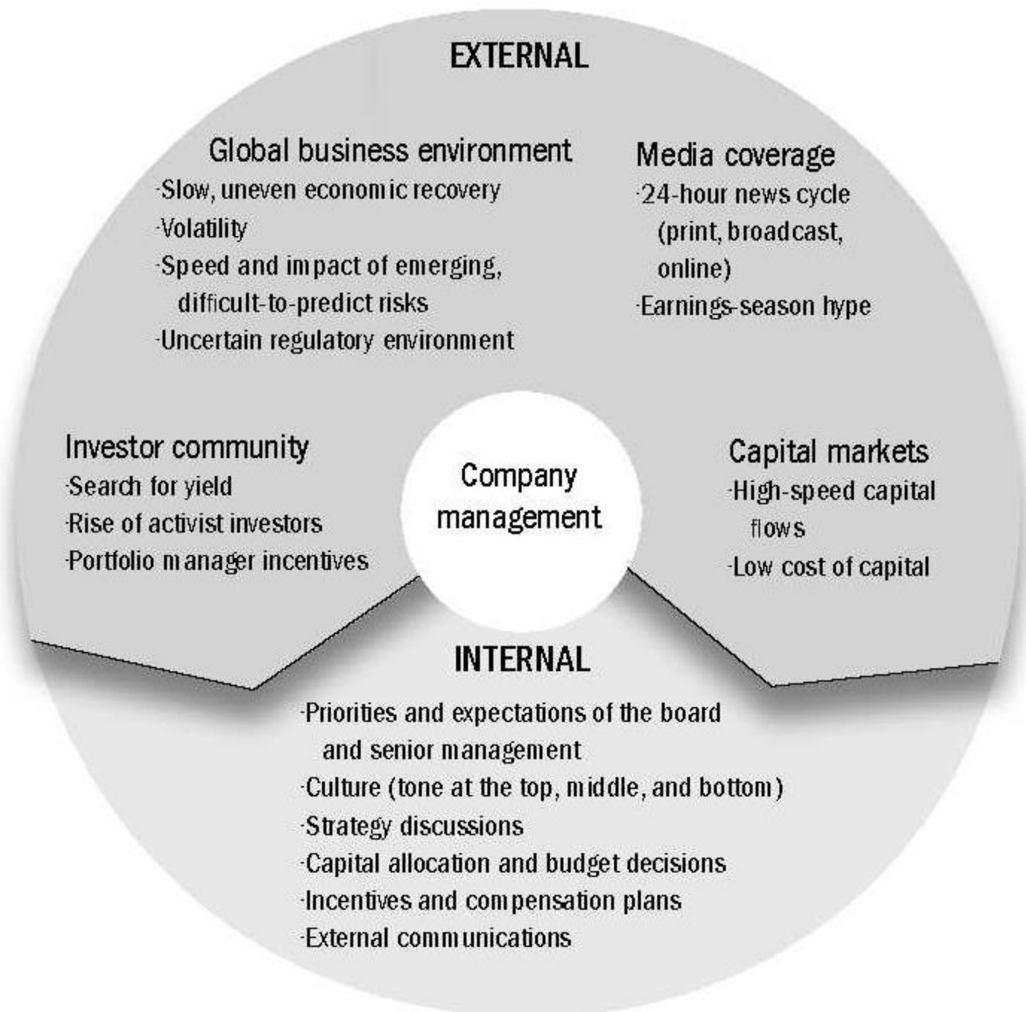
NACD

# Sources of Short-Term Pressures



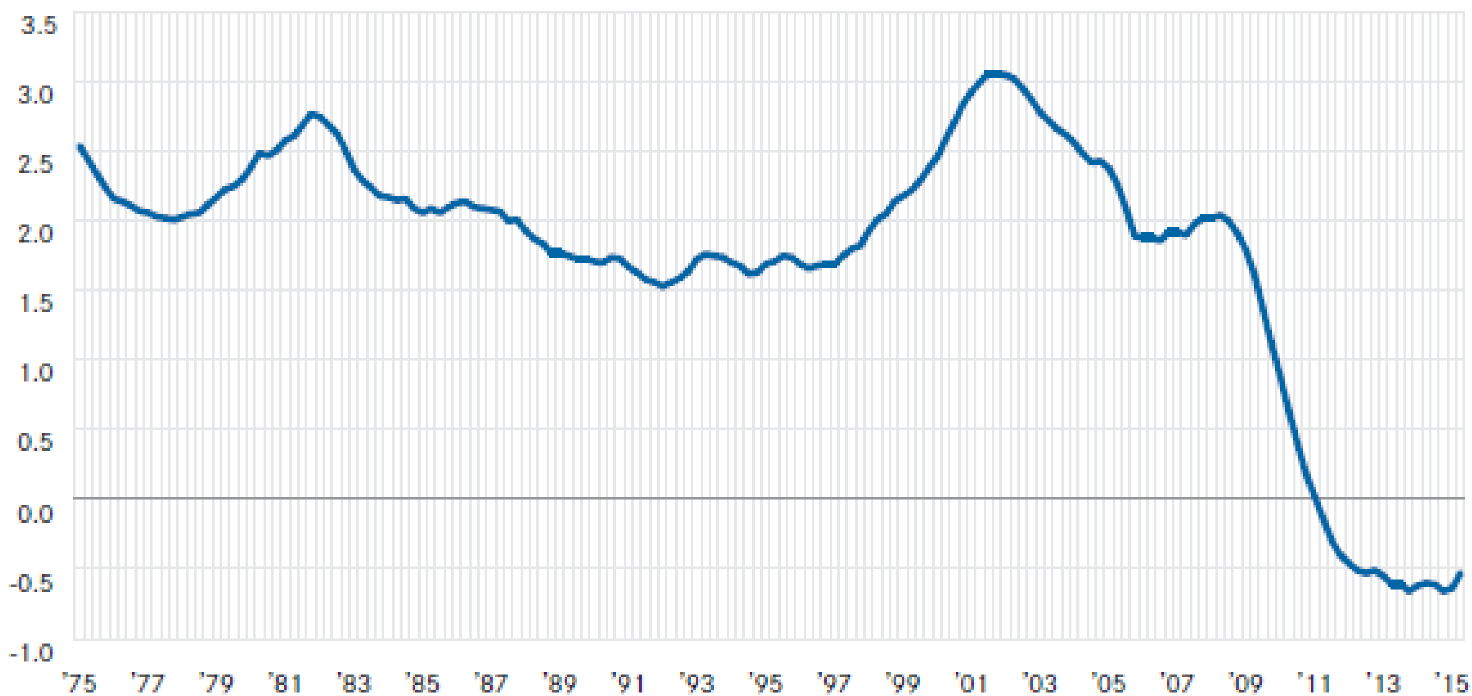

Source: *The Board and Long-Term Value Creation,* NACD Blue Ribbon Commission. 2015

# Decline in Business Investment

Chart 1

**Decline in business investment**

(as measured by the 10-year moving average in the financing gap as a share of gross value added in the nonfinancial corporate sector)




Note: The financing gap is equal to capital expenditures less the sum of the internal funds in the nonfinancial corporate sector.

*Sources:* Federal Reserve Board: Flow of Funds, Bureau of Economic Analysis

*Source: Is Short-Term Behavior Jeopardizing the Future Prosperity of Business?* The Conference Board. 2015.

# Non-GAAP: The Current Confusion

- Definition of non-GAAP in its current context

  *Non-GAAP measures adjust their GAAP counterparts in some fashion. In contrast, "other metrics" are data points—like the number of stores or customers—or metrics calculated using GAAP amounts and a data point (e.g., sales per square foot) that might provide insight into the strategy and future growth of the business.*

- Non-GAAP financial measures

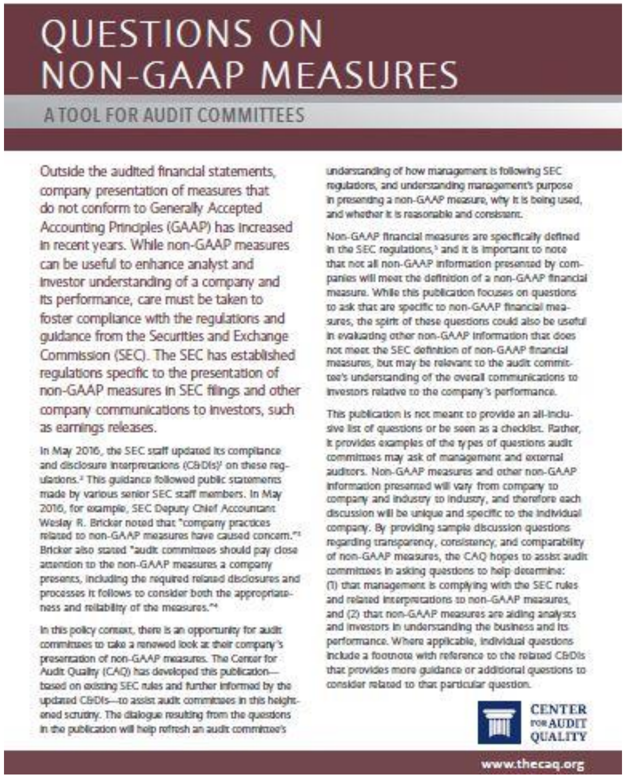
  EBITDA, Adjusted EBITDA, Adjusted EPS, Constant Currency

- Other non-GAAP metrics

  Same store sales; average revenue per customer, sales per square foot

# Non-GAAP: The Current Confusion

- Expectation gap: audited vs. non-audited information
- New tool for audit committee members:



QUESTIONS ON NON-GAAP MEASURES

A TOOL FOR AUDIT COMMITTEES

Outside the audited financial statements, company presentation of measures that do not conform to Generally Accepted Accounting Principles (GAAP) has increased in recent years. While non-GAAP measures can be useful to enhance analyst and investor understanding of a company and its performance, care must be taken to foster compliance with the regulations and guidance from the Securities and Exchange Commission (SEC). The SEC has established regulations specific to the presentation of non-GAAP measures in SEC filings and other company communications to investors, such as earnings releases.

In May 2016, the SEC staff updated its compliance and disclosure interpretations (C&DIs)[1] on these regulations.[2] This guidance followed public statements made by various senior SEC staff members. In May 2016, for example, SEC Deputy Chief Accountant Wesley R. Bricker noted that "company practices related to non-GAAP measures have caused concern."[3] Bricker also stated "audit committees should pay close attention to the non-GAAP measures a company presents, including the required related disclosures and processes it follows to consider both the appropriateness and reliability of the measures."[4]

In this policy context, there is an opportunity for audit committees to take a renewed look at their company's presentation of non-GAAP measures. The Center for Audit Quality (CAQ) has developed this publication—based on existing SEC rules and further informed by the updated C&DIs—to assist audit committees in this heightened scrutiny. The dialogue resulting from the questions in the publication will help refresh an audit committee's understanding of how management is following SEC regulations, and understanding management's purpose in presenting a non-GAAP measure, why it is being used, and whether it is reasonable and consistent.

Non-GAAP financial measures are specifically defined in the SEC regulations,[5] and it is important to note that not all non-GAAP information presented by companies will meet the definition of a non-GAAP financial measure. While this publication focuses on questions to ask that are specific to non-GAAP financial measures, the spirit of these questions could also be useful in evaluating other non-GAAP information that does not meet the SEC definition of non-GAAP financial measures, but may be relevant to the audit committee's understanding of the overall communications to investors relative to the company's performance.

This publication is not meant to provide an all-inclusive list of questions or be seen as a checklist. Rather, it provides examples of the types of questions audit committees may ask of management and external auditors. Non-GAAP measures and other non-GAAP information presented will vary from company to company and industry to industry, and therefore each discussion will be unique and specific to the individual company. By providing sample discussion questions regarding transparency, consistency, and comparability of non-GAAP measures, the CAQ hopes to assist audit committees in asking questions to help determine: (1) that management is complying with the SEC rules and related interpretations to non-GAAP measures, and (2) that non-GAAP measures are aiding analysts and investors in understanding the business and its performance. Where applicable, individual questions include a footnote with reference to the related C&DIs that provides more guidance or additional questions to consider related to that particular question.

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# Warning Signs of Short-Termism

- Infrequent boardroom discussions about future-oriented topics
- Compensation for key executives does not include incentives for long-term performance
- High turnover in the C-suite
- Declines in investments in R&D
- Push for dividends or stock buybacks

# Strategies for Curbing Short-Termism

- Understand the business model
- Do capital allocation decisions support long-term strategies
- Portion of executive compensation plans based on long-term goals
- Emphasize to investors the connection between long-term strategies and short- and mid-term actions
- Consider offering extra dividends or enhanced voting rights to reward long-term investors
- Move away from quarterly earnings guidance

# Key Takeaways

- Get on offense, and be prepared
- Maintain a sharp focus on tone and transparency
- Avoid over-emphasis from the top about meeting quarterly expectations
- Culture drives behavior

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