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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TRANSPARENCY

Non-GAAP measures should be presented to supplement the GAAP measures, and their purpose and calculation should be clear to investors. Non-GAAP measures included in filings with the SEC (e.g., Forms 10-K, 10-Q), or furnished to the SEC (e.g., press releases) should be clearly labeled as non-GAAP and not given any more prominence than their closest GAAP measures.[6] Non-GAAP measures should supplement, not supplant, the GAAP measures. The following questions may help audit committees address the transparency of the company's non-GAAP disclosures or whether improvement may be needed.

1 What is the purpose of the non-GAAP measure? Would a reasonable investor be misled by the information?

2 Has the non-GAAP measure been given more prominence than the most directly comparable GAAP measure? For example, an earnings release headline or caption that may present a non-GAAP measure without the comparable GAAP measure.[7]

3 How many non-GAAP measures have been presented? Is this necessary and appropriate for investors to understand performance?

4 Why has management selected this particular non-GAAP measure to supplement GAAP measures that are already established and consistently applied within its industry or across industries?

5 Does the company's disclosure provide substantive detail on the purpose and usefulness of the non-GAAP disclosure for investors?

6 How is the non-GAAP measure calculated? Does the disclosure clearly and adequately describe the calculation, as well as the reconciling items between the GAAP and non-GAAP measure?

7 How does management use the measure, and has that been disclosed? For example, is the measure linked to executive compensation?

8 Is the non-GAAP measure sufficiently defined and clearly labeled as non-GAAP? Could the title or description of the measure be confused with a GAAP measure?

9 Are any of the "per-share" non-GAAP measures in substance per-share non-GAAP liquidity measures, which are prohibited, or could they be used as liquidity measures even if disclosed as a performance measure?[8]

10 What are the tax implications of the non-GAAP measure? Does the calculation align with the tax consequences and the nature of the measure (i.e., performance vs. liquidity)?[9]

11 Does the company have material agreements, like a debt covenant, that require compliance with a non-GAAP measure? Does the company disclose that?[10]

CONSISTENCY

According to a 2014 survey conducted by the University of Washington and the University of Georgia, 27 percent of companies disclosed non-GAAP earnings that excluded one-time losses but did not report adjusted figures for one-time gains.[11] Audit committees should consider asking questions of management to determine whether non-GAAP measures are consistent indicators that provide accurate insight into a company's performance—and not calculations solely aimed at showing the company in a favorable light.

1 Are the non-GAAP measures presented by the company balanced? Do the measures eliminate similar items that affect both revenue and expense, or do they only eliminate one or the other?

2 Has the company presented this measure before? Has the company stopped presenting certain measures?

3 Has the method or nature of the inputs to the calculation changed since the last time presented? If so, why and have the comparable periods been revised consistently?

4 If the calculation has changed, are the changes adequately described? Is there a need to revise prior period measures for consistency and to avoid a potentially misleading presentation? Would they have been materially different such that the prior period calculations should be revised?[12]

5 Is there a correlation between what the measure presents, and the company's actual results? For example, if a non-GAAP measure presents positive growth, does that correlate with the GAAP results of the company? If not, have those differences been clearly communicated to investors?

6 Have items characterized as nonrecurring, infrequent, or unusual occurred in the past two years? Are these items not reasonably likely to recur again in the next two years?[13]

COMPARABILITY

There is no authoritative framework that defines the calculation of each non-GAAP measure. This enables the non-GAAP measure calculations to be tailored from one company to the next. The more tailored the calculation, the less comparable the measure may be across an industry. The less comparable the measure, the more confusing it may be to investors. Audit committees could consider asking the following questions to promote comparability of the non-GAAP measures presented.

1 Do other companies present this measure or similar measures? If not, why is this measure important for this company but not its peers?

2 Is management aware of differences in their calculation compared to other companies? Why are the calculations different?

3 If there are differences from peers, is the disclosure transparent about how the measure is calculated differently than peers?

4 Have any industry groups defined standard calculations that companies within the industry could follow in order to present more comparable measures to investors?

OTHER IMPORTANT QUESTIONS

Several procedural questions apply to all three categories—transparency, consistency, and comparability—set forth above.

1 Who in management is responsible for the oversight of non-GAAP measures? Does management maintain a policy on non-GAAP measures? Does that policy address the calculation, presentation, and disclosure of these measures?

2 Has the disclosure committee reviewed the non-GAAP measures?

3 What is the source of the information used in the calculation? Are there adequate controls and oversight in place over both the calculation and disclosure of the measure?[14]

4 How has management involved legal counsel on presentation and usage of non-GAAP measures and their compliance with SEC regulations?

5 Has management monitored SEC speeches and comment letters regarding non-GAAP measures and considered those in making its own presentation?

6 Is management aware of any others in the industry who have received an SEC comment letter about a particular non-GAAP measure, and, if so, have they considered that in reference to their disclosures as applicable?

7 Has internal audit been involved with non-GAAP measures? What feedback have they given management?

THE AUDITOR'S ROLE

SEC rules prohibit the presentation of these measures in the audited financial statements on which the auditor provides an opinion. However, they are often included in other areas of the annual and quarterly filings, such as in Management's Discussion and Analysis. Public Company Accounting Oversight Board (PCAOB) standards require auditors to read and consider other information included in documents that contain annual or interim financial statements. The rules refer to this additional information as "other information." According to current PCAOB standards, the auditor is required to read the other information for material inconsistency with the financial statements, but is not required to perform any other procedures over this information in situations where no inconsistencies are identified. Non-GAAP information is also presented in information not filed with SEC for which the auditor has no responsibility (e.g., press releases, earnings presentations).

The auditor's role with company performance measures, including non-GAAP measures, under current PCAOB standards was a topic of conversation at the PCAOB's Standing Advisory Group (SAG) meeting in May 2016.[15] This discussion highlighted that some users may have a misunderstanding about the level of auditor involvement with non-GAAP measures. It was noted that in certain situations, at the direction of the audit committee or management, auditors may perform additional procedures over these measures.

As such, audit committees should ask the following: What level of involvement do the auditors have with the company's non-GAAP measures? What feedback have they given management?

CONCLUSION

These questions are meant to spark a dialogue among audit committees, management, and auditors on the non-GAAP measures presented by companies. While no one question is a silver bullet, collectively they can assist audit committees in assessing whether the information presented to investors is meaningful and not confusing or misleading.

APPENDIX: DEFINITIONS

COMPANY PERFORMANCE METRICS

These metrics consist of non-GAAP financial and other metrics and information presented by companies in their SEC filings, press releases, conference calls, and other information distributed by the company.

NON-GAAP FINANCIAL MEASURES

The SEC defines a non-GAAP financial measure, often referred to as a non-GAAP measure, as a numerical measure of a registrant's historical or future financial performance, financial position, or cash flow that (i) 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 (ii) 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.[16] A common example might be earnings before interest, taxes, depreciation and amortization (EBITDA).

As previously noted, the SEC recognizes that the use of non-GAAP financial measures may be useful to investors and has established regulations specific to the presentation of non-GAAP financial measures in SEC filings and other company communications to investors, such as earnings releases. The spirit of these regulations is that the non-GAAP measure should be a relevant and meaningful measure that does not mislead investors. A non-GAAP financial measure should supplement, not supplant, the GAAP measures presented. These rules require that non-GAAP financial measures be clearly labeled as non-GAAP and not be presented more prominently than the GAAP measure.

OTHER NON-GAAP INFORMATION

Companies could choose to present other information to investors that is not defined or directly determined under GAAP related to the strategic focus and future orientation of the company. Some of this information may be measures or metrics that do not meet the definition of a non-GAAP financial measure. These measures could include performance metrics, key performance indicators (KPIs), and other financial measures. Examples of these metrics include unit sales, number of subscribers, and number of advertisers. Other examples include metrics that are calculated using amounts partially derived from GAAP numbers (e.g., same store sales, revenue per subscriber). However, some of this non-GAAP information, such as integrated reporting or sustainability reporting, may not be a metric.

NOTES

[1] See the C&DIs released by the SEC on May 17, 2016 http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[2] The SEC rules applicable to non-GAAP disclosures are Regulation G and Item 10(e) of Regulation S-K. Regulation G is applicable to all non-GAAP financial measures included in public disclosures made by registrants with any shares registered under the Securities Exchange Act of 1934 (Exchange Act) or is required to file reports pursuant to the Exchange Act. Item 10(e) is applicable to any filing with the SEC under the Securities Act of 1933 (Securities Act) and/or the Exchange Act. Additionally, item 2.02 of Form 8K also has non-GAAP requirements.

[3] Wesley R. Bricker, "Remarks Before the 2016 Baruch College Financial Reporting Conference" (speech, New York, New York), Securities and Exchange Commission, https://www.sec.gov/news/speech/speech-bricker-05-05-16.html.

[4] Ibid 3.

[5] See appendix for definition per the SEC regulations.

[6] See question 102.10 of the C&DIs for 1) Guidance on information "furnished" to the SEC and 2) examples of non-GAAP disclosures that the staff would consider to be more prominent https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[7] Ibid.

[8] Non-GAAP liquidity measures are prohibited from being presented on a per-share basis; See question 102.05 of the SEC's C&DIs: https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[9] Adjustments to arrive at non-GAAP should not be shown net of tax, but as separate components. See C&DI question 102.11 https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[10] See question 102.09 of the C&DIs https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[11] Dave Michaels. "SEC Cracks Down on Novel Earnings Measures That Boost Profits," *Wall Street Journal*, April 26, 2016. Accessed May 24, 2016. http://www.wsj.com/articles/sec-cracks-down-on-novel-earnings-measures-that-boost-profits-1461870107.

[12] See question 100.02 of the C&DIs https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[13] See question 102.03 of the C&DIs https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[14] Note that a benefit of the Committee of Sponsoring Organizations (COSO) 2013 *Internal Control — Integrated Framework* is the ability to expand the application internal control beyond financial statement reporting. http://www.coso.org/documents/990025p_executive_summary_final_may20_e.pdf.

[15] See link to materials from PCAOB SAG meeting May 18-19, 2016: https://pcaobus.org/News/Events/Pages/SAG-meeting-May-2016.aspx.

[16] See Item 10(e)(2) of Regulation S-K, 17 CFR 229.10(e)(2) and Item 101 of Regulation G, 17 CFR 244.101.

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