Non-GAAP Measures – What Do They Say About Fraud Risk?

Wednesday, July 18, 2018

ANTI-FRAUD COLLABORATION
PROMOTING INTEGRITY IN FINANCIAL REPORTING

CENTER FOR AUDIT QUALITY

fei financial executives international

NACD NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

The Institute of Internal Auditors

CPE Credits

This program qualifies for 1.5 CPE credits.

Field of Study: Behavioral Ethics

NACD Skill-Specific Credit

This session offers 1.0 NACD skill-specific credit.

Contact the NACD if you have any questions.
(Fellowships@NACDonline.org)

Goals of Today's Program

Provide an understanding as to:

- What are non-GAAP measures?
- Why do companies present non-GAAP measures? What are the benefits?
- When are non-GAAP measures appropriate and when might they be misleading or indicators of fraud? What are the risks?
- Understand key oversight responsibilities of financial reporting supply chain members

Panelists

Phil Billington | VP-Internal Audit | HCA

Heather Dixon | Controller and Chief Accounting Officer | Aetna

Keith Higgins | Chair, Securities and Governance Practice | Ropes & Gray LLP

Serena Wolfe | Partner | Ernst & Young LLP

Moderator

Cindy Fornelli | Executive Director | Center for Audit Quality

CAQ Roundtables

- The CAQ hosted a series of roundtables on non-GAAP measures in 2017
- We explored this topic and issued *A Roadmap for Audit Committees* in March 2018
- Other CAQ publications related to Non-GAAP:
  - ✓ *Non-GAAP Financial Measures: Continuing the Conversation* (December 2016)
  - ✓ *Questions on Non-GAAP Measures: A Tool for Audit Committees* (June 2016)

Defining Non-GAAP

- Non-GAAP ***financial measures*** are defined by SEC rules 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.

- Non-GAAP Financial measures are subject to Regulation G

- Examples include Funds from Operations (FFO), Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA), Adjusted EBITDA

Key Performance Indicators

- Key Performance Indicators (KPIs) are other commonly used performance or operating metrics that may not meet the definition of a non-GAAP financial measure
- Examples include:
  - ✓ Square feet or rent per square foot
  - ✓ Customers or paying customers, subscribers or additional subscribers, members, admissions
  - ✓ Occupancy rate

SEC Guidance – May 2016

A Compliance and Disclosure Interpretation (CD&I) was released by the SEC in May 2016. The updated guidance provides examples of potentially misleading non-GAAP measures that could violate Regulation G, including:

- ✓ presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business;
- ✓ presenting non-GAAP measures inconsistently between periods without disclosing the change and the reasons for change;
- ✓ presenting non-GAAP measures that exclude non-recurring charges but do not exclude non-recurring gains; and
- ✓ using individually-tailored accounting principles to calculate non-GAAP earnings—for example, presenting non-GAAP revenue that accelerates revenue recognition as though the revenue were earned sooner than for GAAP purposes.

Benefits of Disclosing Non-GAAP Measures

- Provides investors with useful information
- Allows the company to tell its story
- Addresses demand from investment analysts
- May assist in cross-industry comparisons or company-to-company comparisons within industries
- Presents core operations or performance adjusted for one-time events

Risks and Challenges of Presenting Non-GAAP Measures

- Information sources may be outside the financial reporting system
- Internal controls over non-GAAP measures may not be as robust as those over GAAP measures (not part of ICFR)
- Lack of consistency from period to period, among peers, among industries
- Lack of transparency
- May drive wrong decisions or behavior

SEC Enforcement Cases

- Meeting analysts' expectations for GAAP or non-GAAP measures may drive financial misstatements
- Swisher – Company misstated financial results to hit EBITDA target in debt covenant
- Constant Contact/Endurance Holdings – Manipulation of "paying customers" and subscriber metrics to meet target KPIs
- MDC Partners – Company did not consistently or transparently present a metric called "organic revenue growth." Also failed to give GAAP metrics equal or greater prominence to non-GAAP metrics in its earnings releases

Role of the Preparer

- Establish policies and procedures related to non-GAAP
- Involve the Controller organization
- Determine the impact on non-GAAP measures created by new accounting standards or new transactions

Role of the Audit Committee

- Ask Questions:
  - ✓ Why are measures used?
  - ✓ How are they calculated or derived?
  - ✓ What controls have the measures been subject to?
- Include non-GAAP in the Audit Committee Charter
- Strong interest in processes (by Disclosure Committee or Audit Committee, as applicable) has a positive effect on the quality of disclosure

Role of Internal Audit

- Get involved in non-GAAP, and be relevant
- Include non-GAAP procedures in Internal Audit charter
- Take a risk-based approach to maximize impact and best utilize resources
  - ✓ Multiple factors to consider in developing approach
  - ✓ Non-GAAP is not one-size fits all

Role of the External Auditor

- Consideration of non-GAAP in fraud risk assessment
  - ✓ Key non-GAAP measures considered when developing audit strategy and fraud procedures
- Responsibility related to non-GAAP as part of the audit
- Opportunities for greater auditor involvement

Key Takeaways

- Focus on implementing structure to reduce subjectivity (policy, approval process, controls)
- Transparency and disclosure are key
- Internal Audit – Get Involved!
- Bending the rules to achieve a result is wrong, whether GAAP or Non-GAAP

We Value Your Feedback…

- **Please** take our brief webcast survey
- Visit AntiFraudCollaboration.org for additional resources and information

CPE Certificate

As a reminder, you may access your CPE certificate by clicking the orange CPE icon if you have fulfilled the attendance check requirements.

If you do not have an opportunity to obtain your CPE certificate during today's presentation, you may obtain your certificate after 24 hours by logging back into the event and clicking the orange CPE icon.

Please note that you will not be able to respond to the attendance checks in the archive, and you must fulfill the attendance requirements during the actual presentation to receive your CPE certificate.

ANTI-FRAUD COLLABORATION

PROMOTING INTEGRITY IN FINANCIAL REPORTING

ANTIFRAUDCOLLABORATION.ORG