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Client Alert

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Mind the Non-GAAP: Considerations for Using Non-GAAP Financial Measures in the Face of Increased Scrutiny

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Non-GAAP measures, those that present financial performance differently from financial statement presentation under generally accepted accounting principles (GAAP), are again attracting scrutiny from the financial press and regulators. For example, in February 2016, the *Wall Street Journal* reported that, for 2015, GAAP earnings of S&P 500 companies were 25% less than their pro forma adjusted results. The gap is apparently the widest on record since 2008, a year when companies took record charges. Claims that non-GAAP measures, which include or exclude amounts in adjustment to GAAP measures, are essentially "earnings before bad stuff" have not escaped notice of the SEC. In a speech delivered before the American Institute of Certified Public Accountants in December 2015, SEC Chair Mary Jo White said that non-GAAP measures deserve close attention, and she has also reportedly said the SEC is considering whether it should rein in their use via regulation. James Doty, Chairman of the Public Company Accounting Oversight Board (PCAOB) has indicated concern that the proliferation of unaudited and non-GAAP measures creates a risk of undermining investor protection goals of financial statement audits. Though it is not clear if and when the SEC may adopt new regulations impacting non-GAAP measures, this topic of conversation suggests that companies face risks of SEC comments or enforcement action, shareholder litigation or investor scrutiny, and greater auditor focus related to their use of these measures.

When used in SEC filings (such as Form 10-K, 10-Q, 8-K or the proxy statement), non-GAAP measures must be presented in accordance with Regulation S-K Item 10(e)(1)(i). It requires that the non-GAAP measure be given no greater prominence than the comparable GAAP measure, the inclusion of a reconciliation to the most directly comparable GAAP measure, an explanation of the reasons management believes the non-GAAP measure is useful to investors, and if material, an explanation of the other purposes for which the company's management uses the non-GAAP measure. Non-GAAP measures should not be used to "smooth" earnings from period to period, distort results, or present the company in the most favorable light, but rather to improve transparency and provide insight into indicators management uses to manage the business and analyze its results.

Despite the press reports and regulatory focus, non-GAAP measures need not be problematic. Though Chair White indicated that non-GAAP measures can be a source of confusion, when handled appropriately, they can help convey information that is useful to help investors understand the company's performance not otherwise provided by GAAP measures alone. Therefore, companies should not be compelled to retreat from their use, but rather focus on using non-GAAP measures correctly to enhance the usefulness of their overall disclosure.

Non-GAAP measures are not audited or specifically required, but when they are used, they form a key and meaningful component of a company's communication with investors about the company's results and its value and may be material to an understanding of the company. To ensure compliance with the letter and the spirit of the SEC's disclosure regime, companies are well-advised to determine and present their non-GAAP results with the same analytical rigor and quality assurance process as audited results. To achieve this, and to avoid unnecessary negative scrutiny, companies should:

- *Ensure Audit Committee Oversight*: Particularly because non-GAAP measures are not subject to audit by a company's outside auditor, management and the audit committee should take proactive steps to ensure the audit committee is providing appropriate oversight over their preparation and use. The company's disclosure controls and procedures should address non-GAAP measures, and the audit committee should understand the process by which the company decides to present non-GAAP measures, any changes to the company's approach from period to period and the extent of input from outside advisors.

- *Use Non-GAAP Measures Consistently:* A company should address non-GAAP measures as part of its overall financial disclosure policy, consistent with its disclosure goals and results of operations. Much like GAAP, the non-GAAP measures a company presents or the manner in which they are calculated should not change much from period to period. In general, the same non-GAAP measures will be presented each period and a company should resist the temptation to present a non-GAAP measure in one period because it presents a better story. When introducing a new measure, a company should clearly convey the reason for its use and disclose whether it is expected to be presented going forward or merely presented on a limited basis to address a specific scenario.

- *Conduct a Peer Analysis:* Industry analysts and investors generally adopt a consistent method for evaluating industry peer companies. A company should be knowledgeable about the financial metrics used by its peers and, unless there is a reason to depart from standard industry practice, should consider presenting the same or a subset of the same non-GAAP measures. If there are differences from other industry players, clearly explain the differences and the company's rationale for employing them. Avoid using similar terminology for metrics that are calculated differently from the similarly-named metrics used by peers or others.

- *Remain Focused on the Disclosure Purpose:* Do not lose sight of the purpose for providing disclosure, which should be to help investors understand the company's performance. Make every effort to provide plain-English, non-boilerplate discussion and analysis and consider whether non-GAAP measures help the company achieve those goals. If certain non-GAAP measures no longer serve that purpose, retire their use; consider whether narrative disclosure in addition to or instead of non-GAAP measures would be a more effective tool.

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