



October 28, 2016

Non-GAAP financial measures: Top 10 takeaways from our panel discussion

On October 13, 2016, the U.S. Corporate Reporting Users' Forum (CRUF) co-hosted an expert panel with Morgan Stanley—***Non-GAAP & Performance measures: Assessing the impact of the SEC's updated guidance.*** The panel included regulator, standard setter, buy-side, sell-side and public accounting representation.

The objective of the event was to explore how companies are responding to the SEC Staff's recently updated [Compliance & Disclosure Interpretations \("C&DIs"\)](#) on non-GAAP financial measures.

Our Top Ten Takeaways:

1. **Non-GAAP prominence matters:** SEC regulations require that GAAP measures receive at least equal prominence in press releases and SEC filings. A major focus of the SEC this year is to remind preparers to give equal prominence to GAAP measures, where required. However, panelists noted that not all forms of communication are subject to the same rules. For instance, investor relations slides need not give equal prominence to GAAP measures, but they still must *reconcile* any cited non-GAAP measure to the closest related GAAP measure. See Exhibit 1 (below) for a summary of communication and applicable rules.
2. **The non-GAAP/GAAP “gap” is not the primary focus:** The audience asked the panel if regulators and standard setters are concerned with reducing the reporting gap between non-GAAP and GAAP. Panelists clarified that the gap itself is not the primary area of concern. Rather, they are focused on ensuring adjustments and presentation conform to applicable rules. The updated interpretations are intended to provide companies with more clarity on what is considered permissible.
3. **“Cash EPS” is misleading:** Long-standing rules prohibit liquidity measures such as “free cash flow,” “operating cash flow,” and “cash earnings” from being presented on a per share basis. Only performance measures – anchored in accrual accounting principles – may be presented on a per share basis. Panelists commented that named measures such as “Cash EPS” are, therefore, potentially misleading and not permitted.
4. **Stock-based compensation not under scrutiny:** Audience members questioned the panel on the merits of performance measures that omit stock-based compensation expense. Panelists commented that current SEC regulations do not prohibit such adjustments. Panelists also noted a “shift” in the market as more investors and preparers are now preferring to include stock-based compensation within performance measures.

5. **Recurring cash adjustments to receive more attention:** Audience participants questioned the permissibility of adjusting out recurring cash costs, such as restructuring, legal fees and M&A integration costs. Panelists highlighted that the updated SEC guidance prohibits excluding normal recurring cash costs. However, panelists noted that a long duration of adjustments, operating strategy and industry factors are important considerations in determining whether or a not an adjustment is normal and recurring.
6. **Inconsistent adjustments are problematic:** Panelists discussed instances where reporters adjust out nonrecurring expenses, but include nonrecurring gains. The updated guidance emphasizes that such inconsistencies are prohibited. Panelists also desired historical recast if definitions of non-GAAP measures have changed.
7. **No tailor-made accounting:** The new guidance emphasizes that companies are prohibited from tailoring their accounting away from the standards. For instance, panelists discussed companies that adjust their non-GAAP measures for changes in deferred revenue, thus accelerating and *tailoring* revenue recognition. Panelists also highlighted other areas of potential concern, such as pension accounting and non-GAAP share count methodologies.
8. **Non-GAAP only statements are prohibited:** The guidance also emphasizes that companies are prohibited from presenting a full non-GAAP income statement. A full non-GAAP statement is problematic because regulations require reconciliation, and a full statement may create prominence issues and may be considered potentially misleading.
9. **Cash tax rates don't belong in performance measures:** An audience member questioned when it is appropriate to use cash tax rates. Panelists observed that cash taxes are appropriate for cash-flow and liquidity measures, but not for performance measures. The updated guidance requires consistent application of deferred tax accounting in non-GAAP performance measures. A panelist provided an example of a company that is not profitable on a GAAP basis, generates large taxable losses, but is "profitable" on an adjusted earnings basis. It is inconsistent and potentially misleading to present such "profitability" along with the accumulation of tax losses (which drive the low cash tax rate).
10. **Standardization may be good and bad:** There was a colorful debate on the merits of standardizing and enforcing key performance and liquidity measures. Panelists opined that more standardization and regulation may help prevent perceived abuses. However, some investors in the audience argued that diversity of reporting may create investment opportunities and alpha, as differences between reporting and the underlying economics of the business cannot persist indefinitely.

What's next: expect more comment letters-- and potentially enforcement action. Panelists observed that SEC comments to companies are available to the public via the SEC Edgar system after review ([link](#)). The first "wave" of comment letters were issued after the SEC updated the non-GAAP guidance in May. Panelists noted that

many companies 'self-corrected' potential reporting issues during the 2nd quarter earnings process. Panelists also noted that another "wave" of comment letters is expected to be released within the next few months. Further, Chair White has indicated that the Commission may pursue enforcement, if appropriate ([link](#)).

Event panelists:

- **Mark Kronforst**, Chief Accountant, Division of Corporation Finance, U.S. Securities and Exchange Commission
- **Marc Siegel**, Board Member, Financial Accounting Standards Board
- **Douglas Oare**, Managing Director, Head of US Investment Grade Research, BlackRock
- **Simon Flannery**, Managing Director, North America Telecommunications Analyst, Morgan Stanley
- **Beth Paul**, U.S. Strategic Thought Leader, Accounting Services Group, PwC (*Moderator*)

Please note, all panelists participated in an individual capacity and their views and remarks do not necessarily represent the views of their member organizations.

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Exhibit 1

Non-GAAP – Different rules for different purposes

Regulation G Any Public Disclosure	Item 2.02 of Form 8-K Earnings Release	Item 10(e) of Regulation S-K Forms 10-Q and 10-K/20-F
<ul style="list-style-type: none"> • Can't be misleading • Disclose most directly comparable GAAP number • Reconciliation from non-GAAP to GAAP 	<ul style="list-style-type: none"> • Regulation G plus • Non-GAAP cannot have greater prominence • Why management believes non-GAAP is useful * • How management uses non-GAAP - if applicable <p>* Does not need to be repeated if disclosed in 10-K</p>	<ul style="list-style-type: none"> • Item 2.02 plus • Exclude charges or liabilities that require cash settlement from liquidity measure (EBIT and EBITDA are exceptions) • Exclude items identified as nonrecurring, infrequent or unusual from performance measure when occurred in last 2 years or will likely recur in 2 years • Can't include in financial statements or pro forma • Can't use misleading titles

Source: PwC webcast – *Non-GAAP financial measures: How the SEC's updated guidance will impact registrants*, September 13, 2016