Non-GAAP Measures: SEC Serves Notice That it's Serious

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For years, some public companies have asserted that GAAP results do not always accurately reflect their earnings and cash flow potential and have resorted to non-GAAP measures to "set the record straight" with investors and creditors. The Securities and Exchange Commission (SEC) has expressed concern over how these measures are being communicated and recently backed it up by imposing a significant penalty on one company. This signals that a refresher of relevant SEC guidance on non-GAAP measures might be in order.

Use of Non-GAAP Measures is Common Among Public Companies

In earnings calls with analysts, many financial managers focus almost entirely on non-GAAP measures. Additionally, it is not uncommon for non-GAAP measurements to make their way into Management's Discussion & Analysis.

One of the most common non-GAAP measures is free cash flow, which companies are free to define in a manner that they think best communicates with their constituents. Generally, free cash flow is a derivative of operating cash flow reduced by capital expenditures from the investing section of the cash flow statement. It is intended to give investors an indication of the entity's ability to meet debt service and dividend requirements. Often, non-GAAP calculations of revenue growth and operating expenses are used to give investors an indication of what to expect in terms of recurring operational results. And with the emphasis on future expectations, this approach has some logic.

It is also common practice among publicly traded companies to "recompute" their quarterly and annual earnings to adjust for unusual or non-recurring items. This sends a stronger message to readers of the unusual nature of these adjusted items than just discussing these items or highlighting them in year-over-year reconciliations.

A review of the *Fortune* 100 found that 57 of them adjusted their 2017 earnings in their annual press releases, totaling a collective net income increase of over $113 billion. Even after normalizing these statistics for the impact of tax reform that resulted in material swings in 2017 earnings, half of the companies adjusted for additional items.

The most common adjustments related to the impact of acquisition-related costs, such as intangible amortization, increased depreciation and integration costs. But adjustments also related to restructuring charges, litigation settlements and stock compensation costs.

Notable in the earnings releases is the lack of uniformity regarding how earnings are adjusted for these items. Some releases expressed adjustments in terms of earnings per share while others adjusted operating income or income before income taxes. This makes it difficult for readers to understand the full impact of the adjustments or compare results among companies within an industrial sector.

SEC has Long History of Non-GAAP Oversight

Effective March 2003, the SEC released "Final Rule: Conditions for Use of Non-GAAP Measures" in compliance with the Sarbanes-Oxley Act of 2002 (SOX). The release has subsequently been updated through a Q&A format on the SEC website under "Non-GAAP Financial Measures." The last update was as of April 4, 2018.

The overall theme of the SEC's releases centers on the acknowledgement that non-GAAP measures may be meaningful metrics for measuring performance of business and industry specific measures. But balancing this acknowledgement is concern that non-GAAP measures are not standard, but rather tailored to each company. With lack of comparability, the potential for inaccurate or even misleading information is possible.

To address these concerns, the SEC has prescribed several boundaries that should be kept in mind when non-GAAP measures are presented:

- A non-GAAP measure should not be featured more prominently than the nearest GAAP equivalent. Generally, the requirement can be met by presenting GAAP measures in releases or presentations prior to the inclusion of the non-GAAP equivalent. Use of fonts and other formatting tools should also be considered.
- When non-GAAP measures are presented, a schedule should be included in any communication that reconciles this measure to its non-GAAP equivalent.
- Consistency is required when adjustments to GAAP amounts, such as earnings per share, are adjusted to non-GAAP measures. For example, a loss on the sale of assets or a business should not be adjusted in one period and a similar gain not be adjusted in the same or subsequent period.
- Adjustments should only be made for non-recurring items. The SEC suggested that if a similar item has occurred in the prior two years or is reasonably expected to occur in the next two years, it likely fails to meet this restriction. For example, many companies seem to be perpetual in restructuring. In this circumstance, it may not be appropriate to adjust earnings for restructuring charges.

With the continuing pressure to meet market expectations, companies often make adjustments to earnings for items to avoid reporting disappointing results. It is advisable to review these adjustments in light of SEC requirements prior to releasing them to the public. ■

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