

CPE ARTICLE

KEY PERFORMANCE INDICATORS AND NON-GAAP MEASURES, SEC NEW GUIDANCE AND COVID-19 DISCLOSURES

By: Josef Rashty

CURRICULUM: Accounting and Auditing

LEVEL: Basic

DESIGNED FOR: CPAs in public practice and industry, both public and private companies

OBJECTIVES: Explain Key Performance Indicators (KPIs) and non-GAAP measures; compare and contrast the nature, governing rules and disclosure requirements of KPIs and non-GAAP measures in the public filings of registrants, as well as private companies that may also publish certain metrics in their financial reports

KEY TOPICS: Definition of KPIs and non-GAAP measures; SEC guidance; KPI vs. non-GAAP presentations and disclosures; impacts of COVID-19; and examples of company disclosures in Form 10-K

PREREQUISITES: None

ADVANCED PREPARATION: None

About the Author: Josef Rashty, CPA, Ph.D. (candidate) is a member of the Texas Society of CPAs and provides consulting services in the Silicon Valley area of California. He can be reached at j_rashty@yahoo.com.

In January 2020, the Securities and Exchange Commission (SEC) issued Release Nos. 33-10751 and 34-88094 (FR-87), a guidance advising registrants to make additional disclosures about Key Performance Indicators (KPI) and other metrics in the MD&A section of their Forms 10-K and 10-Q filings. These disclosure requirements are broadly similar to certain disclosures that the SEC requires for non-GAAP measures, including why the particular metric is useful and how management uses it. The new SEC guidance became effective on February 25, 2020.

Furthermore, the COVID-19 outbreak has wreaked havoc in the financial markets around the globe. Many economists predict that the sharp drop of Western economies early on, including the U.S. and Europe, will follow with a painful slow recovery.

The recent market conditions have created many new uncertainties that management needs to communicate to stakeholders. Meanwhile, companies may use KPI and non-GAAP measures to describe the impact of COVID-19 in their financial reports based on the most recent SEC guidance.

This article explicates KPIs and non-GAAP measures and juxtaposes their nature, governing rules and disclosure requirements. It also provides an overview on COVID-19 disclosures based on the SEC and CAQ Center for Audit Quality guidance. Private companies often publish certain metrics in their financial reports and they may equally benefit from the provisions discussed in this article.

Definition of KPIs

KPIs are quantifiable measurements (either financial or non-financial) that companies use to demonstrate how effectively they achieve their business objectives. KPIs are important components of the information needed to explain a company's progress towards its goal.

Some of the commonly used KPIs are: capital expenditure ratios to revenue and number of employees; expected return on new stores; sales per square foot; accounts receivable turnover; inventory turnover; backlog and booking; and gross sales per employee.

Definition of Non-GAAP Measures

Non-GAAP financial measures, similar to KPIs, are indicators of historical or future financial performance, financial position or cash flow that exclude items included in the most directly comparable GAAP measure. Commonly used financial non-GAAP measures include earnings before interest and taxes (EBIT); earnings before interest, taxes, depreciation and amortization (EBITDA); free cash flow (FCF); and earnings per share (EPS) that exclude stock compensation or certain other charges.

SEC Guidance on KPIs

The SEC has always required that registrants provide additional disclosures about metrics that they include in their management discussion and analysis (MD&A) of their SEC filings. The new guidance does not change any of that, but it provides guidance on how these rules should be applied when companies present KPIs in their MD&As. Item 303(a) of regulation S-K requires disclosure of information that a company believes is necessary to an understanding of its financial condition and results of operations.

Item 303(a) also requires discussion and analysis of other statistical data that in the company's judgment enhance readers' understanding of their MD&A. The SEC notes that companies often disclose different types of financial and non-financial metrics in their filings. For example, some metrics relate to external or macro-economic matters, some are company specific, and some are a combination of external and internal information.

The SEC expects the following disclosures to accompany each KPI metric:

- A clear definition of the metric and how the company calculates it;
- A statement indicating the reasons why the metric provides useful information to investors;
- A statement indicating how management uses the metric in managing or monitoring the performance of the business.

The guidance also requires that if a company changes the method by which it calculates a particular metric from one period to another, the company should consider disclosing the following:

- The differences in the way the company has calculated the metric compared to prior periods;
- The reason that the company has made a change;
- The effects of the change on the other information that the company has disclosed;
- Any other differences in the methodologies used that are relevant to metrics.

Furthermore, companies must have sufficient controls in place to ensure consistency and accuracy in the presentations of KPIs.

SEC Guidance on Non-GAAP Measures

Public Business Entities (PBEs) provide information to investors and other market participants in many different ways, including SEC filings (e.g., 10-Ks, 10-Qs and 8-Ks), their websites, earning releases, investor calls, and analyst presentations and road shows. The SEC regulates the disclosure of non-GAAP financial measures under Regulation G and Regulation S-K Item 10 (hereinafter Item 10).

The SEC, under the direction of the Sarbanes-Oxley Act of 2002 (SOX), adopted Regulation G for PBE disclosures. Regulation G, effective in 2003, applies to PBEs whenever a company publicly discloses material information that includes non-GAAP financial measures. Item 10, on the other hand, provides guidance for non-GAAP financial measures included in SEC filings.

Regulation G [Release No. 33-8176 and 34-47226 (FR 65)], as directed by the Sarbanes-Oxley Act, requires companies to include a presentation of the most directly comparable GAAP financial measure and its reconciliation to the corresponding non-GAAP financial measure.

As part of FR 65, the SEC added Item 12 "Disclosure of Results of Operations and Financial Condition" to Form 8-K. Item 12 does not require that PBEs issue earning releases or similar announcements; however, if they do, they need to complete Item 12 in their Form 8-Ks.

Item 10(e)(1)(i) requires the following disclosures in SEC filings:

- A reconciliation of non-GAAP measures to GAAP presentations;
- A disclosure statement for the reasons that management believes that non-GAAP presentations provide useful information to investors;
- To the extent that is material, a statement disclosing the additional purposes, if any, for which the management believes that non-GAAP presentations provide useful information to investors;
- The SEC does not permit PBEs to present non-GAAP measures in a prominent manner compared to GAAP measures. For example, non-GAAP measures cannot be presented in bold or prior to GAAP measures (even for reconciliation purposes);
- Companies must present comparable GAAP measures whenever they present non-GAAP measures.

The SEC has issued its "Frequently Asked Questions" regarding use of non-GAAP measures (last updated April 2018). The following are some of the main provisions of this guidance:

- Q&A 100.02 requires that companies present non-GAAP measures consistently between different periods;
- Q&A 100.03 considers non-GAAP measures misleading if they exclude only charges but not the relevant gains. For example, a non-GAAP measure that is adjusted only by non-recurring charges when there were non-recurring gains that occurred during the same period;
- Q&A 100.04 does not permit non-GAAP measures that use individually tailored recognition methods for financial line items (including revenue). For example, the SEC does not permit tailored expense recognition methods for stock compensation that differ from U.S. GAAP calculation;
- Q&A 102.05 permits that companies reflect non-GAAP measures in their SEC filings; for example, companies can disclose in their MD&A or risk factors of Form 10-K non-GAAP measures;
- Q&A 102.10 provides examples that the SEC prohibits for non-GAAP presentations; some of these examples are as follows:
 - Presenting a full non-GAAP income statement (even as a reconciliation to a GAAP income statement);
 - Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures;

- Providing discussion and analysis of non-GAAP measures without a comparable GAAP discussion and analysis.

KPI vs. Non-GAAP Presentations and Disclosures

Companies can present and disclose both KPIs and non-GAAP measures in any or all of the following venues:

- Form 10-Ks and 10-Qs (MD&A and business section)*;
- Form 8-Ks for earnings release;
- Company's websites;
- Earning release broadcasts, conferences and interviews.

***Non-GAAP information usually does not appear in the footnotes to financial statements in Forms 10-K and 10-Q, and referencing KPIs in the footnotes is rare.**

However, non-GAAP presentations are subject to additional restrictions subject to Regulation G and Item 10 (as this article discussed earlier). For example, companies cannot present non-GAAP measures more prominently than their corresponding GAAP measures.

There is a fine line between KPIs and non-GAAP measures, and often it is very difficult to distinguish one from the other. The distinctive character of a KPI is that it usually provides additional and supplemental information to users of financial statements, whereas non-GAAP measures are often used in lieu of GAAP measures.

For example, "average number of customer visits per store" is a KPI and is an indicator that provides supplemental information on revenues in current periods and projection of revenues in future periods. However, EBITDA is a non-GAAP measure that provides information in lieu of a company's earnings (a GAAP measure). Thus, users of financial information judge the performance of a company based on EBITDA instead of its corresponding GAAP earnings.

COVID-19 Disclosures

In April 2020, SEC Chairman Jay Clayton and SEC Division of Corporation Finance Director William Hinman released a joint statement highlighting certain considerations on the impact of COVID-19 on non-GAAP measures and KPIs. They indicated that the registrants may consider reflecting various impacts of COVID-19 in their non-GAAP measures, which may include certain

COVID-19 non-recurring expenses as long as they are separable from routine operational costs.

When using non-GAAP financial measures, companies must be aware of certain SEC requirements, including SEC Regulations G and Item 10, and other publications related to compliance and disclosure interpretations. Companies need to disclose the impact of COVID-19 on a company's financial condition and results of operations (including KPI calculations and disclosures in MD&A).

In April 2020, CAQ Center for Audit Quality published "COVID-19 Considerations for Non-GAAP Financial Measures and Performance Metrics." This report acknowledges that companies may need to adjust or tailor their non-GAAP measures and KPIs because of COVID-19 related factors. These changes could make these metrics less consistent or comparable initially, but transparent disclosure of how companies calculate them and why management finds them meaningful aid investors in understanding the effects of COVID-19 on a particular company.

Additionally, the SEC's Division of Corporation Finance provided guidance on non-GAAP measures and KPIs in "Disclosure Guidance: Topic No. 9, Coronavirus (COVID-19)." Some key components of this guidance require that registrants explicate the impact of COVID-19 on their operations and financial performance. It also requires that companies address the reasons that management finds COVID-19 non-GAAP measures and KPIs helpful in assessing the impact of the pandemic in their financial reports.

Finally, the guidance reminds companies of their obligations under Item 10 and Regulation G with respect to non-GAAP measures, as well as the SEC's recent guidance with respect to KPIs that was issued in January 2020. However, management views are not sufficient unto themselves and in addition, audit committees and external auditors need to weigh in regarding the scope and adequacy of COVID-19 disclosures.

Examples

MobileIron Inc. (MOBL – NASDAQ) (the Company) is a software company that provides unified endpoint and enterprise mobility management for mobile devices, such as multi-factor authentication. In its Form 10-K for the fiscal year-end December 31, 2019, filed on March 6, 2020, the Company disclosed the following KPIs and non-GAAP measures.

Key Performance Indicators

We should note that MobileIron prepared its 10-K prior to the new SEC promulgation and COVID-19 outbreak and as a result, it has not incorporated all of the provisions of the most recent SEC guidance.

Annual Recurring Revenue

MobileIron defines the "Annual Recurring Revenue" (ARR) as a KPI in its MD&A. The Company properly defines this indicator that how and why it is calculated and how management relies upon it for its decision making:

Beginning with the fourth quarter of 2018, we began monitoring a new operating metric, total annual recurring revenue ("Total ARR"), which is defined as the annualized value of all recurring revenue contracts active at the end of a reporting period. Total ARR includes the annualized value of subscriptions ("Subscription ARR") and the annualized value of software support contracts related to perpetual licenses ("Perpetual license support ARR") active at the end of a reporting period and does not include revenue reported as perpetual license or professional services in our consolidated statement of operations. We are monitoring these metrics because they align with how our customers are increasingly purchasing our solutions and how we are managing our business. These ARR measures should be viewed independently of revenue, unearned revenue and customer arrangements with termination rights ... and ARR is not an indicator of future revenue...

Backlog

MobileIron discloses the following paragraph regarding its "backlog" in the business section of its Form 10-K. This disclosure reflects properly the role of backlog in the financial position of the Company. It clearly states why it is not using it and it is not a good comparison indicator for the reader even if disclosed.

FASB and the SEC have used the term "backlog" sporadically and in rare occasions. The new guidance may require that preparers define the term more clearly and how it is typically calculated in their industries:

As is typical in the software industry, we expect a significant portion of our software license orders to be received in the last month of each quarter. We do not believe that our backlog at any particular time is meaningful because it has historically been immaterial relative to our total revenue and is not necessarily indicative of future revenue in any given period.

Bookings

MobileIron discloses the following paragraph regarding its "bookings" in the risk factor section of its Form 10-K. This disclosure reflects properly the role of bookings

in the financial presentation and disclosures of the Company. However, the authoritative accounting literature has rarely used this term, and FASB has not defined the term and its calculation. Again, the substance of the new guidance may require that preparers define the term more clearly and how they are calculating it:

Our quarterly operating results have fluctuated in the past and may fluctuate significantly in the future. The timing and size of sales of our solutions makes our revenue highly variable and difficult to predict and can result in significant fluctuations in our revenue from period to period. Historically, a substantial portion of our bookings and revenue have been generated from sales of software solutions sold as perpetual licenses or on-premise subscriptions that generate up-front revenue, which tend to close near the end of a given quarter.

Turnover

MobileIron discloses the following paragraph regarding its employee or personnel "turnover" (in two different contexts) in the risk factor (the first and second paragraphs) and footnotes (the third paragraph) sections of its Form 10-K. These disclosures reflect properly the financial impact of employee turnover in the financial position of the Company and the associated risks involved. However, the authoritative accounting literature does not clearly define employee turnover and prescribe a method for its calculation. The substance of the new guidance may require that preparers define the term and its calculation more clearly:

Our success is substantially dependent upon the continued service and performance of our senior management team and key technical, marketing, sales and operations personnel. Over the last five years, we have experienced substantial turnover in our sales, engineering and executive teams, and this could continue in the future.

We have invested, and intend to continue to invest, in improving our sales operations to drive additional revenue and support the growth of our customer base. We work with our channel partners to identify and acquire new customers, as well as pursue follow-on sales opportunities. We need to further leverage our channel by training existing and new partners to independently sell and support our products. Newly hired sales personnel typically require several months to become productive and turnover of productive sales personnel can inhibit our revenue growth.

Forfeiture Rate [stock compensation calculation]. The forfeiture rate is calculated based on expected employee turnover. We have applied the same rate to our entire employee population.

Non-GAAP Measures

MobileIron discloses the following non-GAAP measures in the MD&A section of its Form 10-K. The following paragraph clearly reflects the reason that the Company has decided to present non-GAAP measures in its MD&A. Since MobileIron is reporting net loss for both GAAP and non-GAAP purposes, it has not discussed the impact of the non-GAAP presentations on its income tax expense:

To supplement our financial results presented on a GAAP basis, we provide investors with certain non-GAAP financial measures, including non-GAAP gross profit, non-GAAP gross margin, non-GAAP operating loss, non-GAAP operating margin, non-GAAP net loss, non-GAAP net loss per share, and free cash flow. Non-GAAP financial measures exclude stock-based compensation, the amortization of intangible assets, a litigation settlement charge and restructuring charges.

In the following paragraph, MobileIron states that it is excluding stock-based compensation expenses, but it does not explain the reason that it is excluding it [Item 10(e)(1)(i)]:

In our non-GAAP financial measures, we have excluded the effect of stock-based compensation expenses. Stock-based compensation expenses will recur in future periods.

In the following paragraph, MobileIron states that it is excluding restructuring charges because they are "difficult to predict." However, the SEC does not justify an exclusion just because management has difficulty predicting certain expenses:

In our non-GAAP financial measures, we have excluded the effect of the severance and other expenses related to reductions in our workforce, contract termination costs and costs associated with the exit of office facilities. Restructuring charges may recur in the future; however, the timing and amounts are difficult to predict.

In the following paragraph, MobileIron states that it is excluding amortization of intangible assets, but it is not clear why it is doing so [Item 10(e)(1)(i)]:

In our non-GAAP financial measures, we have excluded the effect of the amortization of intangible assets. Amortization of intangible assets can be significantly affected by the timing and size of acquisitions of companies or technology. Beginning with the second quarter of 2018, we no longer had amortizing intangible assets.

In the following paragraph, MobileIron states that it is excluding litigation charges because they are not consistently recurring; however, the SEC does not justify an exclusion just because certain expenses are difficult to normalize and have fluctuations. Certainly, one may expect that the Company will incur legal expenses in the future:

In our non-GAAP financial measures, we have excluded a charge for the cost of the settlement of certain shareholder litigation. While it is possible that we will have material litigation-related charges in the future, we do not expect it to be a consistently recurring expense.

In the following paragraph, MobileIron makes an incontrovertible point that the above expenses are not consistent from period to period, but that argument per se is not enough to justify an exclusion for non-GAAP purposes. Item 10 states that eliminating or smoothing certain items if the registrant expects it to recur within the next two years or similar charges have occurred for the past two years is not a valid reason for non-GAAP exclusion:

We believe that the exclusion of stock-based compensation expense, the amortization of intangible assets, the litigation settlement charge, and restructuring charges from gross profit, gross margin, operating loss, operating margin, net loss, and net loss per share provides useful measures for management and investors because stock-based compensation, the amortization of intangible assets and restructuring charges have been and can continue to be inconsistent in amount from period to period. Other than in 2017, we have not historically had a material litigation-related settlement charge. While it is possible that we will have material litigation settlement charges in the future, we do not expect such charges to be a consistently recurring expense. We believe the inclusion of these items makes it difficult to compare periods...

In addition, we evaluate our business performance and compensate management based in part on these non-GAAP measures. There are limitations in using non-GAAP financial measures because the non-GAAP financial measures are not prepared in accordance with GAAP, may be different from non-GAAP financial measures used by our competitors and exclude expenses that may have a material impact on our reported financial results. Further, stock-based compensation expense is a significant recurring expense in our business and an important part of employee compensation provided.

In the following paragraph, MobileIron disclosed the "free cash flow" as another non-GAAP measure. The Company has properly disclosed that how and why it calculates this non-GAAP measure and the fact that the other companies may calculate it differently:

Our non-GAAP financial measures also include free cash flow, which we define as cash provided by (used in) operating activities less the amount of property and equipment purchased. Management believes that information regarding free cash flow provides investors with an important perspective on the cash available to invest in our business and fund ongoing operations. However, our calculation of free cash flow may not be comparable to similar measures used by other companies. We believe these non-GAAP financial measures are helpful in understanding our past financial performance and our future results. Our non-GAAP financial

measures are not meant to be considered in isolation or as a substitute for comparable GAAP measures and should be read only in conjunction with our consolidated financial statements prepared in accordance with GAAP. Our management regularly uses our supplemental non-GAAP financial measures internally to understand, manage and evaluate our business, and make operating decisions. These non-GAAP measures are among the primary factors management uses in planning for and forecasting future periods. Compensation of our executives is based in part on the performance of our business based on certain of these non-GAAP measures.

MobileIron discloses reconciliations for non-GAAP gross profit, non-GAAP gross margin, non-GAAP operating loss, non-GAAP operating margin, non-GAAP net loss, and non-GAAP net loss per share following the above disclosures.

Accurate and Useful Information

The disclosure of KPIs and non-GAAP measures have been and continue to be under the purview of the SEC. The number of the most recent SEC comment letters are adduced to explain that this is an area of great concern to the SEC. Deloitte in its "Roadmap to SEC Comment Letter Considerations" (2019) states that 31% of 2019 SEC reviews included comments on non-GAAP disclosures (the highest among all categories and closely followed by revenue recognition).

The SEC has constantly hammered home that KPIs and non-GAAP measures must be useful and reflect management perspectives on how they use such measures on the day-to-day operations of their companies. To see this aright, companies need to go back to some of the original guidance of the SEC and rely upon their underlying concept that the objective is to provide accurate and useful information to the public.

A terse formulation of the idea is that the purpose of non-GAAP presentations is not to make financial statements more appealing to the public. Thus, companies should not flout this underlying concept of the SEC guidance and use KPIs and non-GAAP measures to flourish and polish their financial picture.

Finally, management needs to consider stakeholders when it is presenting non-GAAP measures and KPIs that reflect adjustments related to COVID-19. The disclosures should help stakeholders understand how management evaluates and deals with the impact of the pandemic. Management needs to state reasons for presenting non-GAAP measures and KPIs, and ensure that they present a fair and balanced view of the company's performance in light of the recent economic disruptions.