Non-GAAP Financial Measures

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AGENDA

Background

Definition and examples of Non-GAAP Measures

Why do companies use Non-GAAP measures?

SEC Rules and Interpretations

Recent areas of SEC focus and changes in Non-GAAP disclosures

Looking forward
Non-GAAP measures

Background

- Dramatic increase of press coverage and increasing SEC focus
- Concerns about the increased use and prominence
- Larger differences between such measures and amounts reported under GAAP
- Potential for such measures to be misleading
- Issuance of updated Compliance & Disclosure Interps
- Call for registrants to self-correct
- Non-GAAP comments have increased as a % of total SEC comments
Evolution of non-GAAP measure rules and regulations

2001: SEC issues Regulation G and S-K Item 10(e)
2003: SEC issues “cautionary advice” to registrants
2010: SEC increases focus on non-GAAP measures as measures increase in use and prominence
2015: New and updated C&DI’s issued by SEC
2016: Compliance & Disclosure Interpretations (C&DI’s) issued by SEC
A numerical measure of a registrant’s *historical or future* financial performance, financial position or cash flows that:

• *Excludes* 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

• *Includes* amounts...that are excluded from the most directly comparable measure so calculated and presented”.

The definition of a non-GAAP financial measure is intended to “capture all measures that have the effect of depicting either:

• [A] measure of performance that is different from that presented in the financial statements, such as income or loss before taxes or net income or loss, as calculated in accordance with GAAP; or

• [A] measure of liquidity that is different from cash flow or cash flow from operations computed in accordance with GAAP.”
Non-GAAP measures

GAAP or Non-GAAP?

<table>
<thead>
<tr>
<th>Common Non-GAAP Measures:</th>
<th>GAAP or Non-GAAP?</th>
</tr>
</thead>
<tbody>
<tr>
<td>- EBITDA and Adjusted EBITDA</td>
<td>- Operating Earnings</td>
</tr>
<tr>
<td>- Adjusted Net Income</td>
<td>- EBIT</td>
</tr>
<tr>
<td>- Adjusted EPS</td>
<td>- Net Sales</td>
</tr>
<tr>
<td>- Free Cash Flow</td>
<td>- Revenue from 10 largest customers</td>
</tr>
</tbody>
</table>

- Revenue excluding acquisitions (Organic Revenue)
- Total Billings
- System-wide Franchise Revenue
- Segment Adjusted EBITDA
- Restructuring cost per share
- Net Debt
- Constant Currency amounts
Non-GAAP measures

Items that are NOT considered non-GAAP financial measures

Statistical Measures based solely on GAAP amounts
- Gross profit margin or operating margin

Statistical Measures based on GAAP amounts and non-financial information
- Same store sales

Presentation of components of a GAAP line item
- Revenue by Product Line

Any measure expressly required by GAAP or SEC rules
- Segment profitability measure
Non-GAAP measures
Common adjustments

Some of the more common adjustments include:

• EBITDA related
• Stock compensation
• Restructuring costs
• Impairments
• Legal settlements
• Acquisition-related costs
  – Direct costs of acquisition
  – Amortization of intangibles
  – Integration costs
• Investment gains and losses
• Pension-related
• Tax related adjustments
Non-GAAP measures

Alternative presentations

The following table summarizes unallocated operating expenses and certain items impacting comparability:

<table>
<thead>
<tr>
<th>Item</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spinoff-related transaction expenses</td>
<td>$7.1</td>
<td>—</td>
</tr>
<tr>
<td>Restructuring and impairment charges</td>
<td>$11.4</td>
<td>$6.2</td>
</tr>
<tr>
<td>Acquisition-related expenses</td>
<td>$2.6</td>
<td>$0.5</td>
</tr>
<tr>
<td>Loss on disposition of business</td>
<td>—</td>
<td>$6.2</td>
</tr>
<tr>
<td>Litigation settlement (gain)loss</td>
<td>$(12.6)</td>
<td>—</td>
</tr>
<tr>
<td>Pension settlement charges</td>
<td>$16.1</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$24.6</strong></td>
<td><strong>$12.9</strong></td>
</tr>
</tbody>
</table>
Non-GAAP measures
Why do companies present Non-GAAP measures

Non-GAAP measures may:
• Provide additional insight into operations that GAAP does not provide
• Provide more meaningful period-to-period comparisons and analysis of trends
• Represent normalized or “core” operations
• Assist investors in viewing a company’s operations consistently with the way management does in budgeting, management compensation
• Be utilized in calculating Debt Covenants
• Provide consistency with peer companies
• Be requested by analysts

Are there other reasons?
• Issues with GAAP?
• Inherent bias?
## Non-GAAP measures

### The Rules

<table>
<thead>
<tr>
<th>SEC Rule</th>
<th>Overview of the requirements</th>
</tr>
</thead>
</table>
| Regulation G        | • Non-GAAP financial measures must not be misleading.  
|                     | • The most directly comparable GAAP measure must be presented.  
|                     | • A quantitative reconciliation of the non-GAAP financial measure to the most comparable GAAP measure must be presented for:  
|                     | − a historical non-GAAP measure and  
|                     | − forward-looking information (to the extent available without unreasonable effort)                                |
| Item 10(e) of Regulation S-K | Expands upon Reg. G requirements to also include:  
|                     | • Present most directly comparable GAAP measure with greater or equal prominence of that of the non-GAAP measure  
|                     | • Disclosure indicating why the registrant believes that the non-GAAP measure is useful to investors  
|                     | • Disclosure of the additional purposes, if any, for which the registrant uses the non-GAAP measure                                     |
Non-GAAP measures
Additional prohibitions

• Excluding “charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP liquidity measures, other than [EBIT and EBITDA]” (the “liquidity measure prohibition”).

• Adjusting “a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when” (1) the nature of the charge or gain is such that it is reasonably likely to recur within two years or (2) there was a similar charge or gain within the prior two years (the “performance measure prohibition”).

• Presenting “non-GAAP financial measures on the face of the registrant’s financial statements prepared in accordance with GAAP or in the accompanying notes”.

• Presenting “non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X.”

• Using “titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.”

• Presenting per-share measures of liquidity
Non-GAAP measures
Updated Compliance and Disclosure Interpretations

**Examples of non-GAAP measures presented with excessive prominence (C&DI 102.10)**

- Non-GAAP measures in press release headlines w/o GAAP comparable
- Non-GAAP measure in bolder or larger font than GAAP
- Non-GAAP measure that precedes a comparable GAAP measure
- Descriptive comments only for a non-GAAP measure (e.g. “record performance”)
- More discussion and analysis of non-GAAP measures than GAAP measures
- Tabular disclosure/reconciliation that starts with a non-GAAP measure
- A full non-GAAP income statement
- Omitting disclosures related to forward looking non-GAAP measures

“Non-GAAP measures are intended to supplement ...and not supplant the information in the financial statements.”

*Jim Schnurr, Former Chief Accountant, Office of the Chief Accountant*
Non-GAAP measures
SEC comment letter trends—Recent areas of focus

**Prominence:** When a registrant presents its non-GAAP financial measures more prominently than its GAAP measures (e.g., the registrant presents them before, or places greater emphasis on them than its GAAP measures, or presents a full non-GAAP Income Statement).

**Sample comments:**

1. We note that in your executive summary you **focus on key non-GAAP financial measures** and not GAAP financial measures which may be inconsistent with the updated Compliance and Disclosure Interpretations issued on May 17, 2016 (specifically Question 102.10). We also note issues related to prominence within your earnings release. Please review this guidance when preparing your next earnings release.

2. We note that your reconciliation of EBITDA **starts with the non-GAAP measure** and reconciles to the GAAP measure (net income). In future filings please revise your presentation to start with the GAAP measure so that the GAAP measure is presented with equal or greater prominence. This comment also applies to any non-GAAP measures presented in an earnings release. Refer to Question 102.10 of the Compliance and Disclosure Interpretations.
Non-GAAP measures

Full non-GAAP income statement

Example

Company X presented a summary of its statement of operations in its first quarter 20X6 earnings release. To arrive at its “ongoing” operations, X presented its line items on a GAAP as-reported basis as well as adjustments to various expense items that it believes should be excluded. Although not all line items from the historical statement of operations in the “as-reported” column have been adjusted, such presentation may represent a full non-GAAP income statement and could be prohibited:

<table>
<thead>
<tr>
<th></th>
<th>As Reported</th>
<th>Adjustments</th>
<th>Ongoing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$300</td>
<td>$—</td>
<td>$300</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$100</td>
<td>$(20)</td>
<td>$80</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$200</td>
<td>$(20)</td>
<td>$220</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>$75</td>
<td>$(25)</td>
<td>$50</td>
</tr>
<tr>
<td>Operating income</td>
<td>$125</td>
<td>$45</td>
<td>$170</td>
</tr>
<tr>
<td>Interest expense</td>
<td>$10</td>
<td>$10</td>
<td>$10</td>
</tr>
<tr>
<td>Other nonoperating expense</td>
<td>$10</td>
<td>$(5)</td>
<td>$5</td>
</tr>
<tr>
<td>Pretax income</td>
<td>$105</td>
<td>$50</td>
<td>$155</td>
</tr>
<tr>
<td>Taxes</td>
<td>$25</td>
<td>$10</td>
<td>$35</td>
</tr>
<tr>
<td>Net income</td>
<td>$80</td>
<td>$40</td>
<td>$120</td>
</tr>
</tbody>
</table>
Non-GAAP measures
Updated Compliance and Disclosure Interpretations

Financial measures using individually tailored accounting principles
(C&DI 100.4)

- Using a registrants' own set of accounting principles to determine a non-GAAP measure
- Most often seen with adjusted revenue
- Staff may not object to a measure that adjusts to reflect the adoption of the new revenue recognition accounting standard
Non-GAAP measures
SEC comment letter trends—Recent areas of focus

Individually tailored revenue adjustment:

Sample comment:
The adjustment “change in deferred amusement revenue and ticket liability” in arriving at your non-GAAP measure “adjusted EBITDA” appears to accelerate the recognition of revenue associated with the deferred amusement and ticket liability that otherwise would not be recognized in any of the periods for which adjusted EBITDA is presented. Accordingly, adjusted EBITDA substitutes a tailored revenue recognition method for that prescribed by GAAP and does not comply with Question 100.04 of the staff’s Compliance & Discussion Interpretations on Non-GAAP Financial Measures. Please remove this adjustment from your computation.
Non-GAAP measures
Updated Compliance and Disclosure Interpretations

Potentially misleading measures *(C&DI 100.01–100.03, 102.03)*

− Adjusting for normal recurring cash operating expenses in a performance measure

− Inconsistent adjustments between periods without proper disclosure

− Cherry picking (i.e. excluding only non-recurring costs but not non-recurring gains)

− Adjusting to eliminate or smooth items identified as non-recurring, infrequent or unusual when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years.
Non-GAAP measures
SEC comment letter trends—Recent areas of focus

**Nature of adjustments:** Comments on the nature of reconciling adjustments and the related disclosures.

**Sample comments:**

1. We note that your non-GAAP measures exclude purchased intangible amortization, restructuring costs, asset impairments, acquisition-related costs, and income tax items and that you describe these items as infrequent or unusual although you have reported similar items for multiple fiscal years. Please note that Item 10(e)(1)(i)(A) of Regulation S-K prohibits you from adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years. In addition, your non-GAAP measures appear to exclude certain normal, recurring, cash operating expenses which is inconsistent with the updated Compliance and Disclosure Interpretations issued on May 17, 2016. Please review this guidance when preparing your next earnings release.

2. Given that your ongoing acquisition of businesses is a critical strategy you employ to achieve and maintain growth in your business, please tell us why you remove the impact of acquisition-related expenses and the amortization of intangible assets you acquire, as well as the impact of other fair value adjustments recorded under acquisition accounting in presenting your non-GAAP financial measures.
Non-GAAP measures
Updated Compliance and Disclosure Interpretations

Prohibition on presenting liquidity measures on a per share basis (C&DI 102.05)

- Designated performance measures that are really liquidity measures
- Prohibition depends on whether the non-GAAP measure can be used as a liquidity measure
- SEC focus on the substance of the non-GAAP measure and not management’s characterization of the measure
Non-GAAP measures
SEC comment letter trends—Recent areas of focus

Liquidity or performance measure:

**Sample comments:**

1. You disclose that you believe the non-GAAP measures presented, including Adjusted EPS, allow investors to gain a better understanding of the factors and trends affecting the ongoing cash earnings capabilities of your business for which capital investments are made and debt is serviced. From this it appears the non-GAAP measures are intended to be measures of liquidity. Presenting non-GAAP liquidity measures on a per share basis is not consistent with 102.05 of staff’s Compliance and Disclosure Interpretations on Non-GAAP Financial Measures. Please review this guidance when preparing your next earnings release.

2. Given the nature and magnitude of the vast majority of your non-GAAP adjustments, it appears that your non-GAAP adjusted net income is actually a non-GAAP liquidity measure. As such, please tell us why this non-GAAP measure is not a liquidity measure or represent to us that you will no longer present this measure on a per share basis. Please see Compliance & Disclosure Interpretation on Non-GAAP Financial Measures, or CDI, Question 102.05. non-GAAP financial measures.
Non-GAAP measures
Updated Compliance and Disclosure Interpretations

Non-GAAP tax expense (C&DI 102.11)
− Tax adjustments commensurate with the non-GAAP measure of profitability
− Clear explanation of how the adjustment was determined
− Cash tax adjustments
− “Normalized” tax rates
Non-GAAP measures
SEC comment letter trends—Recent areas of focus

**Impact of income taxes:** Comments on the calculation of the tax impact of non-GAAP adjustments and the related disclosures.

**Sample comments:**

1. Please expand your disclosures to explain how you calculated the tax effect for the adjustments to net (loss) income attributable to . . . and per diluted share in accordance with the guidance in Question 102.11 of the Non-GAAP Financial Measures Compliance & Disclosure Interpretations.

2. Tell us why you believe that removal of non-cash income taxes and not reflecting income taxes on non-GAAP adjustments in arriving at non-GAAP adjusted earnings is appropriate. Refer to question 102.11 of our Non-GAAP Financial Measures Compliance and Disclosure Interpretations issued on May 17, 2017.
Non-GAAP measures

Most recent trends

• Most companies have addressed prominence issues
• SEC looking for greater detail in purpose and use disclosures
• Improve clarity in reconciliations
• Challenges on Liquidity vs. Performance measures
• Additional focus on:
  • Recurring cost adjustments
    • Restructuring expenses and legal settlements
  • Measures using individually tailored accounting principles
    • Considering areas other than revenue
  • Subjective adjustments
    • Synergies and cost savings
Non-GAAP measures
SEC comment letter trends—Recent areas of focus

**Purpose and use:** Includes comments on whether the disclosures demonstrate the purpose of the measures (i.e., their usefulness to investors and how management uses them).

**Sample comment:**
Please revise to disclose the reasons why you believe your presentation of each of the non-GAAP financial measures provides useful information to investors regarding your financial condition and results of operations. The justification for the use of the non-GAAP financial measure must be substantive. Merely indicating that you provide such non-GAAP financial measures to give investors additional data to evaluate your operations is not sufficient support for disclosure of the non-GAAP financial measures. Please also revise to expand your disclosure of the additional purposes for which management uses each of the non-GAAP financial measures. Please refer to Item 10(e) of Regulation S-K.
Non-GAAP measures
Disclosure controls and procedures

Disclosure Controls and Procedures (DCPs) Vs. Internal Control Over Financial Reporting

Design DCPS to ensure that procedures cover:

<table>
<thead>
<tr>
<th>Compliance</th>
<th>NGM presented in compliance with rules, regulations and guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consistency</td>
<td>Adjustments evaluated and presented in an appropriate and consistent manner each period</td>
</tr>
<tr>
<td>Data quality</td>
<td>Calculated based on reliable inputs</td>
</tr>
<tr>
<td>Accuracy</td>
<td>Calculation is arithmetically accurate</td>
</tr>
<tr>
<td>Transparent disclosure</td>
<td>Descriptions of adjustments and required disclosures are clear and not confusing</td>
</tr>
<tr>
<td>Review</td>
<td>Reviewed by the appropriate levels of management</td>
</tr>
<tr>
<td>Monitoring</td>
<td>Internal audit, disclosure committee or audit committee reviews the controls or is involved in the oversight</td>
</tr>
</tbody>
</table>
Non-GAAP measures
Impetus for additional changes

• SEC comment process and/or enforcement
• Auditor association
• Management and Board of Directors
• Investor or Analyst pressures
Non-GAAP measures

Auditor’s role

Current role:
Association related procedures
Agreed-upon procedures (if requested by client)

Possible Future roles:
Attestation of non-GAAP measures
Supplemental information under Audit Standard 17, Supplemental Information Accompanying Audited Financial Statements
Non-GAAP measures
Metrics or Key Performance Indicators (KPIs)

What are KPI’s?

• Non-financial data-points
  – Number of on-line users
  – Web page clicks
  – Customer retention rates

• Ratios or statistical measures based on data points and financial measures
  – Same store sales
  – Revenue per customer
  – Rental rates per square foot
Non-GAAP measures
Metrics or Key Performance Indicators (KPIs)

What are the rules around KPI’s?

• Not subject to Reg G or Item 10(e) unless based on a non-GAAP measure

• SEC suggests registrants:
  – clearly define the metrics used and how they are calculated
  – describe any important assumptions and limitations (e.g., whether the metric is a “hard” amount or an estimate)
  – present a metric within a balanced discussion
  – clearly describe how a metric is related to current or future results of operations
  – consider controls around metrics
## SEC Comment Letter Trends: Overall Summary

<table>
<thead>
<tr>
<th>Topic</th>
<th>Percentage of All Reviews</th>
<th>Rank</th>
<th>Change in Rank From Prior Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>MD&amp;A</td>
<td>23%</td>
<td>1</td>
<td>—</td>
</tr>
<tr>
<td>Results of operations</td>
<td>23%</td>
<td>1</td>
<td>—</td>
</tr>
<tr>
<td>Liquidity</td>
<td>11%</td>
<td>2</td>
<td>—</td>
</tr>
<tr>
<td>Critical accounting policies and estimates</td>
<td>9%</td>
<td>3</td>
<td>—</td>
</tr>
<tr>
<td>Contractual obligations</td>
<td>3%</td>
<td>4</td>
<td>—</td>
</tr>
<tr>
<td>Non-GAAP measures</td>
<td>23%</td>
<td>5</td>
<td>—</td>
</tr>
<tr>
<td>Fair value</td>
<td>18%</td>
<td>6</td>
<td>—</td>
</tr>
<tr>
<td>Segment reporting</td>
<td>14%</td>
<td>7</td>
<td>—</td>
</tr>
<tr>
<td>Income tax</td>
<td>13%</td>
<td>8</td>
<td>—</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>13%</td>
<td>9</td>
<td>—</td>
</tr>
<tr>
<td>Intangible assets and goodwill</td>
<td>12%</td>
<td>10</td>
<td>—</td>
</tr>
<tr>
<td>Signatures, exhibits, or agreements</td>
<td>8%</td>
<td>11</td>
<td>—</td>
</tr>
<tr>
<td>Acquisitions, mergers, and business combinations</td>
<td>8%</td>
<td>12</td>
<td>—</td>
</tr>
<tr>
<td>ICFR</td>
<td>8%</td>
<td>13</td>
<td>—</td>
</tr>
</tbody>
</table>

Comment Letter trend information was derived from data provided by Audit Analytics based on the percentage of all comment-letter-yielding Form 10-K and 10-Q reviews that include a comment on topic.