Highlight:

- Companies often use non-GAAP financial measures in Management’s Discussion & Analysis, earnings releases, and other communications to provide insight into the business.
- Enhancing the transparency of non-GAAP financial measures can help users better understand a company’s past performance and anticipate future performance.
- Companies may enhance users’ understanding of non-GAAP financial measures by providing the most comparable GAAP measure with equal or greater prominence, including robust discussion of management’s use of the measures, if applicable, and disclosing more details of how items included in the non-GAAP metric affect reported GAAP results.
- Companies should also consider the consistency of the calculation and presentation of non-GAAP information from period to period.

Transparency, consistency, and comparability are key

- Companies often disclose non-GAAP financial measures to provide additional insight into the business. These measures adjust the reported GAAP results, which may facilitate a users’ understanding of a company’s underlying operational performance, liquidity or financial position. This information may provide insights into a company’s business, its past results, and its potential for future prospects.
- Although non-GAAP financial measures are commonly used, their comparability varies from one industry to another, as well as from one company to another. In addition, a lack of transparency regarding their determination, along with inconsistency in how the measures are calculated may limit their efficacy. Further, the subjectivity inherent in how non-GAAP financial measures are calculated could make them susceptible to bias or misinterpretation without proper context and explanation.
- When presenting non-GAAP financial measures, it is important to give equal or greater prominence to the most comparable GAAP measures, ensure that appropriate disclosures are provided, accurately label the non-GAAP measures, and identify an adjustment as non-recurring only if that is the case.
- Non-GAAP financial measures are most effective when they are accompanied by clear and transparent disclosure of what is included or excluded from the measure and the supporting rationale. A robust discussion of how management uses non-GAAP financial measures, if applicable, and the context in which they should be considered increases their usefulness.
The prevalence of non-GAAP financial measures

What is a non-GAAP financial measure

A non-GAAP financial measure is a numerical measure that adjusts the most directly comparable measure determined in accordance with GAAP. Such measures provide supplemental information regarding a company’s historical or future financial position, performance, cash flows, or liquidity. For public companies, non-GAAP financial measures are governed by SEC regulations.

Why companies use non-GAAP financial measures

One of the objectives of financial reporting is to provide sufficient information to allow users to consider a company’s prospects for future cash flows. Companies often supplement their GAAP financial reporting with non-GAAP information that is intended to provide additional insight into the business. Such measures may convey changes to the business that are organic separate from those that may be considered unusual, infrequent, or not representative of underlying trends.

Common non-GAAP financial measures

Common non-GAAP financial measures include earnings before interest, taxes, depreciation and amortization (EBITDA), adjusted EBITDA, funds from operations, adjusted earnings or adjusted earnings per share, and net debt. Non-GAAP financial measures may disaggregate different aspects of a company’s operations or remove the effects of large, unusual, or unique transactions, such as acquisitions or dispositions. Companies may choose to exclude the impact of these transactions if they believe this will provide information that can benefit a user’s assessment of a company’s historical results, long-term prospects, or the effects of business decisions.

The use of certain non-GAAP financial measures may be more common in specific industries. Users of the financial statements of companies in those industries may have expectations regarding the inclusion of these measures in investor communications, including Management’s Discussion & Analysis (MD&A). For example, distributable cash flow is generally considered an important non-GAAP financial measure for publicly traded partnerships. Accordingly, this measure is frequently disclosed by such partnerships.

Disclosure requirements

In general, public companies that disclose non-GAAP financial measures are required by the SEC to include the most directly comparable GAAP financial measure with equal or greater prominence. The measure should also be reconciled to the most directly comparable GAAP financial measure. Additionally, in most cases companies are required to disclose the reasons why the non-GAAP metric provides useful information to investors and what management uses the measure for, if applicable.

Non-GAAP financial measures may not be included in financial statements and the accompanying notes. Measures required by GAAP, such as the presentation of segment profitability, are not considered non-GAAP financial measures, even if such measures exclude amounts usually included in net income.

The limitations of non-GAAP financial measures

A company has flexibility in which non-GAAP financial measures it chooses to report, if any, and how it calculates such metrics, subject to certain prohibitions. Accordingly, what a company reports could vary over time or from what its competitors report. Therefore, a limitation inherent in non-GAAP financial measures is that they are subjective and may not be comparable to similarly titled non-GAAP financial measures used by other companies.
Enhancing the transparency of non-GAAP financial measures

What can companies do?

When presenting non-GAAP information, a company can take certain actions that may increase the usefulness of the information.

Benchmarking

Understanding what metrics are commonly used may help management determine which metrics are useful for investors. Also, if management is aware of differences in the industry in the calculation of similarly titled non-GAAP financial measures, they could enhance their disclosure by describing how the measures may be different. These explanations could alert users to possible adjustments that may be needed when comparing financial measures provided by different companies.

Transparency

Companies should consider how they title a non-GAAP financial measure to clearly convey the nature of the measure. For example, when a non-GAAP financial measure such as EBITDA includes additional adjustments not commonly included in EBITDA, it is likely to be more appropriate to title the measure as adjusted EBITDA.

Companies should also consider providing transparent disclosures of how the measure is calculated. Clear identification of the components included in determining the measure and where such components are reflected in the GAAP financial statements can facilitate a user’s overall understanding of the metric.

Consistency

Companies should consider the consistency of the calculation and presentation of non-GAAP information from period to period. One way to achieve this is to have policies on how non-GAAP measures are calculated.

Companies should be thoughtful and balanced to avoid eliminating the impact of an item that reduces earnings in one period while not eliminating a similar item in a different period when it increases earnings.

In instances where a company changes how it determines a non-GAAP measure, it may want to consider including transparent disclosure of the changes and the rationale.

Companies should also consider consistency across reporting mediums, such as in press releases, investor presentations, and in financial reporting, including in MD&A. If non-GAAP information is considered to be important for presentation and discussion in investor presentations and press releases, companies should consider whether the measure should also be discussed in MD&A or other applicable sections of annual and quarterly reports.

Expansive disclosure

When presenting non-GAAP measures, management should consider enhancing its discussion of such measures and why it believes them to be useful and important. While companies are prohibited from including non-GAAP measures in their financial statements and the accompanying notes, MD&A and other investor communications might be enhanced if they contain a discussion and analysis of the impact of non-recurring, unusual items or trends that are not considered core influences on the results of operations, financial position, or cash flows.

By providing greater detail regarding how management evaluates a company’s business and what it considers not to be core to the company’s operations, users may be able to more clearly understand how historical results provide insights into future performance. This may enhance their overall evaluation of the company.

In summary

There are several actions that a company can take to increase the usefulness of its non-GAAP financial disclosures. Companies, in consultation with counsel, as necessary, should consider whether enhancements can be made to the effectiveness of their non-GAAP disclosures. Specifically, companies may consider whether transparency of the components of the measure, consistency of the calculation of the measure each period or with peers, and disclosures of the measure can be enhanced.
Questions and answers

Q: What are the regulations governing non-GAAP financial measures?
A: SEC registrants must comply with Regulation G, which addresses all public non-GAAP financial disclosures. They must also comply with Item 10(e) of Regulation S-K, which covers non-GAAP information included in documents filed with the SEC, and Instruction 2 to Item 2.02 of Form 8-K for information furnished to the SEC.

Q: If a company provides a non-GAAP financial measure in one period, does that create a precedent under which it is required to provide the same measure in perpetuity?
A: No. There is no requirement to include a measure merely because it was provided in the past. However, companies may want to consider whether using the same measure in subsequent periods would be beneficial. For example, situations may arise where components of a non-GAAP financial measure were previously significant and their inclusion in a non-GAAP financial measure provided useful information to investors, but they have become inconsequential in subsequent periods. In these situations, companies may want to change the determination of the measure or eliminate it.

Q: What is an external auditor’s responsibility pertaining to non-GAAP financial measures?
A: Currently, the external auditor’s opinion does not cover non-GAAP financial measures because they are not included in the financial statements. Professional standards do require auditors to read other information in a document containing the financial statements and accompanying audit report and to consider whether the other information or the manner of its presentation is materially inconsistent with information appearing in the financial statements.

Q: Is a segment measure of profitability determined on a basis different than the consolidated amounts considered non-GAAP?
A: No. The disclosure requirements related to segment reporting require companies to present information in a manner consistent with how management uses information to make decisions. Thus, the segment performance measure used by the chief operating decision maker is, by definition, a GAAP financial measure. For example, if the segment measure of profitability is EBITDA, EBITDA at the segment level is a GAAP measure, although EBITDA for the consolidated entity would be a non-GAAP financial measure.