Non-GAAP measures are more popular than ever

Companies use non-GAAP measures to tell their story. Some companies use them to show investors management’s view of its core operations; typically by eliminating non-recurring charges and other amounts they believe are outside of ongoing operations. For example, a company may exclude the effects of a major strategic restructuring or stock-based compensation. Non-GAAP measures supplement a company’s financial statements; they can provide investors additional information that may be helpful as they assess the business.

Some of the most common non-GAAP measures are:
- EBIT - earnings before interest and taxes
- EBITDA - earnings before interest, taxes, depreciation, and amortization
- Adjusted earnings and adjusted EBITDA
- Free cash flow

The average number of non-GAAP measures reported by public companies has increased from 2.5 to 7.5 over the past 20 years. The significant increase has caused the SEC to put a spotlight on these measures to ensure that companies are providing transparent information that does not mislead users.

A measure becomes a non-GAAP measure when it excludes (or includes) amounts from the most directly comparable measure calculated in accordance with GAAP. Measures of operating performance that are not based on GAAP measures are not subject to the non-GAAP guidance; for example, sales, number of employees, number of subscribers, and amount of debt repayments planned but not yet made.

<table>
<thead>
<tr>
<th>Year</th>
<th>Percent of S&amp;P 500 Using at Least One Non-GAAP Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>59%</td>
</tr>
<tr>
<td>2016</td>
<td>76%</td>
</tr>
<tr>
<td>2018</td>
<td>97%</td>
</tr>
</tbody>
</table>
Knowing the SEC rules for non-GAAP measures

There are three sets of rules governing the use of non-GAAP measures: Regulation G, Item 2.02 of Form 8-K (which applies to quarterly or annual earnings releases), and Regulation S-K, Item 10(e). The requirements differ depending on where a non-GAAP measure is disclosed.

<table>
<thead>
<tr>
<th></th>
<th>Reg G</th>
<th>Item 2.02, Form 8-K</th>
<th>Reg S-K, Item 10(e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Any public disclosure</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
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<tr>
<td>(website, analyst report)</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Earnings release</td>
<td>✔</td>
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<td>✔</td>
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<tr>
<td>SEC filings</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
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Regulation G applies to all non-GAAP measures presented in a public disclosure (e.g., company’s website, analyst presentation).

Non-GAAP measures included in quarterly or annual earnings releases or other filings furnished to the SEC under Item 2.02 of Form 8-K must comply with Regulation G as well as the additional requirements in Item 2.02.

Non-GAAP measures included in an SEC filing must comply with Regulation S-K, Item 10(e), which includes all of the requirements included in Regulation G and Item 2.02 of Form 8-K.

**Regulation G**
- The non-GAAP measure taken together with the accompanying information cannot be misleading
- The most directly comparable GAAP measure must be disclosed
- A reconciliation starting with the most directly comparable GAAP measure and reconciling to the non-GAAP measure must be included

**Item 2.02 of Form 8-K**
- The GAAP measure must be displayed with equal or greater prominence than the non-GAAP measure
- Management must disclose why it believes the non-GAAP measure is useful
- If applicable, management must disclose how it uses the non-GAAP measure

**Regulation S-K, Item 10(e)**
- Charges or liabilities that require cash settlement cannot be excluded from any measure of liquidity
- A measure cannot be labeled as non-recurring or infrequent (or similar title) if it excludes amounts resulting from an event that has occurred in the last two years or is expected to occur again in the next two years
- Non-GAAP measures cannot be included in financial statements or pro-forma information
- Non-GAAP measure titles cannot be misleading
SEC comments

Non-GAAP measures have long been on the list of top 10 areas of comments made by the SEC. Common comments on non-GAAP measures include:

<p>| | |</p>
<table>
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<tbody>
<tr>
<td>1</td>
<td>GAAP measure not given enough prominence</td>
</tr>
<tr>
<td>2</td>
<td>Reconciliation between GAAP and non-GAAP measures is missing or does not start with the GAAP measure</td>
</tr>
<tr>
<td>3</td>
<td>Non-GAAP measure is not presented consistently between periods or the reason for changing a non-GAAP measure is not disclosed</td>
</tr>
<tr>
<td>4</td>
<td>Management’s explanation of why a non-GAAP measure is useful to investors is inconclusive</td>
</tr>
<tr>
<td>5</td>
<td>Use of an individually-tailored accounting principle (a company cannot make up its own GAAP)</td>
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One newer area of comment relates to the use of individually-tailored accounting principles (i.e., company-specific GAAP). Measures that change financial statement measures in a way that conflicts with GAAP are not allowed. Companies should ask four questions to determine whether they are violating this rule; if the answer is yes to any of these, use of the measure is not permitted.

- Does the adjustment shift GAAP from accrual basis to a cash or modified basis of accounting (e.g., recognize revenue on a cash basis)?
- Does the adjustment include transactions that are also reportable in another company’s financial statements?
- Does the adjustment reflect part but not all of an accounting concept?
- Does the adjustment render the measure inconsistent with the economics of a transaction or agreement?

Final thoughts

Non-GAAP measures have become an important part of the financial reporting process and should be treated that way. Management should critically evaluate which non-GAAP measures it chooses to present by assessing the relevance for investors and other financial statement users, considering common measures used in its industry, and the availability of information needed to adjust the companies financial statements (i.e., is the information needed for investors to adjust GAAP numbers readily available).

Companies should implement processes and review procedures for non-GAAP measures similar to those used for financial statement information. In addition, management should review its non-GAAP measures with its board of directors and audit committee. Research suggests that independent board involvement increases the quality of non-GAAP measures.

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