To GAAP or non-GAAP? The SEC is watching

Understanding the use of non-GAAP financial measures continues to be an area of focus for the SEC. Is it for your audit committee, too?

August 2019

The SEC continues to scrutinize the use of non-GAAP financial measures. What audit committees should know.
Nearly 20 years after the dot-com boom sparked a proliferation of non-GAAP financial measures, they’re back in style. The statistics tell us that nearly all S&P 500 company financial statements contain at least one non-GAAP metric. And the discrepancy between profits reported using generally accepted accounting principles (GAAP) and non-GAAP measures is growing.

What’s the big deal about using non-GAAP measures? For one thing, the SEC is watching and can ask questions about companies’ use of non-GAAP metrics. So what should companies and their audit committees know about this issue? That’s what we want to share with you.

“There has to be a similar consistency in the reporting of non-GAAP numbers and key performance indicators (KPIs) as we expect in GAAP numbers.”

A brief history

The debate over the use of adjusted financial measures is not new. Non-GAAP measures were popular in the 1990s, and many companies used them in earnings press releases. But the accounting scandals of the early 2000s caused concern that those measures were misleading investors, resulting in the SEC issuing “Cautionary Advice” and leading to the Commission’s first enforcement action based on non-GAAP financial measures.

What are non-GAAP measures?

Non-GAAP measures adjust a company’s historical or future performance, financial position or cash flows by excluding or including amounts from the most directly comparable GAAP measure.

In 2003, as directed by the Sarbanes-Oxley Act, the SEC adopted Regulation G and Item 10(e) of Regulation S-K, which addressed the disclosure of non-GAAP financial measures. The disclosure requirements of these two rules differ, but both require, at a minimum, that public companies disclose a reconciliation of the non-GAAP metric to the closest GAAP metric and require that the measure not be misleading.

Then in 2010, the SEC revised its guidance, allowing companies to include non-GAAP measures in SEC filings that adjusted for nonrecurring items, as long as recurring items were not labeled as nonrecurring. Also, the SEC encouraged companies using non-GAAP measures outside of their SEC filings to include those measures in SEC filings so that communications with investors were consistent.

Commonly used non-GAAP measures

Percentage of S&P 500 companies using a particular type of non-GAAP metric

<table>
<thead>
<tr>
<th>Measure</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income (including Operating income)</td>
<td>82%</td>
</tr>
<tr>
<td>Earnings per share</td>
<td>79%</td>
</tr>
<tr>
<td>Cash flow</td>
<td>35%</td>
</tr>
<tr>
<td>EBITDA (including adjusted EBITDA)</td>
<td>24%</td>
</tr>
</tbody>
</table>

Why is this topic relevant?

Over the last several years, non-GAAP measures have been back in the spotlight. More companies now use non-GAAP measures, and the majority of the time, their non-GAAP results are better than those reported under GAAP.

The last time the SEC updated its interpretive guidance by releasing additional Compliance & Disclosure Interpretations (C&DIs) was in May 2016. Since those C&DIs were released, the SEC has reiterated their views on non-GAAP through a number of public remarks.

The most significant themes of the updated C&DIs are:

- The kinds of non-GAAP measures that are potentially misleading
- The presentation of GAAP measures with “equal or greater prominence”
- The prohibition of certain per-share presentations
- The calculation and presentation of the income tax effects of non-GAAP adjustments

Certain of the C&DIs denote a shift by SEC staff to a more prescriptive approach to non-GAAP financial measures. For example, the C&DIs provide examples of disclosures that give undue prominence to non-GAAP measures, such as including only a non-GAAP measure in an earnings release headline. A number of the disclosure practices are common in public company earnings releases. Any changes companies make related to non-GAAP information should be evaluated for compliance with this guidance.

“Integrity and consistency in the non-GAAP and key operational figures are essential characteristics”

“I am concerned that the lack of uniform standards and the lack of comparability may result in presentations that are not fairly balanced or fairly presented. In effect, what non-GAAP metrics measure, or attempt to communicate, more often are in the eye of the preparer rather than the beholder.”
SEC comment letters referencing non-GAAP issues

<table>
<thead>
<tr>
<th>Year</th>
<th>Letters</th>
<th>Percentage of all letters</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>382</td>
<td>17.6%</td>
</tr>
<tr>
<td>2017</td>
<td>948</td>
<td>26.1%</td>
</tr>
<tr>
<td>2016</td>
<td>922</td>
<td>22.4%</td>
</tr>
</tbody>
</table>

During the period of January to June 2018, the most common non-GAAP comments to companies included measurements with undue prominence, presentation on a “net of tax” basis and measurements using individually tailored recognition and measurement methods.

What are the rules around non-GAAP information?

Unless you are steeped in the SEC rules covering non-GAAP information, they can be confusing. Part of this is caused by rules that are dependent on where or how the non-GAAP information is communicated. We summarize elements of the various rules but cannot address all aspects of the regulations and interpretive guidance. For more information, see the SEC’s website at www.sec.gov.

Determining the applicable non-GAAP rules

<table>
<thead>
<tr>
<th>Where does the non-GAAP disclosure appear?</th>
<th>Which regulation governs?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings calls</td>
<td>Regulation G</td>
</tr>
<tr>
<td>Media interviews</td>
<td></td>
</tr>
<tr>
<td>Investor and industry presentations</td>
<td></td>
</tr>
<tr>
<td>Certain press releases (including earnings guidance)</td>
<td></td>
</tr>
<tr>
<td>Annual and quarterly earnings press releases</td>
<td>Item 2.02 of Form 8-K</td>
</tr>
<tr>
<td>Filings with the SEC</td>
<td>Regulation S-K Item 10(e)</td>
</tr>
<tr>
<td>- Form 10-K</td>
<td></td>
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<tr>
<td>- Form 10-Q</td>
<td></td>
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<tr>
<td>- Registration statements</td>
<td></td>
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<tr>
<td>- Proxy statements</td>
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</tbody>
</table>

Which non-GAAP rules govern the presentation of non-GAAP measures depends on where the disclosure will appear.

The disclosure requirements vary based on the applicable regulation. Regardless of the source, all of the governing regulations share an overarching principle that non-GAAP information cannot be misleading.

Non-GAAP disclosure requirements

<table>
<thead>
<tr>
<th>Disclosure requirements</th>
<th>Regulation G</th>
<th>Item 2.02 of Form 8-K</th>
<th>Regulation S-K Item 10(e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Most directly comparable GAAP measure</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Reconciliation to GAAP measure</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Equal or greater prominence of GAAP measure</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Why management believes investors would find the non-GAAP measure useful</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Management purpose, if any, of the non-GAAP measure</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
</tbody>
</table>
Companies may also be subject to express prohibitions depending on which regulation governs a particular non-GAAP disclosure. For example, adjusting a non-GAAP performance measure to eliminate or smooth items described in a filing with the SEC as being nonrecurring, infrequent or unusual when such items are likely to recur or have occurred over a two-year period is prohibited under Item 10(e). In addition, non-GAAP disclosures are prohibited from being included in financial statements or the accompanying notes.

Remember: Non-GAAP financial measures are often not subject to a company’s internal control over financial reporting.
Can the non-GAAP adjustments be trusted?

The use of GAAP provides uniformity in how companies report their financial performance. But most S&P 500 companies choose to report non-GAAP metrics in addition to GAAP measures. If done appropriately, non-GAAP measures can provide insights into a company’s business, past performance and potential prospects.

However, with the proliferation of the use of non-GAAP measures—the majority of which show non-GAAP results exceeding GAAP results—critics have questioned whether, in some instances, the alternative metrics are painting too rosy a financial picture. In addition, non-GAAP measures are not audited, and the preparation of non-GAAP information is not typically covered by a company’s internal control over financial reporting. These factors have led to an overall lack of trust in non-GAAP measures.

Non-GAAP measures have also caught the eye of the Public Company Accounting Oversight Board (PCAOB). Because non-GAAP measures are not included in financial statements and are often only included in press releases, the non-GAAP information is not covered by the external auditor’s professional auditing literature. Although auditors do not report on non-GAAP measures, some management and audit committees may use the external auditors as an informal sounding board on whether the company has complied with the non-GAAP regulations. The PCAOB’s Standing Advisory Group has discussed the possibility of expanding auditor responsibilities to provide assurance over non-GAAP measures to help build trust. Stay tuned for further developments on potential auditor responsibilities with regard to non-GAAP measures.

“Audit committees that clearly understand non-GAAP measures presented to the public—and who take the time and effort in their financial reporting oversight role to review with management the preparation, presentation and integrity of those metrics—are an indicator of a strong compliance and reporting culture.”

Where does the audit committee fit in?

Here are some questions audit committees can ask of management:

**Why has management chosen to present non-GAAP measures?**

- What is the purpose (regardless of how long the measures have been used)?
- Are measures consistent with those used by competitors and peer companies? If not, why not?
- Has management received questions or feedback from investors or analysts?

**What are the incentives for possible “earnings management”?**

- Does the company have a written policy on what will give rise to a non-GAAP adjustment? How is materiality considered in this policy?
- What are the areas of judgment?
- Is management “cherry picking” by adjusting for losses but not removing similar gains or are they not being consistent with the comparable-period adjustment?

**What is management’s process to calculate the non-GAAP measures?**

- What procedures are in place to ensure the calculations are accurate and consistent with those of prior periods?
- Is the process covered by management’s internal control over financial reporting or other disclosure controls?

- Has the company considered having internal audit perform a review of the internal controls over the use of non-GAAP measures to determine whether or not the controls are effective?
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The audit committee has a significant role in overseeing the presentation of non-GAAP measures. And non-GAAP measures will likely continue to be an area of focus for the SEC staff.

For more information about the steps companies can take to build confidence in their non-GAAP measures and other key performance indicators, listen to PwC’s CFOdirect podcast “Mind the GAAP! Here are 5 things you need to know about non-GAAP financial measures.”

Is the presentation and disclosure fair, balanced and transparent?

- Are GAAP measures presented with equal or greater prominence?
- Is the disclosure descriptive and transparent or “boilerplate”?
- Have the company’s latest SEC comment letters focused on any non-GAAP matters?

Do the measures comply with the SEC regulations and the SEC staff’s 2016 interpretive guidance?

- Can the measures potentially be considered misleading?
- Are prohibited measures excluded?
- Are adjustments to arrive at a non-GAAP measure labelled as nonrecurring, infrequent or unusual expected to recur in the next two years?
How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC’s Governance Insights Center.

**Maria Castañón Moats**  
Leader, Governance Insights Center  
maria.castanon.moats@pwc.com

**Stephen G. Parker**  
Partner, Governance Insights Center  
stephen.g.parker@pwc.com