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Report from the Working Group on Non-GAAP Financial Measures

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Non-GAAP Financial Measures

2016 Recommendations

- Prescribe definitions – difficult to find NGFM that fit all business models.
- Limit the number and use of NGFM – may result in a significant loss of information for investors and constrain management's ability to explain how they manage resources and companies.
- NGFM should be independently validated through self-regulation of industry/trade organizations – it is unclear whether this is a viable approach.

Non-GAAP Financial Measures

2016 Recommendations (continued)

- Require disclosure and presentation of NGFM in financial statements to ensure they are consistently calculated and audited –significant concerns about whether this can be achieved in a timely manner.

- Mandate inclusion in supplementary information and make NGFM subject to AS 17, *Auditing Supplementary Information Accompanying Audited Financial Statements*.

Non-GAAP Financial Measures

Key Takeaways - 2017

- The financial reporting models of U.S. and International standards setters and regulators do not require audited performance metrics. Yet management often says these reflect the way they manage companies better than many GAAP measures, and investors continue to demand NGFM and KPIs. Investors benefit from the increased disclosures provided by NGFMs, but the lack of standardization and auditing has made NGFMs potentially dangerous to the stability and efficiency of the markets.
  - *The validity, predictive ability (value relevance) and usefulness of NGFMs and entity-specific Key Performance Indicators (KPIs) continues to be debated and unclear, yet investors demand and use these data,*
  - *NGFM/KPIs may influence market prices in the short term.*
  - *NGFM/KPIs promulgated and used by data aggregators exacerbate the problems.*

Non-GAAP Financial Measures

Key Takeaways

- Some members of the issuer, investor, and data or forecast aggregator communities are pushing the market down a "slippery slope" of poor quality accounting metrics and disclosure

- Regulators and standard setters' reporting models need to evolve to reflect needs of management and investors for different or industry-specific performance metrics

Non-GAAP Financial Measures

Key Takeaways

- Regulators and standard-setters must determine who should define industry-specific key performance indicators and NGFM, which should be audited for assurance. Alternatively, standard-setters and regulators should provide display, reconciliation, and disclosure guidance for performance metrics defined and presented by management.
- Management should be required to transparently define (and reconcile) selected company- or industry-specific NGFMs, and the PCAOB should require auditors to audit reported NGFMs and reconciliations
- NGFM and KPI should be provided for at least three years regardless of whether management elects to discontinue a metric after providing it for one or two years

Non-GAAP Financial Measures

Approach for This Year's Presentation

The 2017 NGFM team took a two-pronged approach to our research this year:

- Additional research on how investors and management use NGFM
- Developed recommendation(s) and proposed auditing pathways

Non-GAAP Financial Measures

NGFM and KPIs

NGFM and KPIs used by Industrial and Investment Management

- EBITDA (variously defined) multiples are used to track and report performance and for the evaluation of and decisions on acquisitions and divestitures (industrial and AUM).
- EBITDA Multiples are often used to track and compare peer performance
- Various Free Cash Flow proxies, Revenue and EBITDA growth are key metrics for measurement of value

Non-GAAP Financial Measures

NGFM and KPIs

NGFM and KPIs – Other Uses and Users

- Rating Agencies
- Credit Investors
- Banks for the evaluation of credit lines
- The U.S. Federal Reserve Bank for limits on acquisition-related debt
- Data Aggregators and Analysts contributing to Consensus Earnings Estimates

Non-GAAP Financial Measures

NGFM and KPIs

Concerns

- Academic and Street research has rarely found value relevance or predictive ability

- For example, a recent study found little relationship to value but NGFM users were generally companies reporting lower GAAP earnings and excess management compensation.

Non-GAAP Financial Measures

Disclosure of Material and Unusual Adjustments to GAAP

- We are concerned that corporations are selectively reporting one-time and recurring items as NGFMs that may make "core" operations look more favorable and not disclosing one-time adjustments that would make "core" operations look worse

- We believe this is misleading

Non-GAAP Financial Measures

Disclosure of Material and Unusual Adjustments to GAAP

Examples:

- Supplier rebates
- Channel movements
- Weather
- Favorable contract adjustments
- Large cuts in operating budgets (such as R&D)

Non-GAAP Financial Measures

Disclosure of Material and Unusual Adjustments to GAAP

Many companies adjust GAAP metrics for recurring or essential expenditures:

- Stock Compensation
- Interest and depreciation expense by debt and capital asset-intensive companies.
- Inconsistently defined and noncomparable use of restructuring charges
- Reconciliations contain or exclude varying items from one period to the next.
- "Non-cash" expenses is a common rationale. However, analysis shows that cash flows occur (or have occurred) in different periods. Standard-setters have not paid attention to the statement of cash flows adding to the need for operating and free cash flow proxies.

Non-GAAP Financial Measures

Disclosure of Material and Unusual Adjustments to GAAP

- Exchange Act Rule 12b-20
  - "In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading."
- Sarbanes Oxley Act Section 401
  - "…does not contain an untrue statement of material fact or omit to state a material fact necessary in order to make the pro forma financial information , in light of the circumstances under which it is presented, not misleading."
- Using FASB-defined KPIs would restrict issuers from using selective disclosure within their NGFMs of material and unusual nonrecurring transactions

Non-GAAP Financial Measures

Recommendations – Preferred Path

- The FASB should develop and define new relevant key performance indicators (“KPIs”), to replace NGFMs
- NGFM and KPIs should be included in the financial statements and audited alongside the rest of the financial statements
- In addition, all material unusual and nonrecurring transactions should be disclosed in the footnotes of the financial statements to discourage issuers from using NGFMs to selectively report one-time items

Non-GAAP Financial Measures

Recommendations

- Investors desire business level metrics beyond what is provided in GAAP, and we believe these metrics can be provided through GAAP defined NGFM and KPIs
- NGFM and KPIs should be developed at the industry level
  - Recognizes each industry's unique operating environment
  - May more comprehensively incorporate investors' desired metrics
  - Consider utilizing SASB's industry classifications (SICS) as a roadmap
    - SASB allows companies to select the industry category that best fits their organization
    - Companies with multiple business lines are allowed to report KPIs from multiple industry groups

Non-GAAP Financial Measures

Recommendations

- Once the FASB has defined industry-specific KPIs, auditors should be required to test and give an opinion on the defined KPIs in the Auditor's Report

- The KPIs should be audited with the same level of scrutiny as the rest of the financial statements

Non-GAAP Financial Measures

Recommendations – Concerns

- The FASB has not placed NGFM and KPIs on its agenda
- The IASB proposes to define EBIT but has no plans related to EBITDA
- Major recent standards (for example, revenue reporting, leases, and credit losses) are primarily "one-size-fits-all" and eliminate many legacy industry-specific standards
- Performance metrics are analytical tools and may be beyond the remit of accounting standard setters

Non-GAAP Financial Measures

Recommendations – Alternatives

- Standard-setters and regulators should combine their efforts to develop display, reconciliation, and disclosure requirements for NGFM and KPIs that would be audited.
- NGFM and KPIs would be selected and defined by management with input from industry representatives.
- The minimum period for reconciliations and disclosure should be three years regardless of whether management decides to discontinue use after one or two years.

Non-GAAP Financial Measures

Interim Path – Expand the Audit

- Because of the length of time and uncertainty of acceptance associated with our preferred recommendation, we offer an interim path towards modernizing financial reporting which we believe could better fit the needs of investors
- The SEC should utilize its authority from the Sarbanes-Oxley Act to update Regulation G to require issuers to disclose how they define NGFMs
- The PCAOB should then require that the reconciliations from NGFMs to GAAP be audited based on each issuer's definition of NGFMs

Non-GAAP Financial Measures

Issuer-Defined NGFMs

Benefits of Issuer-defined Metrics

- Consistency (or disclosed differences) in reporting, and the ability to audit the NGFMs
- Prevent firms from changing their NGFMs year to year without disclosing the changes to investors
- More useful to investors
- May provide the framework for financial reporting modernization initiatives such as FASB/IASB defined KPIs

Non-GAAP Financial Measures

Auditing of Defined NGFMs

- Audit procedures as defined in AS1105 and AS2701 could serve as the basis for the new standard
- Reconciliations of NGFMs in the financial statements and MD&A should be audited
- Materiality should be measured on the NGFM's adjustment relative to the GAAP metric on a line item basis

Non-GAAP Financial Measures

Use of NGFMs in Earnings Releases

- We remain concerned about the use of NGFM and KPIs in earnings releases
  - Timeliness of earnings releases makes auditing prior to release potentially undesirable
  - However some investors do react to earnings releases
- Consider requiring a reconciliation to GAAP of NGFM used in the quarterly earnings releases as a footnote to the financial statements
- Knowing that the footnote with a reconciliation of the quarterly releases would be audited may mitigate poor disclosure in these currently unaudited releases