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GAAP or Non-GAAP?

As best-of-breed companies continue to search for more meaningful and effective ways to communicate with investors, analysts and business partners, the use of non-GAAP [generally accepted accounting principles] financial measures is making a comeback. Each quarter, many established and emerging public companies — such as the Walt Disney Co. and Zynga, respectively — use non-GAAP financial measures to provide insight into key operational metrics and to supplement increasingly complex GAAP results.

Further, a recent study of venture-backed initial public offerings by law firm Wilson Sonsini Goodrich & Rosati determined that half of the companies surveyed disclosed non-GAAP financial measures.

As business models evolve and grow in complexity, and as those in financial reporting roles struggle to satisfy the growing appetite of a hungry investing public, non-GAAP measures are being used increasingly by smart companies as a strategic asset to communicate effectively and clearly their financial performance from the prevue of management.

What Exactly is a Non-GAAP Measure?

The U.S. Securities and Exchange Commission (SEC) considers a non-GAAP financial measure a numerical measure of past or future financial performance, financial position or cash flows that includes amounts that are excluded from the most directly comparable GAAP measure or excludes amounts that are included in the most directly comparable GAAP measure.

Common examples of non-GAAP measures are EBITDA (earnings before interest, taxes, depreciation and amortization), EBIT (earnings before interest and taxes) and FFO (funds from operations). Further, companies that disclose operating income that excludes "nonrecurring" items such as restructuring expenses or impairment charges are using non-GAAP financial measures.

Non-GAAP financial measures do not include operating or other statistics that are not financial in nature or measures that are based on GAAP information. For example, the following do not meet the definition of a non-GAAP financial measure: number of employees, subscribers or stores; return on sales or gross margins computed using GAAP amounts; estimated revenues/expenses of a new product line provided that the estimates are based on GAAP computations. Companies are prohibited from presenting non-GAAP financial measures on the face of the GAAP financial statements or in the notes.

Past Abuses and Sarbanes-Oxley

The dot-com boom of the late 1990s and early 2000s saw many emerging companies develop new financial metrics to communicate their potential worth to eager investors. Public company earnings and press releases frequently supplemented GAAP information with pro forma non-GAAP data.

However, because regulators had provided very little guidance and because there was no clear definition of the term "pro forma," one company's pro forma earnings could not be consistently measured against another's. Furthermore, without uniform characteristics, companies developed their own pro forma measurements to focus investor attention where management wanted.

In December 2001, the SEC issued a cautionary advice release (Release 33-8039, FR 59) to remind registrants of the need to comply with the antifraud provisions of the federal securities laws when providing pro forma financial information in earnings releases. The SEC warned public companies that non-GAAP financial information can mislead investors if it is not presented appropriately.

The SEC made an even stronger statement in January 2002 when it announced the settlement of its first enforcement case involving non-GAAP earnings information (against publicly traded Trump Hotels & Casino Resorts). The SEC alleged that the company made misleading statements in its Q3 1999 earnings release in order to create the impression that it exceeded analysts' expectations.

Shortly thereafter, the United States Senate passed the Public Company Accounting Reform and Investor Protection Act and the House passed the Corporate and Auditing Accountability and Responsibility Act, which together, were signed into law as the 2002 Sarbanes-Oxley Act. Section 401(b) of the Sarbanes-Oxley Act required the SEC to develop rules regarding financial information that is computed on a basis other than GAAP, and in January 2003, a final rule was issued by the SEC.

Ultimately, the SEC's goal was to ensure that investors are not misled by financial information that differs from what is presented in the GAAP basis financial statements.

The SEC's Rules — in Plain English

Broadly speaking, the SEC has three key rules that govern non-GAAP financial measures. These rules generally apply to all registrants, regardless of market capitalization:

- **Regulation G** is an anti-fraud provision that applies to all company communications (press releases, conference calls, webcasts, etc.). Under Regulation G, registrants cannot make public a non-GAAP financial measure that contains an untrue statement of a material fact or omit a material fact that is necessary to make the information not misleading.

When a registrant publicly discloses non-GAAP financial measures, the registrant must provide (a) the most directly comparable financial measure determined in accordance with GAAP; and (b) a quantitative reconciliation of the differences between the non-GAAP measure and associated comparable GAAP measure.

For non-GAAP measures that are presented orally, these two disclosure requirements can be met by posting the required information to the registrant's website and disclosing the availability of these disclosures.

- **Item 10(e) of the SEC's Regulation S-K** governs the use of non-GAAP measures in annual (10-K) and quarterly (10-Q) reports and contains even more extensive rules for using non-GAAP measures than the general standard under Regulation G.

To comply, non-GAAP financial measures must be accompanied by the quantitative reconciliation required by Regulation G; the reason that management believes the use of the non-GAAP financial measure is useful for an investor; the additional purposes for which management uses non-GAAP measures; and the most directly comparable GAAP financial measure must be presented with equal or greater prominence than the non-GAAP measure.

A key provision in Item 10(e) is the prohibition of using terms such as "non-recurring," "infrequent" and "unusual" under certain circumstances.

- **Item 2.02 of Form 8-K** requires public companies to furnish to the SEC all earnings releases or announcements disclosing material non-public financial information. This requirement exists even if the registrant does not present any non-GAAP financial information. In the Form 8-K, the registrant should briefly identify the release or announcement and include the related text as an exhibit.

In November 2009, the SEC settled charges against SafeNet Inc. and several of its officers and employees in connection with an alleged earnings management scheme that materially misstated the company's GAAP and non-GAAP financial results. The SEC charged that the defendants violated Regulation G by reporting non-GAAP earnings that improperly excluded certain ordinary expenses as nonrecurring charges. Additionally, the company's chief executive officer and chief financial officer allegedly mischaracterized these items in earnings calls.

The SEC 'Lightens Up'

Also in 2009, SEC staff reviewed its interpretations of non-GAAP measures to ensure that the existing non-GAAP guidance was not causing companies to keep key information out of their SEC filings. The SEC believed that while many registrants frequently include non-GAAP measures in earnings releases, many had been reluctant to include these same measures in SEC documents because of concerns about future SEC staff comments.

As a result of its review, the SEC issued new Compliance and Disclosure Interpretations (C&DIs) on the use of non-GAAP financial measures in January 2010. While the SEC's rules on non-GAAP financial measures were not amended, the new C&DIs provided some new and revised interpretations, which effectively provided registrants with more flexibility to disclose non-GAAP measures in SEC filings.

The most important change was the SEC's revised guidance on nonrecurring, infrequent or unusual items. Item 10(e) of Regulation S-K prohibits adjusting a non-GAAP measure to eliminate or smooth items described as nonrecurring, infrequent or unusual if 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 last two years.

The SEC made it clear to registrants that they can still adjust for such a charge or gain; however, they cannot describe the charge or gain as nonrecurring, infrequent or unusual unless it meets the criteria specified in the previously sentence.

The Good, the Bad and Groupon

Groupon's well-publicized use of non-GAAP financial measures has illuminated an emerging trend in financial reporting: corporate America's use of these indicators is once again on the rise.

When Groupon filed for its initial public offering in 2011, it boldly declared "we don't measure ourselves in conventional ways." When Groupon introduced financial indicators such as "adjusted consolidated segment operating income," or adjusted CSOI, the investment community, as well as the SEC, severely criticized Groupon for its use of non-GAAP measures and suggested the company was conceited and otiose.

In fact, one financial pundit suggested that CFOs might soon skip straight to EBE — earnings before expenses. Whether Groupon's use of non-GAAP measures were self-serving or were actually beneficial to investors and analysts, the company's management deserves some credit for its efforts to translate complex GAAP-based information into financial data that told its story.

To be sure, the use of non-GAAP measures must be made with care and thoughtfulness. However, with clearly defined rules in place, a more relaxed regulatory environment and increasingly complicated GAAP data and business models to analyze, proactive executives should evaluate their communication strategies with investors and business partners and consider the potential benefits of non-GAAP measures.

Non-GAAP measures can be particularly useful in helping companies tell their story more effectively, which is becoming increasingly important given the evolving nature and complexity of today's businesses.

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