Non-GAAP financials can be described as “numbers management talks about once the auditor leaves the room.” Often described as “adjusted,” “core,” or “cash” earnings, these figures purport to give investors a cleaner view of a company’s true operations before the subtraction of a whole host of pesky expenses required by generally accepted accounting principles, or U.S. GAAP. Non-GAAP financials are not audited and are most often disclosed through earnings press releases and investor presentations, rather than in the company’s annual report filed with the SEC.

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Topics Cover
- Non-GAAP financials
- Current IPO market
- Solutions for oversight of financial metrics
Has non-GAAP Reporting Become an Accounting Chasm?

By Drew Bernstein | As originally published on CFO.com

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An in-depth study by Audit Analytics revealed that 97% of companies in the S&P 500 used non-GAAP financials in 2017, up from 59% in 1996, while the average number of different non-GAAP metrics used per filing rose from 2.35 to 7.45 over two decades. This has led to a growing divergence between the earnings calculated according to accepted accounting principles and the “earnings” touted in press releases and analyst research reports.

As high profile “unicorn” companies have transitioned to become public while still running sizable accounting losses, the definitions and exclusions used to redefine profitability have become elaborate confections. Uber’s most recent earnings release, to cite one example, contains more than 15 separate non-GAAP financial metrics with names like “core platform adjusted net revenue” and “other bets contribution profit (loss) by segment,” along with several pages of definitions as to how they are all derived. The highly anticipated WeWork IPO introduced the exotic concept of “community-adjusted EBITDA,” in a prospectus for a bond offering this past spring, in which it deducted not only interest, taxes, depreciation and amortization, but also basic corporate expenses like marketing, general and administrative, and development and design costs. (It dropped the term in its recent IPO filing but came up with a new “contribution margin excluding non-cash GAAP straight-line lease cost” metric, which sounds less New Age but still resides on a distant planet from GAAP profits.)

This raises the legitimate question of what do words like “earnings” and “profitable” even mean in the era of the non-GAAP arms race? Did Uber, for example, actually lose a worrisome $5.2 billion in the second quarter of 2019, as per GAAP, or did it post a sparkling “core platform contribution profit” of a positive $220 million, to choose one of its non-GAAP, profit-like terms? It has become nearly impossible to discern what the “headline” earnings should be.

At one point, General Electric reported four different versions of earnings per share in its quarterly reports. Some companies have even reportedly taken the extra step of contacting journalists and analysts to provide them with alternative means of measuring GAAP revenues that they can plug into the formula for calculating non-GAAP earnings to get the “correct” figure (which just happens to beat the prior guidance they provided.)

Famed short seller Jim Chanos recently gave an address with the title, “Hiding in Plain Sight: Pro Forma Financial Metrics in the Post-Truth Age,” where he argued that the use of non-GAAP reporting has become so pervasive as to constitute a form of “legal fraud,” where companies massively overstate the true profitability of their business, or lack thereof, with distorted reporting metrics. He points to examples of companies that take “one-time” restructuring charges every year like clockwork and technology companies where the cost of stock-based compensation makes up over half of reported non-GAAP earnings as some of the more egregious examples.
Whether aggressive use of non-GAAP reporting constitutes potential fraud is debatable. But what cannot be argued, is that it is creating a crisis in how investors, analysts, and the media report financial performance and value companies.

### Does non-GAAP Reporting Add Value?

When management is asked why they resort to non-GAAP reporting, the most common response is that these measures are requested by the analysts who follow them and are commonly used in earnings models used to value the company. Indeed, sell-side analysts and funds with a long position in the stock may have incentives to encourage a more favorable alternative presentation of earnings results. Management also argues that non-GAAP measures help the company to more effectively “tell its story” by stripping out the noise associated with one-time accounting events and presenting metrics that are used by senior management and the board to monitor business performance and allocate resources.

If non-GAAP reporting is used as a supplemental means to help investors identify underlying trends in the business, one might reasonably expect that both favorable and unfavorable events would be “adjusted” in equal measure. But research presented at American Accounting Association suggests that companies engage in “asymmetric” non-GAAP exclusions of mostly unfavorable items as a tool to “beat” analyst earnings estimates.

The rising use of opportunistic non-GAAP numbers has coincided with a doubling of the percentage of companies reporting dramatic upside earnings surprises to over 25% over 17 years, even though according to GAAP that percentage of major earnings surprises has remained stagnant. Other research suggests that the engineering of non-GAAP reporting metrics may have replaced or augmented prior techniques such as manipulating accruals as a tool for earnings management or disguising business deterioration. Data suggests that companies with fewer independent directors tend to engage in more aggressive non-GAAP accounting.

Another concern is that boards may be using the same type of non-GAAP performance measures to monitor and reward management performance, allowing top management to in effect adjust or customize the measuring tape after the fact to meet their targets. The Council of Institutional investors recently petitioned the SEC to mandate more clear disclosure as to how non-GAAP metrics used in the award of executive compensation are calculated, and research suggests that aggressive use of non-GAAP financial reporting is correlated with excessive pay for executives. This can create distortions in management decision making. For example, if the expense of stock-based compensation is excluded from the “adjusted” earnings metric used to award top management bonuses, management will quite rationally want to substitute stock and options for cash compensation awards to the greatest extent possible.

On balance, the evidence seems to suggest that while non-GAAP financial reporting can be an effective tool to increase the total informational mix available to investors, the potential for abuse and distortion of market pricing is quite high.

### The SEC Weighs In

The Securities and Exchange Commission has expressed intermittent bouts of concern with the rising prevalence of non-GAAP accounting in public pronouncements and speeches. The Commission has also provided detailed guidance to companies as to the uses of non-GAAP that are and are not permitted, beginning with Regulation G that was issued as part of Sarbanes-Oxley, updates to rules S-K 10(e) on financial reporting in SEC filings, and a series of Compliance & Disclosure Interpretations most recently updated in 2018 that provide technical guidance on how to apply the rules in a wide range of situations and industries.

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Given the “more disclosure is good” orientation of the SEC, these guidelines generally permit the use of non-GAAP financial reporting as long as it is done in a way so as not to be misleading to investors.

While there are a myriad of specific requirements and limited exceptions, some of the most important principles are:

- The GAAP metric must be presented with equal or greater prominence to any non-GAAP equivalent or lookalike that a company chooses to disclose. In other words, if your company has a GAAP loss per share
you better not have a headline that only touts your impressive “adjusted” earnings per share guidance beat.

- Any non-GAAP number discussed needs to be clearly reconciled to GAAP in a table so investors can reconstruct what you added or subtracted to get to the non-GAAP number, with GAAP as the starting place.
- Companies are not permitted to characterize expenses as “one-time” if they have incurred similar charges in the past two years or expect to do so in the upcoming two years (although they are still allowed to exclude such charges from non-GAAP numbers).
- Companies are permitted to present non-GAAP performance measures on a per share basis, such as “adjusted EPS,” but they are prohibited from presenting non-GAAP measures of liquidity or cash flow, such as “free cash flow,” on a per share basis.
- While companies may exclude certain expenses required by GAAP or add back revenue excluded under GAAP, they are prohibited from devising custom-tailored versions of GAAP metrics that act as a substitute for standard accounting. In other words, you can leave items out of the recipe, but you can’t cook up whole new ingredients and call that accounting.
- Companies also need to adjust their non-GAAP profit metrics for the tax effects that would have occurred if they had in fact earned those “adjusted profits,” meaning that they are showing the fictional impact of taxes that they will neither pay in cash nor accrue as if they had earned them under GAAP accounting.
- If companies provide guidance based on non-GAAP metrics, then they are also required to reconcile that guidance to the nearest GAAP equivalent as well, so investors can understand what they are taking out of the mix, unless this would involve unreasonable effort and expense. This would theoretically prevent management from regularly fine tuning the “mix of exclusions” to leap over the earnings hurdle each quarter.

The overarching rule is that companies are prohibited from including material misstatements or omissions that make the presentation of non-GAAP financials misleading.

In addition to the published rules and guidance, the SEC regularly sends comments letters to companies it believes may be crossing the line in how they report results. The number of comment letters has been steadily declining since 2010, but whether it’s due to management doing a better job of complying with SEC guidance or limited resources to apply to reviewing earnings releases is unclear.

Recently, the SEC has been going one step further to take enforcement actions against certain companies it deems to be egregiously misusing non-GAAP accounting. Last year they sanctioned and fined ADT for exclusively trumpeting their non-GAAP performance in an earnings release, while burying GAAP equivalents several paragraphs down into the text. And at the beginning of August, the SEC extracted a settlement and the Department of Justice obtained guilty pleas from several executives on charges of securities fraud by a New York Real Estate Investment Trust, Brixmor Property Group, related to their calculation of a non-GAAP reporting metric, same store net operating income, that they reported to investors.

These actions suggest that the SEC may be moving from words of caution to meaningful action, when they believe that non-GAAP legerdemain crosses the line into fraudulent disclosure.

Non-GAAP: A User’s Guide

This raises the question: How should management and boards determine what amount of non-GAAP disclosure, if any, is most appropriate to employ in their financial disclosures?

While there have been some admirable attempts to establish “leading practices” guidelines, such as the guide to Non-GAAP Measures by the Center for Audit Quality, the range of approaches taken by prominent companies is so disparate, it is hard to find common ground. Indeed, one of the biggest deficits of non-GAAP metrics is they have no standardized definitions or methods of calculation (or even nomenclature), meaning that they are virtually worthless for comparing one company with another or trends in corporate performance over time.
Audit committees, who should be providing oversight of these metrics, are trapped by what might be called “Gresham’s law of non-GAAP,” by which adjustments have become so pervasive that companies that apply a more rigorous approach to reporting have their “earnings” and “profit margins” unfavorably compared to competitors willing to further debase reporting standards. This unfortunate cycle will only be broken when the end users of financial reporting — institutional investors, analysts, lenders, and the media — agree that we are on the verge of systemic failure in financial reporting. In the history of financial markets, such moments of mental clarity most often occur following the loss of vast sums of capital.

Indeed, many short sellers now look at the escalating and more opportunistic use of non-GAAP reporting as an important leading indicator of deteriorating fundamentals, an unsustainable business model, or dishonest management. At some point, logically, there should be a valuation premium accorded to companies that are accounting straight shooters.

Some steps that companies and boards may wish to consider are:

- **Let Investors Do the Math** – Rather than providing a slew of “adjusted,” “core,” “operating,” and “community-based” versions of what earnings “would have been” companies can choose to simply identify all the factors that management believes are unusual, will not be settled in cash, or reflect changes in input pricing or currencies that investors should be aware of. This would then leave it up to analysts to actually analyze the data, apply their own economic judgements, and create value-added models of corporate performance. While this might disrupt the refined ballet of setting and leaping over a unitary adjusted EPS “number,” this is probably healthy for the market.

- **Establish a Non-GAAP Policy** – If the management and Audit Committee still believe that their results will be inescapable to investors without providing “adjusted” metrics that are pre-packaged for the market, then it is a good idea to establish a clear and consistent policy on non-GAAP reporting that establishes what metrics will be used and how they will be calculated. This can lead to greater consistency in the application of non-GAAP, so that accounting windfalls are excluded consistently with accounting expenses. More fundamentally, management and the board should be able to explain why excluding certain “bad stuff,” such as restructuring costs, share-based compensation, acquisition-related charges, asset impairments, depreciation and amortization, legal settlements, taxes, and debt expenses, more accurately represents the underlying economics of the business than a presentation according to GAAP.

- **Make Guidance, Compensation, and Reporting Consistent** – If management wants to provide guidance on a non-GAAP basis, then it should be able to clearly explain the adjustments to GAAP reporting that are baked into that guidance. Similarly, if Boards decide to provide incentive compensation to management or employees on the basis of non-GAAP they should be able to clearly explain why this is a superior metric to drive value creation and precisely what adjustments will be made to GAAP results.

- **Advocate for Accounting Reform** – There have been some management teams and critics of GAAP accounting who have argued that the increasing complexity of the accounting rules are themselves partially responsible for the adoption of non-GAAP reporting. One study found that companies with a higher degree of accounting reporting complexity in their SEC filings, tend to both be more likely to engage in non-GAAP reporting and to make adjustments deemed to be of “higher quality” by researchers. But if companies truly believe that certain accounting rules are obscuring important business performance trends, this would suggest that they should advocate for modernizing and streamlining accounting principles to generate financial statements that provide higher quality information to equity and debt holders, rather than creating customized non-GAAP equivalents. In some cases, useful non-GAAP indicators may point the way towards simplification and reform of more obscure areas of GAAP accounting.

- **Implement Robust Controls for non-GAAP and KPIs** – Recent enforcement actions by the SEC have made it clear that to the extent that non-GAAP accounting is driving securities prices, it should be subject to the same rigorous oversight as GAAP financials. While an independent auditor cannot opine if a non-GAAP number conforms to GAAP, they can advise if it is properly reconciled to GAAP and free of calculation errors. Similarly, key performance indicators (KPIs) are numbers not derived from GAAP that can deepen
investors understanding of business trends and value drivers. This includes things like store count, average monthly users, revenue per customer, cost of customer acquisition, etc. The PCAOB is currently evaluating whether auditors should play a more substantive role in verifying non-GAAP financials and KPIs given their increased prominence in earnings reports and the financial media. They should be subject to review by internal auditors and the audit committee to ensure they are accurate and fairly presented.

Over the past two decades, non-GAAP reporting has become the norm for companies ranging from exotic “unicorns” with disruptive, cash-burning growth models to stolid denizens of the Dow Jones Industrial Average. But the accelerating delta between GAAP and non-GAAP reported earnings calls into question the integrity of how financial data is compiled and employed by market participants. This yawning chasm in alternate accounting systems needs to be addressed if capital is to be allocated efficiently and the accounting system is to maintain its relevance to debt and equity investors.

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