The views expressed in these slides are solely the views of the Investor Advisory Group members who prepared them and do not necessarily reflect the views of the PCAOB, the members of the Board, or the Board’s staff. The PCAOB makes no representation as to the accuracy or completeness of this information.
Report from the Working Group on Non-GAAP Financial Measures

Tony Sondhi (Lead)  
Curt Buser  
Kevin Chavers  
Linda de Beer  
Amy McGarrity  
Peter Nachtwey  
Larry Shover  
Anne Simpson  
Michael Smart  
Robert Tarola  
Lynn Turner  
Gary Walsh
Introduction and Background - SEC Regulations

- Regulation G (applicable to all public disclosures or releases of material information including NGFM), and

- Amendments to
  - Earnings releases and other materials furnished to the Commission - Item 2.02 of Form 8-K, and
  - Item 10 (e) of Regulation S-K applying to the provision of NGFM in filings with the SEC.

Effective Date: March 28, 2003:

*Note:* The amendments include rules on the prominence of the presentation of NGFM versus comparable GAAP measures.
Incremental Requirements:
Item 10(e) of Regulation S-K

- A statement of the reasons registrant’s management believes the presentation of the non-GAAP financial measures provide useful information to investors regarding the registrant’s financial condition and results of operations, and

- To the extent material, a statement disclosing the additional purposes, if any, for which the registrant’s management uses the non-GAAP financial measures that are not otherwise disclosed.

- SEC Compliance and Disclosure Interpretations (CD&I) May 2016.
The use of NGFM has grown significantly since 2010. Academic studies, investor reports and analyses as well numerous articles in the media suggest the use in 2015 and early 2016 is higher than ever.

A March 2016 FactSet report showed:

1. In FY 2015, 20 (67%) of the 30 companies in the DJIA reported non-GAAP EPS in addition to GAAP EPS and in 18 of those 20 firms, the non-GAAP EPS was higher than the GAAP EPS, and

2. The difference between Non-GAAP EPS and GAAP EPS increased to 30.7% in FY 2015 compared to 11.8% in FY 2014.
Non-GAAP Financial Measures

SEC Concerns

SEC officials have noted concern with:

1. The use of individually tailored accounting principles such as adjusted revenue measures to calculate non-GAAP earnings,
2. Non-GAAP per share measures that purport to be liquidity measures, and
3. The tax treatment of non-GAAP adjustments.

Public companies, private equity firms, analysts, and other investors have increased the number and types of NGFM used over the years given growing dissatisfaction with GAAP measures of profitability, operating performance, and liquidity.

U.S. and international regulators have increasingly expressed their concerns with the increasing use of NGFM. Many standard setting bodies have expressed similar disquiet.
Other Regulators’ Concerns

- Banking regulators also have expressed concerns. A regulatory leverage guideline is designed to restrict lending to no more than 6 times a company’s EBITDA. An important reason for this concern is the subsequent sale of leveraged loan units to mutual funds.

- Leveraged loans are not subject to SEC oversight. This raises concerns about lending risks in the acquisition markets, as well as problems with valuation and liquidity risks for investors in funds that purchase these leveraged loans.

- Federal examiners have raised concerns about the leveraged loans in a few recent acquisitions.
Non-GAAP Financial Measures

Effect of “Pulled Forward” Adjustments

<table>
<thead>
<tr>
<th>Company</th>
<th>Unadjusted EBITDA</th>
<th>Adjustments</th>
<th>Adjusted EBITDA</th>
<th>Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>UFC</td>
<td>$170 million</td>
<td>$48 million in future licensing revenue</td>
<td>$300 million</td>
<td>$1.8 billion</td>
</tr>
<tr>
<td>Solar Winds</td>
<td>$178 million</td>
<td>$54 million in stock comp and a “pulling forward” of a recent price increase to a full year</td>
<td>$322 million</td>
<td>$1.6 billion</td>
</tr>
</tbody>
</table>
Non-GAAP Financial Measures

Definition

- Non-GAAP financial measures (related to performance or liquidity) exclude numerical financial measures of a registrant’s historical or future financial performance, financial position, or cash flows that are required to be disclosed by U.S. GAAP, Commission rules, or a system of regulation that is applicable to a registrant.

- Non-GAAP financial metrics exclude (include) amounts that are included (excluded) in the most directly comparable U.S. GAAP measure calculated and presented in the statement of income, balance sheet, or the statement of cash flows of the issuer.
Non-GAAP Financial Measures

Commonly Used Non-GAAP Financial Measures
(not an exhaustive list)

- Adjusted Net Income,
- Core operating expense (excludes stock-based compensation, net effect of amortization and capitalization of software development costs, amortization of acquired intangibles, employer payroll taxes on employee stock transactions, and other acquisition-related items such as acquisition transaction fees),
- Free cash flow (FCF - net cash provided by operating activities less capital expenditures) and variously adjusted FCF, and
- EBITDA and variously Adjusted EBITDA.
Non-GAAP Financial Measures

Reconciliations

Commonly provided reconciliations to GAAP-based metrics:

- Gross Profit,
- Income (loss) from Operations,
- Free Cash Flow and EBITDA,
- Net Income (loss), and
- Diluted Earnings per Share.
Rationales Offered by Companies

- To provide additional/alternative view of operational performance.
- Used internally and in communications with the board of directors in respect of financial performance.
- Provide more meaningful metrics than GAAP measures.
- Provide management perspective to enable comparison to peer companies and facilitates analysis by investors.
Non-GAAP Financial Measures

Issues – Limitations of GAAP Measures

1. Use an inconsistent measurement framework,
2. Do not necessarily capture value-relevant information,
3. Consolidation, proportionate consolidation, and the equity method accounting for investments may distort performance measures, liquidity metrics, and capital allocation decisions,
4. The amount and timing of non-cash charges and benefits incorrectly or inadequately depict performance or liquidity metrics used by management and analysts,
5. May not be sufficiently robust to capture differences between business models, tax structures, and dynamic shifts in business conditions.
FASB and IASB Response

1. The FASB recently issued an agenda consultation paper that discusses financial statement presentation including the income statement, statement of cash flows, and comprehensive income. Potential improvements and the addition of new metrics or subtotals in these statements may reduce the need for NGFM.

2. The IASB has discussed changes to and additions to subtotals in the income statement and consideration of measures like EBIT.
Non-GAAP Financial Measures

Issues – Characteristics of NGFM

- NGFM are a critical means of communication for management;
- NGFM are very useful signals of management behavior;
- Industry leadership often discusses and may prescribe useful NGFM, and
- Investors use NGFM extensively as inputs or adjustments to valuation models.
Non-GAAP Financial Measures

Limitations of NGFM

- No common or uniform definitions;
- Inconsistent application by companies over times, between comparable companies in an industry and across industries or jurisdictions.
- Limited or no clear comparability;
- Often the metrics exclude the most critical and recurring investment expenditures such as amortization of intangibles by companies engaging in multiple acquisitions and recurring expenses, for example, share-based compensation expense by companies that use equity to compensate employees.
Non-GAAP Financial Measures

Inferences and Conclusions

- GAAP and NGFM together can provide a more comprehensive perspective on how management runs the company and the board of directors governs the business,

- It is important to ensure that GAAP and NGFM are consistently and accurately reported and presented, and

- It is, therefore, critical to ensure that all NGFM are audited.
Non-GAAP Financial Measures

Current Audit Guidance

- AS 2710 (AU sec. 550), *Other Information in Documents Containing Audited Financial Statements* governs the auditor’s responsibilities with respect to “other information” in annual reports – read other information, identify material inconsistencies, if any, determine whether revisions are required, if needed include an explanatory paragraph in the auditor’s report, communicate to management and the audit committee, if there is any material misstatement of fact, and consider further action as appropriate.
Non-GAAP Financial Measures

Current Audit Guidance

- AS 4101 (AU sec. 711), Responsibilities Regarding Filings Under Federal Securities Statutes is limited to the auditor’s statutory responsibilities for auditor’s reports included in Securities Act registration statements.

- AS 4101 does not require specific procedures and it does not address the auditor’s responsibilities with regard to company performance measures.

- The auditor’s responsibilities do not extend to corporate earnings releases, investor presentations, or other communications with analysts or the public.
Questions

- Should standard-setters prescribe definitions of common NGFM adjustments?
- Should NGFM be given equal prominence?
- Should NGFM be audited?
- If yes, should all NGFM, regardless of how disclosed or presented, be audited?
Non-GAAP Financial Measures

CFA Institute Survey

Level of Assurance; N=401

- NGFMs presented outside the financial statements should be audited at the same level as GAAP line items: 49.0%, 51.4%, 49.9%
- Assurance around controls and process of generating NGFMs is all that is required: 31.6%, 29.7%, 30.9%
- No assurance is required for NGFMs: 11.8%, 9.4%, 11.0%
- Not sure: 7.6%, 9.4%, 8.2%

Legend:
- Portfolio managers+buy-side analysts=263
- Other+Sell-side analysts=138
- All=401
Recommendations

- Prescribe definitions – difficult to define NGFM to fit all extant business models and tax structures. The definitions would need to be dynamic and robust to meet needs over time.

- 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.
Recommendations (cont.)

- Require disclosure and presentation of NGFM in financial statements to ensure they are consistently calculated and audited – significant concerns about relevant jurisdiction and 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

Assurance of Integrated Reports

Focus Areas:
- Key features of the integrated report (IR)
- The integrity of the IR
- Assurance needs
- Assurance challenges
Assurance of Integrated Reports

Key Features of the IR:

- Concise communication of entity’s:
  - Strategy, governance, performance and prospects
  - Within the context of external environment
  - To create value over the short-, medium- and long term

- How entity uses or affects the six capitals
  - Financial-, human-, natural-, manufactured-, intellectual- and social & relationship capital

- Strategy, resource allocation and outlook

- Analysis of external environment, risks and opportunities

- Acknowledgment by board to ensure integrity of IR
Assurance of Integrated Reports

Integrity of the IR:

- Stakeholders’/users’ need for useful and reliable information for decision making
  - Usefulness = relevant, consistent measurable, presented with balance and clarity
  - Reliable = valid, accurate, complete
- Directors’ fiduciary duty in terms of the information reported in IR, e.g. risk, controls, governance, strategy
- Expectation that board makes a positive declaration as to the integrity of the IR
Assurance of Integrated Reports

Assurance Needs

- Era of ease of access and instantaneous exchange of information – thus IR value is in insights into entity
- Users want comfort on soundness of information in IR
- Assurance model a combination of:
  - Conventional assurance of controls and data
  - Multiple sources to corroborate assessments
  - Transparent reporting on prevailing facts and circumstances, highlighting subjectivity
  - Independent review of the reasonableness of interpretations by board
- “Combined” assurance

Non-GAAP Financial Measures
Assurance of Integrated Reports

Combined Assurance

- Model whereby external and internal assurance processes are combined/coordinated
  - Internal and external assurance providers
  - E.g. internal audit, risk, compliance, statutory actuary, external auditors, environmental auditors, etc.
  - Board’s diligent application of mind
- Address material aspects (risks, processes, structures and information)
- Give comfort to the board on integrity
- Support board’s ability to make positive statement
Non-GAAP Financial Measures

Assurance of Integrated Reports

Assurance Challenges

- Includes predictive, abstract, interpretative and qualitative information, too subjective for limited or reasonable assurance engagements
- Currently only factual disclosures in integrated report assured
- Different types of opinions given on different elements of the integrated report
- Difficulty to develop suitable criteria for the entire integrated report (skills, cost, adequacy of records, systems and controls, auditor liability)
Non-GAAP Financial Measures

Questions
Non-GAAP Financial Measures

Background
Non-GAAP Financial Measures

Relevant SEC Standards

Applicability:

Any entity (including nearly all foreign private issuers) required to file reports pursuant to Sections 13 (a) or 15 (d) of the Exchange Act, other than a registered investment company (generally exempt from Rule 401 – Sarbanes-Oxley (SOX) requirements).
Initially, the SEC limited the use of NGFM in SEC filings in a series of communications titled, *Regarding the Use of Non-GAAP Financial Measures – Frequently Asked Questions (FAQs)*. Due to these restrictions, NFM were generally reported in earnings releases and investor communications.

In 2010, the SEC issued Compliance and Disclosure Interpretations (C&DI) that superseded the FAQs and, in effect, encouraged the inclusion of NGFM in filings when they were provided elsewhere.

In May 2016, the SEC updated its C&DI on NGFM and the staff has emphasized compliance in its reviews of filings and earnings releases.
Non-GAAP Financial Measures

SEC Concerns

- SEC Chair Mary Jo White has said that the growing use of NGFM can be *confusing* (December 2015, AICPA National Conference on Current SEC and PCAOB Developments).

- SEC Chief Accountant, James Schnurr has said the SEC staff “has observed a significant and, in some respects, *troubling increase* in the use of, and the nature of adjustments within, non-GAAP measures as well as their prominence.”
Non-GAAP Financial Measures

Exclusions

Non-GAAP financial measures do not include

1. Operating and other statistical measures such as unit sales and number of employees (for example, Zynga reports, among other operating metrics, on the number of daily active users (DAUs) of its games and its average daily bookings per average DAU (ABPU)),

2. Ratios or statistical measures calculated using exclusively one or both financial metrics calculated using GAAP (for example, operating margin), and measures not considered non-GAAP metrics (see 1 above), and

3. Any measure that provide financial information that is not different from comparable GAAP metrics. Examples include disclosures related to debt, planned repayments, segments, estimated revenues and expenses of new product lines (Software companies planning to offer/new to SaaS arrangements often disclose such estimates).
Non-GAAP Financial Measures

Reconciliation Requirement

- A presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP, and

- A reconciliation (by schedule or other clearly understandable method) which must be quantitative for historical measures, and to the extent practicable, for prospective measures, of the differences between the non-GAAP metric and the most directly comparable measure calculated and presented pursuant to GAAP.

Note: Additional disclosures are required for forward-looking measures that are not available in or required by GAAP.
Non-GAAP Financial Measures

Item 10(e) of Regulation S-K
Prohibitions

- Excluding charges or liabilities that required, or will require cash settlement, or would have required cash settlement absent other settlement mechanisms (Does not apply to EBIT and EBITDA),

- Adjusting non-GAAP measures to eliminate or smooth items that
  (1) Are reasonably likely to recur within two years, or
  (2) Similar charges/gains occurred within the prior two years,

- Presentation on the face of GAAP financial statements, pro forma information required by Article 11 of Regulation S-K, and

- The use of titles or descriptions that are the same as, or confusingly similar to, titles or descriptions of GAAP metrics.
Non-GAAP Financial Measures

Commonly Used Non-GAAP Financial Measures
(not an exhaustive list)

- Sales and marketing, research and development (R&D), and general and administrative (G&A) expense,
- Gross profit, license gross profit, subscription and maintenance, professional services and other,
- Gross Operating Profit, Contract value backlog (Contract amount not yet recognized as revenue),
- Net Income per share,
- Adjusted free cash flow (Adjusted EBITDA + non-cash deferred rent less total capital expenditures (including non-cash purchases of PP&E), net cash interest and taxes paid (with many variations),
- Net leverage (Net debt/Trailing twelve month Adjusted EBITDA),
Non-GAAP Financial Measures

Commonly Used Non-GAAP Financial Measures
(not an exhaustive list)

- Recurring subscription revenue (limited to contractually-committed amounts excluding utilization above the contractual amount) a measure of the success of the SaaS offering,
- Subscription revenue renewal rate - Stability of revenue base and long-term value of client relationships, and
- Return on Capital (Net operating profit after tax (NOPAT)/Average capital base which is the average of interest bearing debt + stockholders’ equity – excess cash).
Non-GAAP Financial Measures

Rationales Offered by Companies

- To provide additional/alternative view of operational performance by excluding non-cash expenses that are not directly related to performance in any particular period.

- Used in planning, monitoring, internal budgeting, resource (capital) allocation, and evaluating own performance, and in communications with the board of directors in respect of financial performance.

- Provide more meaningful period-to-period comparisons and analysis of trends in its business as compared to GAAP measures.
Non-GAAP Financial Measures

Rationales Offered by Companies

- Enables investors and other users to understand, evaluate, and compare across accounting periods, the operating results and future prospects the way management does.
- Facilitates comparison to peer companies, and
- Better understand the impact of the excluded items on gross margins and operating performance.
- Significant, unusual or discrete events may be selectively excluded in the period they occur.
## Commonly Excluded Expenses

<table>
<thead>
<tr>
<th>Expense</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock-Based Compensation</td>
<td>Align interests of owners, employees, and executives in the long-run</td>
</tr>
<tr>
<td>Amortization of Intangibles (acquired R&amp;D, trade names, customer lists and relationships)</td>
<td>Not related to operations during any particular period</td>
</tr>
<tr>
<td>Amortization of debt discount (non-cash interest expense)</td>
<td>Not related to continuing operating performance</td>
</tr>
<tr>
<td>Valuation allowance on deferred tax assets</td>
<td>Not related to operating performance in a specific period</td>
</tr>
<tr>
<td>Income tax effects and adjustments on excluded items</td>
<td>Not related to operating performance</td>
</tr>
<tr>
<td>Other acquisition-related items, such as transaction fees</td>
<td>Vary significantly over time; acquisitions are not made on a predictable cycle</td>
</tr>
<tr>
<td>Restructuring Charges</td>
<td>Do not reflect ongoing operations; not expected to recur</td>
</tr>
</tbody>
</table>
Recent Regulations
SEC Compliance and Disclosure Interpretations (CD&I) May 2016

a) The SEC rules apply whenever a registrant, or person acting on its behalf, publicly discloses material information that includes a NGFM, the following information also must be provided:

1) A presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP, and

2) A reconciliation (schedule or other clearly understandable method) of the difference between the NGFM disclosed or released with the most comparable financial measure(s) calculated and presented in accordance with GAAP identified in paragraph (a) (1) above. This reconciliation must be quantitative for the historical non-GAAP measures presented, and to the extent available without unreasonable effort, quantitative for forward-looking information.
Recent Regulations

SEC Compliance and Disclosure Interpretations (CD&I)
May 2016

b) A registrant, or person acting on its behalf, should not publicly disclose a NGFM that collectively with, any related information and discussion of that measure, contains an untrue statement of a material fact or omits a material fact necessary to ensure that the presentation of the NGFM, as presented, is not misleading.

NGFM may be deemed misleading if the metrics:
1. Exclude non-recurring charges and retain non-recurring gains,
2. Exclude normal, recurring cash operating expenses necessary to the registrant’s business and operations, and
3. Are not comparable between periods and the accompanying disclosures do not adequately explain the change and the reason for the change.
Non-GAAP Financial Measures

Recent Regulations

Unacceptable NGFM:
1. Accelerated revenue recognition, and
2. Individually tailored recognition and measurement methods.

Other Considerations:
1. NGFM that are inconsistently calculated between periods without sufficient disclosure of the change and the reason for the change, and
2. NGFM presented with greater prominence or characterization than related GAAP measures – both form of presentation and substance of the NGFM matter.
Recent Regulations

Liquidity and Tax-related NGFM:

1. Per share liquidity measures are prohibited but liquidity metrics presented as performance measures have long been permitted – the SEC is focusing on the content rather than the label used by management.

2. Free cash flow measures cannot be reported on a per share basis.

3. The SEC also is focusing on clear presentation of the tax effects of adjustments used in all reported NGFM. The SEC requires the depiction of the tax effect as a separate line item in reconciliations of NGFM to related GAAP measures. Registrants need to be clear about the impact of adjustments on the effective tax rate and related valuation allowances.
The FASB Invitation to Comment (ITC) Agenda Consultation
August 4, 2016
Core Challenge and Objective: Prescribe additional categories of operating and net income that would be useful (predictive ability related to both future income and cash flows, and valuation relevance) across many diverse reporting entities.

- The Conceptual Framework does not contain robust concepts of presentation and (dis)aggregation that would facilitate the achievement of the principal objective.
Income from Operating and Nonoperating Activities:

- Alternative A: The FASB would describe, but not define, operating activities and management would use an accounting policy election to define operating activities for their reporting entities – comparability may be elusive.

- Alternative B: The FASB would provide a standardized definition of operating activities – comparability would be achieved but it is unclear whether a standardized definition is feasible.

*Note:* Nonoperating activities would be a residual category in Alternatives A and B.

- Alternative C: The Board would define nonoperating activities and operating activities would be the residual category.
Chapter 4 – Reporting Performance and Cash Flows

**Presentation and Display of Components of Income:**

- Alternative A: The FASB would redefine *infrequency of occurrence* to enable separate display of transactions and events by frequency of occurrence.

- Alternative B: The FASB would require separate identification of a remeasurement component of income designed to delineate changes in the carrying amount of assets and liabilities, for example, fair value gains and losses.

**Note:** Alternatives A and B would entail a separate presentation of transactions and events.

- Alternative C: The Board would define characteristics of natural and functional lines to separate a functional category into natural components.
Chapter 4 – Reporting Performance and Cash Flows

**Segment Reporting (SR):**

- Segment information is designed to reflect management’s view of the company. However, most users find:

  1. Limited useful information provided by segment,
  2. A limited number of reportable segments, and
  3. Inconsistent information over longer periods of time.

**Note:** Although SR has long had the promise of providing management a way to augment GAAP information, it has not supplanted NGFM for either management or users.
Chapter 4 – Reporting Performance and Cash Flows

**Segment Reporting:**

- **Alternative A:** Require additional disaggregation of information (along the lines of amendments to the income statement) by segment to the extent such information is regularly used by the CODM.

- **Alternative B:** Require additional segment disclosures (limited to those reviewed by the CODM) to be reported in a single structured table that would reconcile to consolidated totals.

- **Alternative C:** Replace Topic 280 disclosures with a disclosure principle mandating SR along the lines of presented in the consolidated financial statements but limited to items regularly reviewed by the CODM.
Chapter 4 – Reporting Performance and Cash Flows

Segment Reporting:

Notes:

- The FASB review also contemplates a review of aggregation criteria and potentially requiring SR from a governance rather than CODM perspective.
Chapter 4 – Reporting Performance and Cash Flows

Other Comprehensive Income (OCI) – Changes Considered:

- Minimize reclassification adjustments.
- Eliminate the option for presenting comprehensive income over two statements.
- Emphasize other earnings per-share measures such as operating income per share.
Chapter 4 – Reporting Performance and Cash Flows

Statement of Cash Flows – Changes Considered:

- Provide greater disaggregation of specific cash flows.
- Add classification guidance for certain types of cash flows.
- Reconsider the definitions in each classification and the three-category structure – alternatives considered:
  1. Standardized cash flow statement with defined categories,
  2. Classify and present cash flows along the lines of internal evaluation of cash flows, and
  3. Present cash outflows and inflows along income statement lines.