NON-GAAP FINANCIAL MEASURES:

Caveat Emptor

MARCH 2021

Author: Kevin Nye, *Executive in Residence, Global Risk Institute*

GLOBAL RISK INSTITUTE

Today, approximately 20 per cent of the financial information used in making investment, lending and capital allocation decisions is prepared in accordance with generally accepted accounting principles (GAAP). Conversely, a full 80 per cent of that same information is unaudited, subject to little or no formal oversight, and its use and definition is at times at the discretion of management. This is a troubling development and should be a flashing caution light to consumers of that information.

So how have we gotten to the point where the information investors and others are looking to primarily consists of non-GAAP financial measures (NGFMs)/Alternative Performance Measures (APMs)? In large part it's a reflection of how our world has evolved and our insatiable demand for current information.

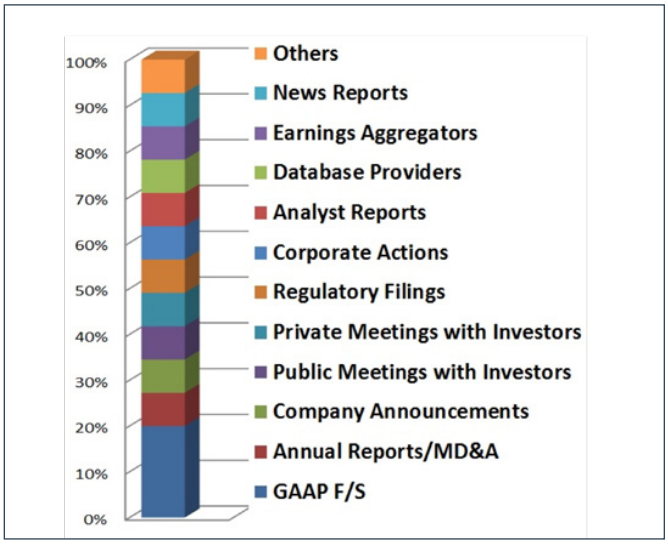
Fifty years ago, investors, lenders and other users of financial information looked to audited financial statements that followed GAAP to understand a company's financial position and performance. The information provided was for the most part complete, consistent and comparable.

Today however, most financial information is consumed on a real-time basis, not from periodic financial statements. It is derived from analyst reports, earnings aggregators and database providers among others (see chart) and with few checks and balances the validity of the information is left to the reader.

To better frame the issue, it is important to understand the basic differences between the various types of financial reporting:

- **GAAP/IFRS** — The information is defined per accepted accounting principles and has been independently examined. The validity and reliability of the information has been tested, including an assessment of systems and internal controls. There is reasonable assurance that the information provided is free from material misstatement.
- **Non-GAAP Financial Measures** (NGFMs)/Alternative Performance Measures (APMs) — These terms are often used interchangeably and are commonly defined by various regulators (IOSCO, ESMA, SEC) as numerical measures of an issuer's current, historical or future financial performance, position or cash flow other than defined by the applicable financial reporting framework (i.e. GAAP/IFRS). While in some instances these numbers are derived from GAAP information (e.g. pro-forma EPS), that is not always the case. Rules and/or guidance governing the use of these measures falls under the purview of the security regulators and is limited in scope.

The Proliferation of Financial Information



Source: CFA Societies Canada, 2019

- **Key Performance Indicators** (KPIs) — Largely used to convey information as to a company's success or progress in a particular area such as strategy, financial or operational performance. Definition and use of these metrics are open to management discretion and not subject to external oversight. Examples include, Same Store Sales, Sales Per Square Foot and Customer Retention among others.

There are valid reasons why the use of these measures has come to impact financial reporting as they do today. In part, the need for additional reporting has been driven by how our economy has changed over the years. We have moved from being dominated by manufacturing to an information-based economy. As a result, accounting principles such as the depreciation of plant and machinery may not be best suited for a technology company whose primary business is the monetization of a growing social network. That is not to say accounting frameworks have not evolved. They have (e.g. GAAP software accounting policies), just not at the rate of transformation in the global economy.

In response, companies and providers of information have turned to alternative methods of reporting to better reflect the issues pertinent to a particular business model. For digital companies, this may be driven by the need to demonstrate value to investors at an early stage in the company's development if they are operating at a significant loss. While this may be helpful in conveying a message, it has created risks that the consumer of this information and those who have responsibility for its oversight need to better understand.

One significant risk in looking at non-GAAP/APM measures for information is in not understanding the motivation behind their use. While in many instances these are provided with the intention of better and more appropriately informing the reader, this is not uniformly the case. All too often, the use of these measures is confusing, self-serving and, in some instances, misleading.

In 2016, the then Chairman of the International Accounting Standards Board (Hans Hoogervorst) highlighted this issue in noting that of the 88 per cent of S&P 500 companies using non-GAAP financial measures approximately 82 per cent showed higher profits than would have been calculated using GAAP measures and referred to this usage as being "clearly designed to present results in a more favourable light".[1]

An example where the use of non-GAAP measures provided such a view of company performance was in the then start-up, WeWork 2018 bond offering where they, "*went to the unusual lengths to show ways in which the company would be profitable…. It called the fully adjusted (earnings) number 'community adjusted EBITDA' by which it subtracted not only interest, taxes, depreciation, and amortization but also basic expenses like marketing, general and administration and development and design costs*".[2] In doing so, the company showed earnings of $223 million as opposed to a GAAP loss of $933 million. Basically, WeWork was saying that it would be profitable if you ignore the costs of its operations.

One would also hope the motive for providing additional non-GAAP information is to add clarity and improve transparency as opposed to obscuring a company's financial performance or offering a more favourable perspective. That is not always the case and investors, lenders and others should be aware of that.

Take for example, Uber's 2019 inclusion in its full year reporting of Adjusted EBITDA:

"*We define Adjusted EBITDA as net income (loss), excluding (i) income (loss) from discontinued operations, net of income taxes, (ii) net income (loss) attributable to non-controlling interests, net of tax, (iii) provision for (benefit from) income taxes, (iv) income (loss) from equity method investment, net of tax, (v) interest expense, (vi) other income (expense), net, (vii) depreciation and amortization, (viii) stock-based compensation expense, (ix) certain legal, tax, and regulatory reserve changes and settlements, (x) asset impairment/loss on sale of assets, (xi) acquisition and financing related expenses, (xii) restructuring charges and (xiii) other items not indicative of our ongoing operating performance.*"[3]

Improved transparency? No! A more favourable view of performance? Yes!

Another such risk arises from what might be described as a knowledge gap. What I am referring to here is the lack of understanding (or misunderstanding) as to what is audited, what is not, the role of an auditor and the scope of an audit.

Many, even relatively sophisticated investors, incorrectly assume that NGFMs/APMs are subject to more formal control and oversight, and, as with information included in the financial statements, has been determined by the auditor to be valid. This is not the case, "*this limited understanding leads investors to have an expectation that all information presented along-side audited financial statements (e.g. MD&A) is reliable because it is believed to be subject to attestation by the auditors*".[4]

This lack of understanding has led to an expectation gap whereby investors and other users of non-GAAP information expect auditors to go beyond their traditional remit. This is a much longer conversation, and until the scope of auditor responsibility changes, it is best to understand what exactly they do and don't do.

The responsibility for narrowing the knowledge gap as to the use of NGFMs/APMs lays with the auditing profession, those overseeing their use and with the those relying on the information. The profession needs to more clearly explain the audit process, corporate directors and audit committee members need to ensure the use of alternative measures improves transparency, and the consumer needs to educate themselves to better understand to what degree the information provided can be considered as being reliable.

Another risk in looking at non-GAAP financial measures is that, as in other things, noise often interferes with clarity. That being, these measures often detract from the real message. The growing use of APMs can at times confuse investors and overshadow actual GAAP numbers. This can obscure the conveyance of primary information, putting both the investor at risk as well as the corporation.

There are numerous examples of this; General Electric's 2017 reporting of four different Earnings Per Share numbers, and Blackberry, in reporting its 2017 earnings focused on non-GAAP revenue to such an extent it raised questions from the SEC. All of which is to say that it is essential the consumer of this information not be distracted by the use of alternative measures to the extent the real message is missed.

The use of Key Performance Measures should also be viewed with a degree of caution. While they can be informative, the reader needs to be aware of the lack of structure and oversight in their use. Alternative performance measures can vary by firm, by industry, and within industry. There are no rules as to how they need to be defined nor do the definitions need to be consistent from one period to the next. Same store sales are often used by retail investors to get a sense of period over period performance. With proper oversight and definition, such information can be useful. This metric however can also vary greatly depending on changes in merchandizing or pricing in a given period.

So if not precisely defined and consistently applied, the information can be misleading.

Executive compensation is another area where KPIs are widely used and are often defined and applied by Management. That is not to say their use is inappropriate but, as with alternative reporting measures, investors need to understand there is little oversight as to their use and any adjustments made year over year. It is important to know what involvement the Board has in the oversight of metrics used, the consistency of their application and any changes made.

Until there is a greater degree of regulation and/or oversight of alternative performance measures and key performance indicators, their use will most likely increase. The question then is, as an Audit Committee member, an investor, or other consumer of this information, how do we best mitigate the risks inherent in this type of reporting?

Most importantly, you need to understand why non-GAAP measures are being used. Is it a valid attempt to provide additional clarity to the reader or is it to portray a company's financial condition or performance as being better than it actually is? The frequent use of the word "adjusted" should be a caution to the reader as to what the real message is.

Another positive step forward would be to close the knowledge gap. Audit Committee members and consumers of financial information need to understand which information is subject to audit and which is not. They need to question how these measures are defined and what oversight they are subject to. Knowing that, one can then begin to question the validity and appropriate use of alternative performance measures in the MD&A, press releases and investor calls.

Lastly, do not get distracted by the noise. While alternative performance measures can be useful, they are not a substitute for information governed by accepted financial reporting frameworks.

So where does that leave us and how should we proceed?

On a positive note, there is an increasing awareness of the need to address many of the outstanding issues relative to APMs. A very real and very important example of this is the IASB, supported by the Sustainability Accounting Standards Board (SASB), proposing a coordinated approach to establish global standards for the reporting of environmental, social and governance performance (ESG). This is a significant development in as much as while these measures will be considered non-GAAP, once implemented, they will provide for improved clarity and consistency and have the legitimacy of being supported by the IASB/SASB.

It should also be noted that CPA Canada has recently released a very helpful paper aimed at assisting Audit Committees in their oversight of Key Performance Indicators[5] (Click here to open):

Beyond this, there are a number of other initiatives focused on bringing more discipline to what is currently a very unstructured area of financial and performance reporting that puts those that rely on this information at risk.

While a step in the right direction, these initiatives will take time. Until then, when it comes to the use of Alternative Performance Measures and Key Performance Indicators, as is said in Latin — '*caveat emptor*'.

© *2021 Global Risk Institute in Financial Services (GRI). This "Non-GAAP Financial Measures: Caveat Emptor" is a publication of GRI and is available at* www.globalriskinstitute.org. *Permission is hereby granted to reprint the "Non-GAAP Financial Measures: Caveat Emptor" on the following conditions: the content is not altered or edited in any way and proper attribution of the author(s) and GRI is displayed in any reproduction.* ***All other rights reserved.***

ENDNOTES

1. IASB Speech – May 11, 2016
2. Wall Street Journal – April 25, 2018
3. SEC Filing – February 6, 2020
4. CPAB – Audit Quality Symposium, May 2017
5. CPA Canada – Key Performance Indicators: Tool for Audit Committees, 2017