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Non-GAAP Financial Measures: What *Not* to Report

SEC regulations prohibit public companies in the United States from publishing certain types of financial information.

Reporting entities that prepare financial statements in accordance with an authoritative set of financial accounting and reporting standards—such as U.S. Generally Accepted Accounting Principles (GAAP)—often supplement their financial statements with additional information. This practice is especially common in the United States, where public companies routinely report a variety of non-GAAP financial measures to present and prospective investors. But even though the rules of GAAP don't apply to such measures, other rules do. In this month's column, I'll provide examples of non-GAAP financial measures that public U.S. companies report, summarize how the U.S. Securities & Exchange Commission (SEC) regulates the reporting of those measures, and examine a recent case in which a high-profile company overstepped the limits that SEC regulations impose.

Going Beyond GAAP

U.S. GAAP identifies specific measures of financial position, financial performance, and cash flow that reporting entities must or may include in their financial statements. U.S. GAAP also prescribes the manner in which those measures are to be determined and presented. But company executives often make managerial decisions on the basis of financial measures other than those dictated by GAAP. And because investors can benefit from looking at a company "through the eyes of management," they usually expect companies to report the non-GAAP financial measures that managers use in addition to reporting GAAP-compliant measures.

One example of a widely used and reported non-GAAP financial measure is "earnings before interest, taxes, depreciation, and amortization" (EBITDA). Conceptually, EBITDA represents the financial performance of an entity without regard for effects of the entity's financing decisions, exposure to income taxes, and current-period allocations of long-lived asset costs. Many corporate boards of directors consider EBITDA such an important measure of financial performance that they base a significant portion of executive compensation on it.

Some non-GAAP financial measures, such as EBITDA, are used extensively by companies in different industries. But other non-GAAP financial measures are industry-specific. For example, many retailers report "same store sales" (i.e., sales made by companies open for at least a year), a non-GAAP financial measure that has little applicability outside the retail industry.

The use and reporting of a particular non-GAAP financial measure may even be limited to a single company. For example, in its Form 10-Q quarterly report filed with the SEC on November 3, 2009, Martin Marietta Materials, Inc. (NYSE: MLM) reported the highly idiosyncratic non-GAAP measure "Gross margin excluding freight and delivery revenues assuming production costs that cannot be inventoried due to operating below capacity for the quarter ended September 30, 2009 were at the level incurred for the quarter ended September 30, 2008."

The SEC'S Perspective

Although a company's managers can define and use non-GAAP financial measures as they see fit, the SEC is concerned with how its registrants report such measures. For example, SEC Regulation S-K prohibits registrants from presenting non-GAAP financial measures on the face of their financial statements or in the accompanying notes when the statements are filed with the SEC. Regulation S-K also requires filers that report non-GAAP financial measures to provide specific disclosures regarding the measures.

Furthermore, when publicly disclosing material information that includes a non-GAAP financial measure, an SEC registrant must present the non-GAAP financial measure within a prescribed context. Most significantly, SEC Regulation G generally requires each publicly disclosed non-GAAP financial measure to be accompanied by the most directly comparable GAAP financial measure and a reconciliation of the differences between the two.

The SEC also limits what non-GAAP financial measures registrants may report. Specifically, Regulation G prohibits registrants (or anyone acting on behalf of a registrant) from releasing a false or misleading non-GAAP financial measure. The application of this rule brings us to the case of the popular Internet-based company Groupon, Inc.

Groupon's Misstep

On June 2, 2011, Groupon filed a registration statement with the SEC as a step toward an initial public offering (IPO) of the company's common stock. The filing of a registration statement enables the SEC to ensure that the filer is in compliance with the SEC's regulations regarding, among other things, the reporting of GAAP and non-GAAP financial information. The registration statement also serves as a prospectus for potential investors to learn about the company and its finances before investing.

Groupon's registration statement featured a non-GAAP measure of financial performance that the company calls "Adjusted Consolidated Segment Operating Income" (Adjusted CSOI). Although other companies report similar GAAP and non-GAAP financial measures, none reports Adjusted CSOI as Groupon defines it.

Groupon certainly has had incentive to emphasize its unique non-GAAP approach to measuring financial performance. By adjusting its GAAP-based operating loss of $117 million in the first quarter of 2011, Groupon reported a positive Adjusted CSOI of $82 million. Most of the difference between the two measures was the result of Groupon ignoring $180 million of online marketing expenses when calculating Adjusted CSOI for the quarter—expenses that were definitely not ignored when calculating the company's operating loss in accordance with GAAP.

Of course, it isn't unusual for a young, growing company to incur substantial marketing expenses, and the vast majority of investors consider such expenses to be important components of financial performance. What was unusual in this case was the assertion by Groupon's management that the company's marketing expenses were somehow not important in measuring its financial performance. Thus, from the SEC's perspective, a non-GAAP financial measure such as Adjusted CSOI has significant potential to mislead investors. Therefore, regardless of how Groupon might use or present Adjusted CSOI, the company violated SEC Regulation G simply by reporting it publicly.

As reported in *The Wall Street Journal* on July 28, 2011, "The Securities and Exchange Commission has asked Groupon to answer questions about the unusual measure it invented, which paints a more robust picture of performance by excluding marketing and other expenses…" At that time, in response to increasing negative attention from the investor community resulting from the reporting of Adjusted CSOI in its registration statement, Groupon had already filed an amended registration statement that provided a clearer explanation of how the company adjusts its operating income or loss in order to arrive at its Adjusted CSOI. But neither the investment community nor the SEC was appeased, so on August 10, 2011, Groupon filed another amended registration statement that didn't report Adjusted CSOI at all.

The Groupon case illustrates that for public U.S. companies—including those seeking to go public—there are some non-GAAP financial measures that mustn't be reported publicly even if the manner of presentation otherwise conforms to the SEC's regulations. It's also clear that the SEC pays close attention to its registrants' reporting of non-GAAP financial measures. **SF**

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