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Is Non-GAAP Reporting Unethical?

The use of non-GAAP financial measures is widespread and sometimes misleading. It can result in higher reported current earnings, forecasts of improved future results, and larger executive compensation.

The constant pressure to report favorable earnings performance motivates many companies to report income numbers that exclude unusual events that almost always seem to be costly and depress earnings. For many years, the use of financial performance measures other than Generally Accepted Accounting Principles (GAAP) has been an important subject to investors and the Securities & Exchange Commission (SEC).

In 1973, the SEC issued Accounting Series Release (ASR) No. 142, "Conditions for Use of Non-GAAP Financial Measures," warning of possible investor confusion from the use of financial measures outside of GAAP. This release states: "If accounting net income computed in conformity with [GAAP] is not an accurate reflection of economic performance for a company or an industry, it is not an appropriate solution to have each company independently decide what the best measure of its performance should be and present that figure to its shareholders as Truth."

One of the objectives of the Sarbanes-Oxley Act of 2002 (SOX) was to "eliminate the manipulative or misleading use of non-GAAP financial measures and, at the same time, enhance the comparability associated with the use of that information." Consequently, the SEC issued Regulation G, "Conditions for Use of Non-GAAP Financial Measures," in January 2003. It requires companies using a non-GAAP measure to disclose that the measure isn't misleading and to provide a reconciliation between their measure and the most directly comparable GAAP measure. The GAAP presentation must have equal or greater prominence. Management must disclose the reasons why the non-GAAP measure provides useful information to investors and offer a statement of additional purposes for which the non-GAAP measure is used. Only GAAP financial information can be presented directly on the face of a company's financial statements, possibly to highlight the fact that the independent audit opinion doesn't cover such information.

Adjusting Earnings

Aside from excluding unusual events for reporting to the public, another prominent use of non-GAAP earnings performance has been to determine executive compensation. Since the passage of the Revenue Reconciliation Act of 1993, executive salaries amounting to more than $1 million aren't tax deductible, but bonus payments of any amount are deductible if they result from achieving established performance goals. A February 26, 2014, article in *The Wall Street Journal*, "Some Companies Alter the Bonus Playbook," notes that more U.S. companies are using nonstandard accounting measures to compute bonus payments.

For example, Exelon Corporation used non-GAAP earnings to pump up executive bonuses significantly. Its 2012 audited earnings per share (EPS), based on GAAP, were $1.42. To arrive at the publicly reported, adjusted non-GAAP operating EPS of $2.85, management made 10 separate adjustments that amounted to a net increase of $1.43 per share, a little more than 100%. Adjustments that increased non-GAAP EPS included plant retirements and divestitures ($0.29), merger and integration costs ($0.31), State of Maryland commitments related to merger ($0.28), amortization of commodity contract intangibles ($0.93), and Federal Energy Regulatory Commission (FERC) settlement ($0.21). These adjustments increased EPS by $2.02.

The adjustments that decreased Exelon's non-GAAP EPS included mark-to-market impact of economic hedging activities ($0.38), unrealized gains related to nuclear decommissioning trust funds ($0.07), and reassessment of state deferred income taxes ($0.14). The total decrease amounted to $0.59. But the EPS used for bonus purposes was $2.91. In other words, Exelon added $0.06 arbitrarily.

Perhaps the most outrageous use of a misleading non-GAAP earnings measure to improve profits was when Groupon, Inc. reported earnings in its initial public offering (IPO) in 2011. It invented a unique measure called "adjusted consolidated segment operating income (CSOI)." The biggest difference from GAAP earnings was online marketing expenses. The rationale for omitting such seemingly normal and recurring expenses wasn't clear in the registration statement, despite the SEC's rule requiring disclosure of the reason non-GAAP information is more informative to investors.

A sample of online earnings press releases from 2013 shows the variety of ways that large and recognizable public companies are describing the costs and expenses they have excluded from their GAAP earnings to arrive at improved non-GAAP performance (see Table 1). Some highlights include Callaway Golf Company, which not only excluded charges related to cost-reduction initiatives as well as gains and sales related to sales of certain brands or products transitioned to a third-party model, but it also presented sales on a constant currency basis and calculated taxes at an assumed rate.

Electronic Arts excluded acquisition-related expenses, amortization of debt discount, certain nonrecurring litigation expenses, change in deferred net revenue (e.g., packaged goods, digital content), loss (gain) on strategic investments, restructuring charges, stock-based compensation, and income tax adjustments. And Gannett Company excluded special items consisting of workforce restructuring charges, transformation costs, pension settlement charges, a noncash impairment charge, a currency-related loss recognized in other nonoperating items, and certain credits to its income tax provision.

Gannett says it believes that such expenses and credits aren't indicative of normal ongoing operations and thus reasons that their inclusion in results makes it more difficult to compare results between periods and with peer group companies. On the contrary, there is likely to be less comparability than if everyone used only GAAP, which is well known and understood, because companies in Gannett's peer group are likely to calculate their own non-GAAP measures in their own way.

For guidance in applying the *IMA Statement of Ethical Professional Practice* to your ethical dilemma, contact the IMA Ethics Helpline at (800) 245-1383 in the U.S. or Canada. In other countries, dial the AT&T USA Direct Access Number from www.usa.att.com/traveler/index.jsp, then the above number.

A Broken System

Several conclusions seem obvious about the relevance and usability of the current financial reporting system. Even considering the imprecise nature of current accounting standards, it's too easy for companies to turn poor GAAP earnings into great non-GAAP earnings by simply designing their own performance measures that can readily be adjusted to unethically report successful accomplishment of the goals created using those same measures. Consequently, non-GAAP earnings reporting should be strictly limited and permitted only in extraordinary circumstances—that is, in cases where current GAAP doesn't clearly reflect economic reality. Companies should have to demonstrate a real necessity and communicate meaningful, unique reasons why they believe using a non-GAAP measure is mandatory to avoid misleading investors and others, not just to portray better short-term profits, earn bigger bonuses, and cash in on stock options.

The widespread use of non-GAAP performance measures seems to provide conclusive evidence that the current financial reporting system is broken. Neither the SEC's December 2013 "Report on Review of Disclosure Requirements in Regulation S-K" nor the February 25, 2014, Financial Accounting Standards Board (FASB) news release, "Post Implementa-

Table 1. Arriving at Non-GAAP EPS

Company	Items Excluded
Analog Devices	Items of a nonrecurring or noncash nature
Anixter International	Acquisitions Foreign exchange effects Impact of copper prices
Baker Hughes	Loss on devaluation of Venezuelan currency
Callaway Golf Company	Gains and sales related to sales of certain brands or products transitioned to a third-party model Charges related to cost-reduction initiatives
Cardinal Health, Inc.	Restructuring and employee severance Acquisition-related costs Impairments and loss on disposal of assets, litigation (recoveries)/charges Net and other spin-off costs
Dell Inc.	Amortization of purchased intangibles, severance, and facility-actions Acquisition-related charges Costs incurred in fiscal 2014 related to Dell's proposed merger Other items
Electronic Arts (EA Games)	Acquisition-related expenses Amortization of debt discount Certain nonrecurring litigation expenses Change in deferred net revenue (e.g., packaged goods, digital content) Loss (gain) on strategic investments Restructuring charges Stock-based compensation Income tax adjustments
Facebook	Share-based compensation Related payroll tax expenses Income tax adjustments
Gannett Company, Inc.	Special items consisting of workforce restructuring charges Transformation costs Pension settlement charges A noncash impairment charge A currency-related loss recognized in other nonoperating items Certain credits to its income tax provision
IBM Corp.	Charges for the amortization of purchased intangible assets Other acquisition-related charges Retirement-related charges driven by changes to plan assets Liabilities primarily related to market performance
Ingram-Micro, Inc.	Charges associated with restructuring, integration, and transition costs and other expense reduction programs Amortization expense associated with intangible assets Gains due to the foreign-currency translation effect on euro-based inventory purchases in the company's pan-European entity
Merck & Co., Inc.	Acquisition-related costs Costs related to restructuring programs Certain other items
Microchip Technology Inc.	The effect of share-based compensation Expenses related to acquisition activities (including intangible asset amortization; inventory valuation costs; severance costs; earn-out adjustments; and legal, general, and administrative expenses associated with acquisitions) Nonrecurring tax events Noncash interest expense on convertible debentures
WGL Holdings, Inc.	The effects of unrealized mark-to-market gains (losses) on energy-related derivatives for regulated utility and retail energy marketing segments Certain gains and losses associated with optimizing the utility segment's system capacity assets Changes in the measured value of inventory for wholesale energy solutions segment The financial effects of warm or cold weather that exceeds weather protection for the regulated utility segment Certain unusual transactions
Williams-Sonoma	Unusual business events
Yahoo!	Stock-based compensation

tion Review Concludes Fair Value Accounting Standard Meets Its Objectives," addresses the need for basic reporting reform.

The Public Company Accounting Oversight Board (PCAOB) should reconsider Release No. 2012-004, which states, "The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document." Perhaps the responsibility should extend further. Companies spend hundreds of millions of dollars each year to prepare GAAP-based financial statements and to have them audited. These large expenditures don't seem to be worth it if more and more investors and others rely on less reliable non-GAAP disclosures instead,

Tell us if you have any comments on this issue. **SF**

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