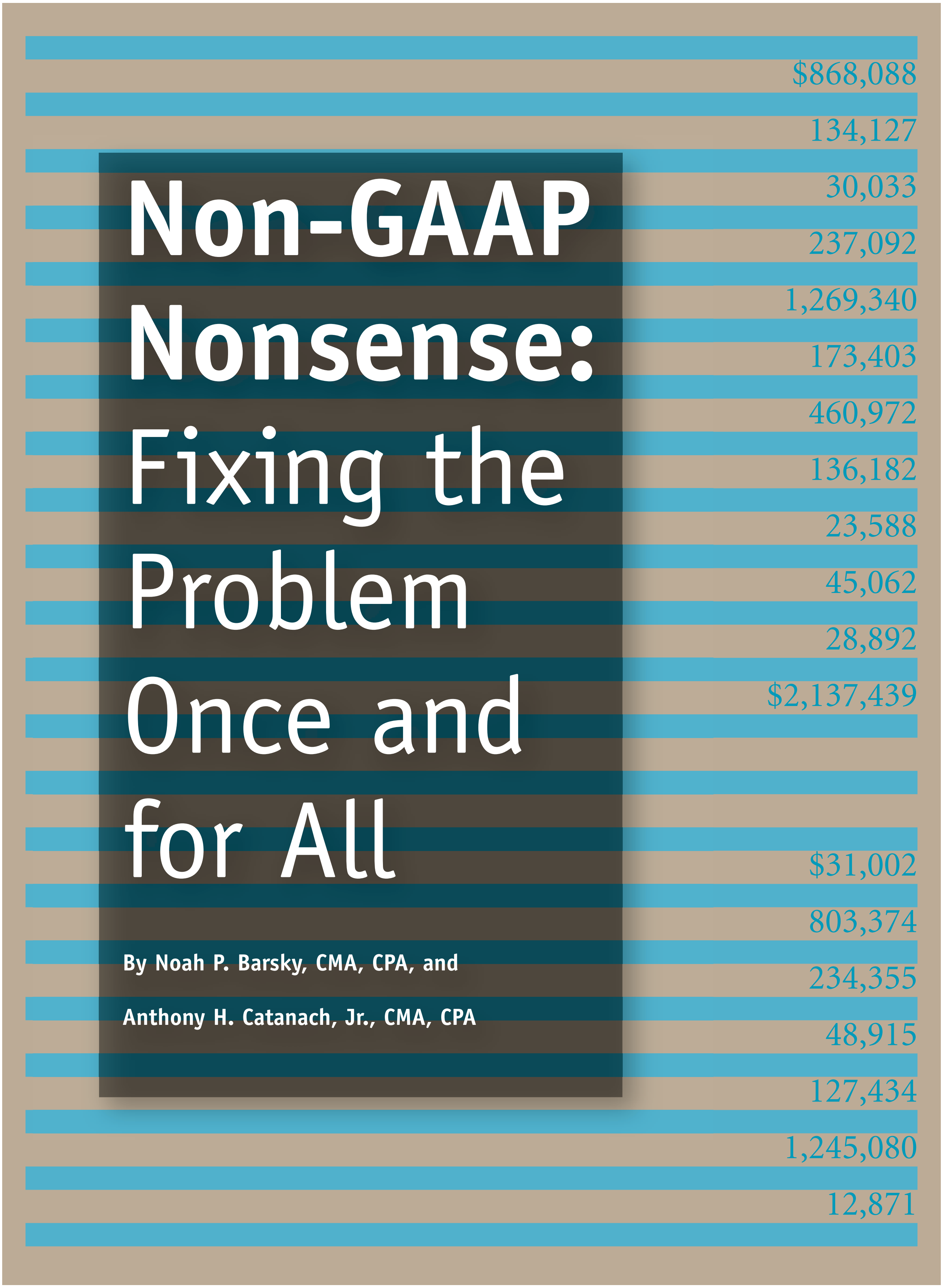

Non-GAAP Nonsense: Fixing the Problem Once and for All

By Noah P. Barsky, CMA, CPA, and
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A decade has passed since the Securities & Exchange Commission (SEC) adopted Regulation G to rein in misleading financial disclosures by registrants. Yet the financial press continues to alert us to "new" and "creative" ways that companies are reporting (and overstating) performance. Just two years ago, Groupon gained notoriety when the SEC required it to revise its prospectus because it had excluded marketing expenses (the company's largest expense) in reporting adjusted consolidated segment operating income (ACSOI) in its initial public offering (IPO). Old-line brick-and-mortar companies also have attracted SEC scrutiny for their disclosure of nonstandard metrics. The market regulator made both real-estate company Prologis and retailer Home Depot remove certain income tables from their periodic filings because they were featured too prominently, exaggerating their importance (see "New Benchmarks Crop Up in Companies' Financial Reports" by Emily Chasan, *The Wall Street Journal*, November 13, 2012). More recently, dealing with earnings before interest, taxes, depreciation, and amortization (EBITDA), an appropriately named company, Black Box, unveiled the amazingly redundant "adjusted EBITDA (as adjusted)" in a press release. Despite repeated management assertions to the contrary, such supposedly innovative and insightful performance measures actually may mask *real operating performance*, so much so that they continue to garner scrutiny from analysts, investors, and regulators.

A Brief History of Pro Forma Reporting

Generally Accepted Accounting Principles (GAAP) are important, and market concerns about non-GAAP reporting aren't new. More than a decade ago, then-SEC Chief Accountant Lynn Turner warned, "The temptation for a CEO or CFO to play the 'Numbers Game' today is great." Just a year later, Isaac C. Hunt, Jr., a then-commissioner of the SEC, delivered his seminal "Accountants as Gatekeepers" speech, notable for its heavy criticism of so-called managed earnings and pro forma financials. Hunt pointed out, "Federal securities laws, to a significant extent, make accountants the 'gatekeepers' to the public securities markets." In venting his frustration with non-GAAP financial metrics, he reminded securities issuers of their responsibilities to "make full and fair disclosure of all material information." As noted by Mark P. Holtzman, Robert Fonfeder, and J.K. Yun in "Goodbye 'Pro Forma' Earnings" (*Strategic Finance*, November 2003), the SEC introduced Regulation G to presumably halt the abuses of disclosures like one-time charges, operating income, income before one-time charges, and street earnings, which don't conform to GAAP (in other words, they are non-GAAP).

Despite these now-distant warnings, non-GAAP reporting continues—no doubt the result of increased market pressures to "deliver the numbers." High turnover rates among CEOs and CFOs suggest that performance expectations are high and increasing. Challenger, Gray & Christmas, Inc., an outplacement company, reported increasing CEO changes in 2013. And CFOs also seem to come and go when a company misses its target. According to Crist|Kolder Associates, turnover among CFOs at large companies rose for the third consecutive year in 2013 to 14.4% (see "CFO Musical Chairs Are Humming Along" by David McCann, CFO.com, August 20, 2013). No wonder—these are the business executives under pressure to make the numbers. Unfortunately, many of these senior executives choose to manage the numbers using pro forma disclosures rather than actually managing the business.

Firms new to the equity markets appear particularly susceptible to the temptations of non-GAAP reporting. In 2012, new issuances by venture-backed firms increased their use of nonstandard measures such as EBITDA and free cash flow, with nearly six in 10 disclosing non-GAAP financial benchmarks (see "New Benchmarks Crop Up in Companies' Financial Reports" by Emily Chasan, *The Wall Street Journal*, November 13, 2012).

Twitter and Groupon, two recent technology IPOs, provide excellent examples of these less-than-transparent disclosures. In its 2013 Form10-K filing with the SEC, Twitter reported two non-GAAP metrics, *adjusted EBITDA* and *non-GAAP net loss*, each of which differed from its GAAP net loss by $720.75 million and $610.99 million, respectively. Groupon, in its 2013 Form 10-K, not only reported an adjusted EBITDA that exceeded net loss by $375.60 million, but it also introduced us to a metric called "operating income (loss) excluding stock-based compensation and acquisition-related expense (benefit), net." This wordy non-GAAP measure was $121.45 million greater than income from operations.

Looking past the simple mathematical adjustments that characterize these metrics, it's clear that they have less to do with daily operating processes and more to do with deemphasizing or downplaying GAAP-required disclosures. In fact, many CFOs argue for their inclusion,

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claiming that GAAP financial statements, particularly the income statement, don't provide a complete and accurate picture of a company's performance.

Here is how Twitter and Groupon justified their use of non-GAAP measures in their 2013 annual report SEC filings. Twitter stated:

"We believe that Adjusted EBITDA and non-GAAP net loss provide useful information about our operating results, enhance the overall understanding of our past performance and future prospects and allow for greater transparency with respect to key metrics used by our management in its financial and operational decision-making."

Groupon argued:

"We have used consolidated operating income (loss) excluding stock-based compensation and acquisition-related expense (benefit), net to allocate resources and evaluate performance internally. However, in recent periods, our management and Board of Directors have increasingly focused on Adjusted EBITDA…as the primary non-GAAP measure for evaluating our consolidated operating results. Accordingly, we do not expect to continue to report Operating income (loss) excluding stock-based compensation and acquisition-related expense (benefit), net on a consolidated basis in future periods."

It's interesting that Groupon's directors have abandoned the "operating income (loss)" non-GAAP metric.

While financial executives claim to be driven to more non-GAAP metrics to present a clearer picture of the future direction of a business, these same managers often lobby for less restrictive financial accounting standards. Isn't it ironic that they now criticize the output of the judgmental, subjective, and frequently vague rules that they advocate as not adequately reflecting their operating performance? More than 10 years ago, SEC Commissioner Hunt also criticized CFOs for using so-called pro forma earnings to describe companies' operations as "we'd like it to be," which always seemed to "paint a rosier picture than GAAP might otherwise allow." So much has changed, and yet perhaps so little has changed.

The Root of the Problem

The pro forma or non-GAAP dilemma largely results from the fact that financial statements by their very nature are retrospective, not future oriented. In short, they tell us what happened yesterday, regardless of whether they are U.S. GAAP or International Financial Reporting Standards (IFRS), historical cost or fair value. At best, all of the revising and adjusting of GAAP financial results are crude attempts to transform these historically focused performance measures into *predictors* of the future. At worst, non-GAAP metrics are blatant efforts to artificially inflate investor *expectations* of future value.

When proposing that non-GAAP disclosures are useful in assessing future operating prospects, financial managers are being disingenuous, given the historical roots of these measures. Are we to believe that in today's global, dynamic marketplace managers really drive their businesses forward by looking in their rearview mirror at two or three artificially contrived metrics? If so, then investors—and regulators—are really in trouble. Coincidentally, companies that report consistently strong profits and operating cash flows generally don't present non-GAAP measures. Their corporate strategies are sound, their business models are effective, and their results are transparent.

Currently, Regulation G governs non-GAAP reporting for companies registering securities in the U.S. capital markets. But what if the SEC scrapped Regulation G and banned *all* non-GAAP metrics in securities filings? No more non-GAAP "everything-but-the-bad-stuff" disclosures would be permitted. All financially related disclosures (including ratios) would be based on GAAP. If analysts and other market participants feel that GAAP numbers need to be adjusted for some reason, surely they can do it themselves.

A Balanced Solution to Pro Forma Reporting

If non-GAAP performance measures are scrapped, how can we meet analyst and investor demands for information with real predictive value? The answer to this disclosure need has been right under the nose of CFOs (and regulators) for a quarter of a century: *the balanced scorecard* (BSC). This time-tested performance measurement framework encourages managers to supplement their financial metrics with forward-looking, nonfinancial metrics. One defining characteristic of these forward-looking metrics is that they can't rely on, or be derived from, financial statement data. Rather, they are based on nonfinancial operating data generated by a company's business model and related processes, not the general ledger.

Robert Herz, the recently retired chairman of the Financial Accounting Standards Board (FASB), made this very argument years ago, stating:

"The information financial market participants require to arrive at company valuations has moved beyond the scope of traditional corporate reporting. The rise of shareholder value as the key metric for assessing stock price requires managers to consider adding value-oriented information to their corporate reports—such as the ways in which nonfinancial assets are expected to provide economic value and how today's innovation will translate into tomorrow's cash flow. These kinds of forward-looking dynamics are becoming central to the operating and internal decision-making processes of a growing number of companies." (See Robert H. Herz, *Reinventing Performance Measurement, Management, and Reporting*, PricewaterhouseCoopers, 2000.)

We realize that it's a practical impossibility for all publicly traded companies to fully adopt the BSC as a performance measurement. But if the SEC does revoke Regulation G and bans non-GAAP measures, it could encourage—and maybe even require—companies to report nonfinancial metrics in a manner consistent with the BSC's well-known learning and growth, business process, and customer dimensions. For example:

◆ How well are company investments in technology, people, and other resources performing? Measures might include assessments of employee skills gaps and satisfaction, as well as technology use and reliability.

◆ How well is a company's business model performing? It should examine market analysis; research and development (R&D); sales and marketing; procurement, production, and distribution; and after-sale customer service. Most investors would value evaluations of the product development cycle and pipeline and supplier relationships.

◆ What indicators show that a company's customers value its product and/or its service? Comparing pricing premiums against the competition in key market segments could provide significant insights into customer satisfaction and product branding.

Getting Back on Track

"Nonfinancial Performance Measures and Strategy Execution"
Mark L. Frigo, *Strategic Finance*, August 2002
Examines which types of nonfinancial measures would best reflect the strategy of an organization. Such measures include assessments of strategic activities, innovation of offerings, operating effectiveness and efficiency, branding, the supporting tenets involving employees, and the value chain.

"Performance Measures that Drive the First Tenet of Business Strategy"
Mark L. Frigo, *Strategic Finance*, September 2003
Discusses how the Return Driven Strategy framework can accelerate the design and development of a performance measurement system. Proposes that performance metrics geared toward a commitment to ethically maximize financial value leads to superior financial results.

"Guidelines for Strategic Financial Analysis"
Mark L. Frigo, *Strategic Finance*, November 2003
Acknowledges that financial performance measures can be seriously flawed. One metric doesn't fit all uses. Proposes adopting the BSC as a process for financial analysis to enable and empower decision makers.

Such metrics can be computed without using any financial accounting data from a company's general ledger that ultimately makes its way to the financial statements. These new metrics must come from data generated from a business model's operations (that is, market analysis, R&D, sales, and marketing; procurement, production, and distribution; and after-sale customer service).

Here's an example of what we suggest that uses Groupon's 2013 10-K. First, since the company already reports a wealth of GAAP financial data in its regulatory filing, the financial dimension disclosures are more than satisfied. Groupon already discloses three operating metrics that fit nicely into the BSC disclosure framework:

◆ Active customers—unique user accounts that have purchased a voucher or product from the company during the trailing 12 months. This metric reports how the number of customers actively purchasing deals is trending.

◆ Gross billings per average active customer—the trailing 12 months' gross billings generated per average active customer. This measure allows the company to evaluate whether growth is driven primarily by growth in total customers or in spending per customer in any given period.

◆ Units—the number of vouchers and products purchased from the company by its customers, before refunds and cancellations.

All three measures fit nicely into the customer dimension of the BSC. Yet Groupon provides little insight into how its business model is performing or if its significant acquisitions and investments in technology and people are paying off. In Groupon's case, the regulators could suggest additional nonfinancial disclosure to address these deficiencies.

A full-blown BSC implementation isn't necessary. We simply are suggesting that companies abandon non-GAAP financial disclosures and classify existing reported operating metrics using the BSC framework. Furthermore, if a company is missing measures for any of the three nonfinancial dimensions, then it needs to seriously consider creating some.

Such a reporting framework offers several improvements:

◆ Analysts and investors will get genuine predictive information about a firm's operations rather than managed financial metrics designed to create false expectations of value. Companies failing to report for all three nonfinancial BSC dimensions might serve as red flags for the quality of management's decision making.

◆ Regulators will no longer need to police registrant filings for adjusted EBITDA and other flaky non-GAAP metrics.

◆ Large accounting and consulting firms will find new revenue opportunities as they install, inspect, and review new nonfinancial reporting systems to facilitate compliance with this reporting framework.

◆ Strategy-focused CFOs will be able to demonstrate their business insight and communicate their firm's value proposition more completely. They will no longer have to feign interest in or overemphasize accounting numbers and financial reporting choices.

Despite the popularity of the BSC (and its variants), few CFOs actually have embraced it for public reporting. This is quite surprising given the shift in the CFO role to a more strategic focus (from accounting and reporting) over the past decade, especially in large firms. Today's best CFOs often come from top MBA (Master of Business Administration) programs where the BSC is a staple of the required coursework (see Noah P. Barsky and Anthony H. Catanach, Jr., "What Makes a CFO the Best?" *Strategic Finance*, April 2013). While many CFOs may be aware of the BSC, they might not be fully versed in business models, particularly given the shift in their backgrounds from accounting to strategy. Without a detailed knowledge of a company's operations, meaningful *nonfinancial* metric reporting may not be possible.

Additionally, short-term performance horizons and financial reporting rewards often create disincentives for senior executives to invest the time and energy to create real performance metrics—particularly if they plan on moving to another opportunity in a couple of years. Also, constructing effective nonfinancial measures can be challenging, especially in a dynamic business environment characterized by speedy transactions and complexity. Despite such obstacles, Mark L. Frigo has created the foundation for a rich literature to help CFOs get back on track, when it comes to performance assessment (see "Getting Back on Track," p. 50).

Time for Reform

It's time that the SEC and today's CFOs put an end to this performance measurement façade called pro forma reporting once and for all. We encourage market regulators to prohibit pro forma reporting, specifically non-GAAP disclosures, and require companies to disclose real operating data and metrics, not just financial measures. Eliminating Regulation G in favor of GAAP reporting supplemented by meaningful nonfinancial data that a quality BSC approach provides would go a long way to offering the insights into business operations necessary for reliable investment and lending decisions. **SF**

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