

Vincent C. Ross  
Institute of  
Accounting Research**Paul A. Zarowin**, *Director*  
pzarowin@stern.nyu.edu  
**Esther Kim**, *Administrative Aide*  
ekim@stern.nyu.edu

## Recent Trends in Non-GAAP Reporting

**Date/Time:** **Monday, November 7, 2016**  
4:00pm - 6:00pm Roundtable Discussion  
6:00pm - 7:00pm Reception with hors d'oeuvres

**Location:** NYU Stern School of Business | Kaufman Management Center  
44 West Fourth Street  
Commons, Room KMC 1-100

### Roundtable Overview:

The Ross Institute of Accounting Research at NYU's Stern School of Business is hosting a Roundtable dedicated in memory of Seymour Jones on *Recent Trends in Non-GAAP Reporting*. The topic is controversial and of great importance to all members of the financial reporting community: preparers and users of financial statements, investors, accountants, regulators, and standard setters.

Non-GAAP reporting has been increasing in recent years, and a great majority of S&P 500 firms now report non-GAAP earnings and other figures. Do these voluntary disclosures enhance the market's information or merely camouflage firms' true performance? Do they make the market more or less efficient? The issue has stimulated many recent articles in the business press, SEC activities, and the FASB's Financial Performance Reporting Project.

For many years, the Roundtables have successfully generated public dialogue, engaging in topics that benefit many sectors of society, bringing together experts from the finance sector, industry, regulatory agencies, government, legal and accounting professions, and academia. The Roundtable consists of brief presentations by members of a panel of experts, followed by audience participation in a Q&A and freestyle discussion. Experts will debate the key issues related to the controversy of the increase in non-GAAP reporting. A networking reception with hors d'oeuvres, wine and beer will follow.

### Confirmed Roundtable Presenters:

- Jack Ciesielski, **Publisher**, The Analyst's Accounting Observer
- Martin Fridson, **Chief Investment Officer**, Lehmann Livian Fridson Advisors
- Monty Garrett, **Senior Vice President, Accounting**, Verizon
- Robert H. Herz, **Former Chairman**, FASB
- Baruch Lev, **Philip Bardes Professor of Accounting and Finance**, NYU Stern
- Francine McKenna, **Reporter**, MarketWatch
- Kyle Moffatt, **Associate Director of Disclosure Operations**, SEC
- Adam S. Parker, PhD., **Chief US Equity Strategist**, Morgan Stanley
- Beth Paul, **Partner**, PwC
- Gerald I. White, **President**, Grace & White, Inc.

**This Ross Roundtable is coordinated by:**  
Paul Zarowin, NYU Stern

**Ross Roundtable**  
**On**  
**Recent Trends in Non-GAAP Reporting**  
**November 7, 2016**

Research Reporter: Amal T. Shehata

True to its mission, the Ross Roundtable invited representatives ranging from professional accountants, academics, standard setters, financial statement preparers, analysts, investors, and more to discuss a controversial and timely topic regarding recent trends in non-GAAP reporting. For many years, the Roundtables have successfully generated public dialogue, engaging in topics that benefit many sectors of society and this event proved to be no different.

Professor Paul Zarowin, Director of the Ross Institute and moderator of the panel, began the event with a dedication to Seymour Jones, presenting his family with a plaque acknowledging his exemplary service to both NYU and the Ross Roundtables. Professor Jones was a renowned audit partner, forensic accountant and former Director of the Ross Institute. “He may be gone but he is forever in our hearts and we will always remember him.”

**Background on the topic:**

Non-GAAP reporting has been increasing in recent years, and a great majority of S&P 500 firms now report non-GAAP earnings and other figures. Do these voluntary disclosures enhance the market’s information or merely camouflage firms’ true performance? Do they make the market more or less efficient? The issue has stimulated many recent articles in both the academic and business press, SEC activities and the FASB’s Financial Performance Reporting Project.

Professor Zarowin began the discussion by providing academic data on recent trends in non-GAAP reporting that clearly indicate how firms view the relevance of this type of reporting. The data across different dimensions consistently indicate that non-GAAP reporting is prevalent, particularly among under-performing firms and that firms and the market consider the metrics to be meaningful, as follows:

- Survey results of 401 financial executives asking them to rank the 3 most important reporting measures to outsiders. As expected, the most important measure was “Earnings” at 51% response rate, followed equally (12% response for each) by “Revenue”, “Cash Flow from Operations” and “Pro Forma Earnings (aka non-GAAP earnings)”;
- Approximately 70% of firms provide non-GAAP earnings;
- Almost 90% of S&P 500 companies report some form of non-GAAP metrics, such as EBITDA, cash flow, non-GAAP net income and so on;

- “Under-performing” firms (i.e., those with negative forecast errors or earnings that are less than expected by the market)<sup>1</sup> are most likely to provide non-GAAP measures. These numbers are higher than the GAAP earnings and present a more positive outlook;
- The market values this information! Research indicates that the non-GAAP reported figures impact stock market prices more than GAAP earnings.

After this background information, Professor Zarowin turned the discussion over to the panelists. Note that the panelists provided their personal viewpoints and they do not necessarily represent the opinions of their organizations.

### **Viewpoints from Academia:**

*Professor Robert (Bob) Herz, Columbia University and former FASB Chairman (via pre-recorded video):*

Professor Herz acknowledged the resurgence<sup>1</sup> of non-GAAP reporting in recent years and how this has triggered research by standard-setting bodies. For example, the FASB released an exposure draft proposal in August, 2016 “*Conceptual Framework for Financial Reporting: Chapter 7: Presentation*” which focuses on how to group individual items into line items and subtotals and other presentation issues. Personally, Bob feels that there is room for meaningful non-GAAP information when properly presented. He stressed the importance of considering the role of technology and how this will impact our “paper-based” thinking. With the power of analytical tools, users can now have multiple views of the same information. He encouraged the audience to shift their focus from financial reporting to key aspects of non-financial reporting, such as key value-drivers, sustainability factors and so on.

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*Professor Baruch Lev, Philip Bardes Professor of Accounting and Finance, NYU Stern*

Professor Lev began his presentation questioning the controversy around non-GAAP reporting. “Since GAAP earnings are reported, what is the problem with managers providing an additional opinion?...If you think non-GAAP earnings are ridiculous, are fraudulent, are wishful thinking, just don’t use them; as simple as that.” Instead of focusing on GAAP versus non-GAAP earnings, he turned his attention instead to the non-GAAP disclosures that provide more meaningful indicators of future performance. The first example he discussed was an innovative and controversial pharmaceutical company, Gilead Sciences. Gilead provides a detailed outline of all of their future drugs, including the phase in the approval process. His current research is summarizing this data, along with predictors of success based on their phase, to create an “expected growth measure”. The second example he discussed was a subscription-based company, Sirius XM. This company also provides extensive quarterly information about their

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<sup>1</sup>Forecast errors equal actual earnings minus the market expectation. The measure of market expectation is the consensus (average) of analysts who cover a firm.

customers, including net additions to subscribers, new car penetration, churn rate (which he equates to customer satisfaction), conversion from free trial offers and more. “Look at the beautiful, detailed, voluntary information they provide...You can really track the development of the business model of the company, which is obscured by earnings.” He further hypothesized that companies are providing this information because there has been a dramatic decrease in the usefulness of financial reporting. In the mid-1980’s, there was a shift in the economy that led companies to invest much more heavily in intangible assets as compared to tangible assets.<sup>2</sup> Since internally-generated intangible assets are expensed while those acquired are capitalized, it became impossible to compare companies in the same industry if they had different approaches. “The accountants were sleeping at the wheel when this revolution happened.” Managers reacted to this deterioration of the usefulness of financial reporting by releasing non-GAAP information. Professor Lev recognizes that the lack of uniformity and consistency of non-GAAP information poses challenges and needs improvement, but he feels strongly that these disclosures are the true predictor of a company’s future.

#### **Viewpoints from analyst/investment community:**

*Jack Ciesielski, Owner, R.G. Associates, Inc and Publisher, “The Analyst’s Accounting Observer”:*

Jack began his presentation by providing data his firm has gathered regarding non-GAAP net income (NI) for 380 companies. This metric is the most common form of non-GAAP information presented by S&P 500 companies and it is most comparable to GAAP NI. Excluding the energy sector, the evidence from 2009 to 2015 confirms that the difference between GAAP and non-GAAP NI is greater than ever, with non-GAAP NI being higher and “smoother” as compared to GAAP NI which declined over the period and had significant volatility. Their research noted that only 31 companies reported traditional “net income-only” basis without any non-GAAP metrics. The most common practitioners (“the poster children”) of non-GAAP reporting was information technology and the health care sector. Information technology is expected to use non-GAAP NI due to the adjustment for stock compensation. More surprising was the health care sector’s frequent use of non-GAAP metrics. The companies in this industry continually acquire amongst themselves, thus resulting in many non-recurring acquisition-related costs, such as restructuring fees, banker’s fees and so on.

The aggregated total costs of non-GAAP adjustments over the 2009 – 2015 period analyzed amounted to \$787 billion. “Ignored costs still consume shareholder’s funds and equity. To ignore the existence of impairment charges and exit costs is to ignore much reporting on economic activity. Just because both investors and companies agree to ignore it doesn’t make it go away.”

Jack ended his presentation with a case study example of Valeant Pharmaceuticals, a company that presented glowing non-GAAP results in contrast with GAAP results. Despite the non-GAAP

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<sup>2</sup> Source: Professors Carol Carrado and Charles Hulten

adjustments and significant capital investments, Valeant did not produce the cash from operations they predicted and the GAAP NI was arguably a more meaningful metric. He encouraged investors to consider multiple metrics and use the different dimensions to gain a deeper understanding of the company. “You have to ask yourself, what’s wrong with GAAP? We’ve never really seen a cogent, convincing explanation of why this (non-GAAP) measure is better than net income.”

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*Martin Fridson*, Chief Investment Officer, Lehmann Livian Fridson Advisors

Martin began his presentation indicating that analysts appreciate having different metrics and he supports companies providing as many measures of financial data as possible to allow users to make their own meaningful assessments. However, he identified the following 2 areas where he finds non-GAAP measures could be exploited: executive compensation and stock performance. In the area of executive compensation, Martin provided several data sources indicating that companies use non-GAAP earnings so the executives can manipulate them to their benefit (since some portion of compensation is based on earnings). “You have the compensation committee throw out the bad stuff and come up with a number that gets the desired compensation. Instead of having pay for performance, you have performance for pay.” Martin also provided data that pointed out that heavy non-GAAP reporting companies have more formal earnings restatements and have material weakness in internal controls as compared to companies that use GAAP reporting. “Extensive literature connects poor-quality earnings with poor stock returns.” He further connected the issue between executive compensation and stock performance by providing data suggesting that companies with heavy non-GAAP earnings are associated with high CEO compensation and poor earnings quality; these characteristics are also associated with low stock returns. “Draw your own conclusions!” In response to these concerns, he proposed Congress require companies that want to be listed on a national exchange must have strict standards for their Board of Directors and compensation committees that put shareholders first, regardless of their state of incorporation (with reference to Delaware<sup>3</sup>). As a final note on a peripheral topic, he noted that companies with bond covenants have provided alternative definitions of EBITDA in order to make the covenants easier to manage. Although this is not strictly a GAAP definition or non-GAAP reporting issue, it is in the same vein of exploiting a definition for the companies’ advantage but to the detriment of the shareholders.

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<sup>3</sup> More companies are incorporated in Delaware than any other state and it is known to provide flexibility to the corporation and board members; Delaware is considered “firm-friendly”.

## **Viewpoint from the Regulators:**

*Kyle Moffatt, Associate Director of Disclosure Operations, SEC*

The proliferation of non-GAAP reporting led to the SEC's May 2016 release of updated guidance on non-GAAP financial measures, "Compliance & Disclosure Interpretations" in order to curb troubling practices that have developed over the years. Since the update was issued, the SEC publicly stated that they would defer comments on the new interpretations. This would allow companies an opportunity to determine their implementation strategy, how they will message to the market and develop alternative approaches to be in compliance. They understand the challenges for companies and do not object to a transition in the 2<sup>nd</sup> or even 3<sup>rd</sup> quarter of 2017. The only exception to this transition stage was for companies submitting IPO's; full compliance was required on the new interpretation. They have been pleased with the results on a few key areas; companies are focusing on clarifying disclosures, they are looking at non-GAAP more closely and analyzing prominence<sup>4</sup> issues. Kyle noted that a few videogame companies have already changed how they report non-GAAP results, such as eliminating the calculation of results based on earned and unearned revenues. Kyle provided a few areas that have and will warrant SEC comments, such as:

- Undue prominence
- Balance: non-GAAP guidance should be accompanied by GAAP guidance
- Objection to full presentation of non-GAAP income statements
- Usefulness of disclosures; companies should ask themselves why they are providing the measure and provide detailed insight on how it is meaningful
- Better description of non-GAAP tax adjustments; a number of factors could warrant a comment, such as the rate used, the nature of the adjustment and so on
- Evaluation of normal recurring cash operating expenses, as well as restructuring and integration costs; Kyle acknowledged that these areas require judgement but they will be evaluated for appropriateness

The goal of the SEC is to create a meaningful dialogue with registrants so they can better understand unique circumstances. Kyle went on to discuss the 2 complex areas they are addressing, as follows:

- Liquidity versus performance measures; the SEC will object to per share measures that are presented as performance measures but really appear to be liquidity measures
- Individually-tailored accounting principles; this represents the most complex issue they are dealing with at this time. They will challenge non-GAAP measures that use

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<sup>4</sup> "Prominence" refers to the issue of entities disclosing their results in a way that places undue prominence on the non-GAAP numbers

tailored accounting for line items (other than revenues) in a practical approach that focuses on egregious violations.

Kyle ended his presentation noting that the SEC may delay discussions of more complex issues, such as pension and derivative adjustments, until they can perform outreach and better focus their approach.

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### **View from the media:**

*Francine McKenna, Journalist/Reporter, MarketWatch*

Francine began her presentation with urgency and passion. “Non-GAAP metrics are, in our opinion, out of control...if journalists and analysts who do this 10 times a day for thousands of public companies cannot quickly figure out which number is the primary GAAP number for the key financial data and which non-GAAP number is intended to be most equivalent, imagine what the average investor thinks...many investors have given up. They are no longer investing on a fundamental basis; they feel bamboozled, they feel misled.” She continued to ponder if there could be more sinister motivations, particularly since the non-GAAP numbers impact the market price. She praised journalists for identifying violations and inappropriate accounting, such as when a company “flips the table” (calculating percentage comparisons in reverse by putting prior year numbers before current year numbers). Francine was shocked that even when journalists regularly identify companies flipping the table, the culprits do not appear fazed or remorseful. She is hopeful that the dedicated taskforce efforts underway since the May guidance was released will result in comment letters for the most egregious violators, which “a little birdie” source alluded was 50% of the companies reviewed. Francine provided 2 recommendations for the roundtable, as follows:

- Consistent with Martin Fridson, she advocates for enforcement when there is manipulative use of non-GAAP for executive compensation. She cited a Wall Street Journal article regarding Mylan. This company received a \$465 million penalty for federal fraud and this criminal penalty was excluded when calculating the metric for executive bonus compensation.
- Companies currently provide non-GAAP metrics in analyst conference calls and earnings releases which are provided days before the actual filings. Who is reconciling the information in these early releases and calls with the actual filings? She noted that the calls and earning release information is currently not part of the audit. Although there was discussion by the PCAOB Investor Advisory Group to consider requiring an audit of non-GAAP metrics, she is not hopeful. She recognizes the increased liability for the auditor with no corresponding increase in fees, “even non-accountants know that is not going to add up.”

## **Viewpoints from analyst/investment community:**

*Gerald White, President, Grace & White, Inc:*

As an analyst who reads financial statements to make long-term investment decisions for his clients, Gerald stressed that non-GAAP is not inherently good or bad. This information can be helpful in certain situations, such as if a company adopts a new investment method or has truly non-recurring items. He provided a timely example of how it can be very helpful if presented in a useful and informative manner, such as the decline in the British pound (due to Brexit) and how this impacts a company's exposure and its specific financial statements. However, non-GAAP information can be misleading in many instances such as excluding certain items arbitrarily for the benefit of executive compensation or companies suggesting that restructuring expenses should not be part of reported income. He noticed that non-GAAP information resembles what used to be "Management's Discussion and Analysis", however, today it appears that management decides to exclude something because they feel it should not count. "The problem with non-GAAP reporting is it favors management rather than investors...it is a way for management to say this is the measurement we think you should use to value the company" but investors should be responsible for making this decision independently. With the sell-side analyst community shrinking, management is now "managing" this group and the financial reporting process has become more of a game to manage expectations; "a game that has gotten more cynical...the only answer is for analysts to do the work and make up their own minds."

*Adam S. Parker, Chief US Equity Strategist, Morgan Stanley:*

Adam began his presentation diminishing the relevance of the difference between GAAP and non-GAAP earnings. "I think it is misleading when you look at the GAAP vs pro forma spread and say 'it's wide', because all you are really saying is that last year something bad happened. So I reject the notion that people can use something like this to predict market-level returns and say 'hey, there is a big gap between GAAP and non-GAAP earnings, let's short the market', that makes no sense." Morgan Stanley (MS) created their own definition of non-GAAP earnings by adjusting for items that MS considered truly non-recurring and for items that they felt should be logically excluded, such as option expenses. When comparing their version of non-GAAP earnings and GAAP earnings, they found that the difference was not significant. Adam brought us back to his ultimate goal for his clients: how to provide investment advice and strong returns based on various historical metrics. The MS research reviewed 3 metrics from 1985 – 2015 that evaluated stocks that are inexpensive based on price to GAAP earnings, price to non-GAAP earnings, price to the modified MS definition of non-GAAP earnings. They found that the least effective predictor of market return was the GAAP metrics, the most effective was the MS-definition of pro forma earnings. "You all might be right but I can't go into the office every day and try to re-educate investors on accounting, I try to help them make money." Adam provided further evidence of the lack of importance of the spread between GAAP versus non-GAAP by comparing it to the accrual metric. This metric represents the disconnect

between earnings and cash flows and it is “a tried and tested metric for predicting subsequent returns.” He found there was basically no correlation between the accrual metric and the spread between GAAP and non-GAAP earnings. “So I have a tried and tested method that I know works (accrual metric) and I compare it to this one that people are postulating might matter and it does not matter. So I am not in love quantitatively with using this pro forma (versus) GAAP spread to predict returns when it is not correlated at all to something I know works.” He also noted that buying stocks that are inexpensive on pro forma earnings and selling those that are expensive generates more return than using GAAP earnings. Adam ended his presentation agreeing with many other panelists that scrutiny of the variables used in calculating executive compensation was critical.

#### **Viewpoint from the Big 4 Accounting Firms:**

*Beth Paul, Partner, PwC:*

As a Partner at the largest public accounting firm, Beth sees this issue from multiple perspectives: how it impacts audit clients, audit committees, Board of Directors and the investment community. She stressed that we live in an information age and that this information is reported because investors ask for it and because management feels it is important to discuss their core operations, unusual or infrequent items. Companies are trying to remove items that do not have predictive value and to show a steady state of earnings or revenues to allow analysts to do their jobs and assess all possible information. Some important information, if not provided in non-GAAP, would not be reported at all as income statements are not required to disclose line items, such as operating income or non-operating income subtotals. This issue is currently on the FASB’s consideration for a project on Performance Reporting that PwC is encouraging them to undertake. The tension that exists around this issue may be due in part to the flexibility of choice. Companies can choose whether or not to disclose non-GAAP information and there is not comparable information across companies or periods. Analysts and companies struggle with this issue. Companies are looking at their non-GAAP reporting more, in part due to the SEC comment letters, but many companies and audit committees have been actively engaged in this discussion. She cited the process already in place for companies that include control policies and procedures and materiality bars designed for non-GAAP information. Despite what some other panelists mentioned, Beth stressed that companies want to be transparent and provide consistency in their non-GAAP metrics. For example, she noted that the real estate industry has created a group to work on consistency amongst themselves and PwC encourages other industries to do the same. She ended her presentation addressing the question of the auditor’s role in auditing the non-GAAP information. “We are not associated; this is non-GAAP, we audit GAAP financial statements and related footnotes...by SEC-mandate, non-GAAP (information) is prohibited from being in the financial statements...so we are not auditing them.” She stressed that although the auditors are not responsible for non-GAAP information, they do provide guidance, best practices and assist their clients in assessing their processes and controls.

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### Question and Answer Highlights

A dynamic Q&A session followed the panelists' remarks. Below are some highlights of the discussion.

"The problem we have in the United States is that when we try to present that information, forward-looking and different, soft, complex and really meaningful, the lawyers sue the hell out of us." Professor Stanley Siegal, NYU Law School

"That is the complexity that some of the companies are counting on. They know no one has time to go back, they know that you (analysts) have to put something out right away, they know that my colleagues (journalists) have to put something out right away and they are expecting that no one is going back to cross-check." Francine McKenna, MarketWatch

"Wouldn't it make sense that if companies are going to release earnings they file their 10Q at the same time?...that would slow things down a bit and give more time to digest the information...maybe there (would be) some more elucidation. If the information systems have progressed to the point where we can practically close overnight, I don't know why (all companies can't (simultaneously) release." Jack Ciesielski, Owner, R.G. Associates, Inc and Publisher, "The Analyst's Accounting Observer

"I work at the biggest equity business in the world and I would say a huge chunk of our business are clients holding stocks 2-5 days so obviously there is a lot of action that happens before the (10)Q comes out and it has nothing to do with a comprehensive assessment of the total P&L." Adam Parker, Morgan Stanley.

"We've got all of these little safe harbors; the legal liability on non-GAAP earnings is far different than if you play around with GAAP earnings." Jack Ciesielski, Owner, R.G. Associates, Inc and Publisher, "The Analyst's Accounting Observer

"...In late 90's...companies were matching and beating (the consensus analysts' estimates published by First Call) by a penny...if you beat by 2 cents, that was a big deal...now there is this consensus that there is something to beat and it is kind of weird that 75% of companies beat earnings estimates." Audience member

"You've really put your finger on it, the problem is there are a lot of companies that are in the business of managing their stock price because it manages their compensation." Gerald White, President, Grace & White, Inc

"When it comes to additional information that is useful, it has got to be verifiable...if it is not in principle auditable, it will on average not be truthful." Professor Joshua Ronen, NYU Stern School of Business

## **Summary**

With the proliferation of non-GAAP reporting and the impact this information has on the market, many questions arise. Are companies merely trying to provide additional, meaningful information? Or do they have ominous intentions to manipulate the market for their own benefit? Is the true problem that there is no standardization around non-GAAP reporting or is the issue that GAAP has become obsolete and does not provide predictive value? These questions and more were addressed during the dynamic roundtable discussion that brought together many varying perspectives. While no ultimate consensus was reached, all who attended came away appreciating the importance and complexity of non-GAAP reporting.