



# Reporting non-GAAP financial and operational measures

**Four steps companies  
can take to mitigate risk**



# Four steps companies can take to mitigate risk

Including non-GAAP (Generally Accepted Accounting Principles) financial and operational measures in your earnings releases and other informational material can be a double-edged sword. On one hand, it provides richer insights to those who, rely on financial statements and other information, e.g., investors, analysts, venture capitalist firms, and bankers. On the other hand, incomplete or inaccurate information may damage company reputation in the eyes of the investor community or result in possible punitive action by regulatory authorities. The U.S. Securities and Exchange Committee (SEC) and other regulatory bodies are increasingly scrutinizing the reporting of non-GAAP financial measures.

As a result, if your company has been reporting non-GAAP financial measures, you may face the risk of having to:

- Eliminate certain non-GAAP financial measures in earnings releases and company disclosures
- Revise your calculations and reporting of non-GAAP financial measures
- Face enforcement actions by the SEC or other federal and state regulatory authorities.

Private companies, especially those planning to go public, are not immune to the issues of reporting non-GAAP and operational measures. For example, it is highly likely that your next financing round or an initial public offering will be marketed using several non-GAAP measures, and therefore you will need to ensure that the following have been considered well in advance:

- Determine the measures that are most critical to depicting the business performance.
- Ensure the definition of these measures takes into account not just the upcoming months, but the next three to five years (e.g., should a metric such as “number of new users” include returning users or not?).
- What controls should be in place to ensure that these measures are being reported consistently and timely each period?

Not appropriately addressing these questions may put a company in a challenging position with its underwriters and others associated with the initial public offering as it creates incremental risk to the offering. Reliability of these measures is also critical in M&A exits.

Despite these potential risks, the use of non-GAAP financial measures to supplement communications under U.S. GAAP continues to climb.<sup>1</sup> Private companies continue reporting similar measures to their investors who rely on this information to better understand the company’s performance, strategy, and initiatives, and in many cases, assess its valuation. What’s more, companies themselves believe that these non-GAAP measures more accurately reflect their value to potential investors.

In this article, we will take a closer look at non-GAAP financial and operational measures and offer steps that companies can take to improve the quality of the reported information.

## “Non-GAAP financial measures can be a source of confusion.”

—Former SEC Chair Mary Jo White<sup>2</sup>

## “Companies should first understand the other information being reported, including how operating metrics are defined. Companies then should have adequate disclosure controls and procedures in place. In some respects, these other reporting processes may require more steps than some GAAP processes, not fewer.”

—Wesley R. Bricker, SEC Chief Accountant<sup>3</sup>

<sup>1</sup> “Non-GAAP financial measures are thriving,” KPMG-Institutes.com, May 24, 2017.

<sup>2</sup> “SEC Staff Warns about Non-GAAP Financial Measures,” *KPMG Defining Issues*, May 2016, No. 16-20.

<sup>3</sup> At the 2017 Baruch College Financial Reporting Conference, available at [www.sec.gov](http://www.sec.gov), May 4, 2017.

# What are non-GAAP financial and operational measures?

A non-GAAP financial measure is generally defined as a numerical measure of historical or future financial performance that excludes or includes the amount from the most directly comparable GAAP measure.<sup>4</sup>

Operational measures can be defined as, “key operating metrics, forecasts, and other kinds of reporting, which may represent important sources of information for investors and supplement the information provided by GAAP.”<sup>5</sup> (See below for representative examples of non-GAAP financial and operational measures.)

**Increasing regulatory scrutiny:** As reporting of non-GAAP financial measures rises, so does the scrutiny of the SEC. The SEC is concerned that these measures may be misleading, tough to interpret, or in former SEC Chair Mary Jo White’s words, “a source of confusion.”<sup>6</sup>

The SEC first provided guidance on non-GAAP measures in 2003, and most recently updated them in 2018.<sup>7</sup> The rules governing non-GAAP financial measures are located in the following documents:

- Regulation S-K, Item 10(e), applicable to all filings with the SEC
- Regulation G, applicable to all public disclosures
- Compliance and Disclosure Interpretations, providing guidance on specific areas of SEC focus
- Form 8-K, providing guidance for applicability of Item 10(e) to earnings release

Non-GAAP Financial Measures	Operational Measures
Adjusted revenue	Same-store sales
Adjusted net income	Average revenue per customer or user
EBITDA	Revenue per available room
Adjusted EBITDA	Sales per square foot
EBITDAR	Customer retention
EBIT	
Adjusted EPS	
Free Cash flow	
Funds from operation	
Net debt	



<sup>4</sup> The technical definition of a non-GAAP financial measure is historical or future financial performance, financial position or cash flow that (i) excludes amounts, or is subject to adjustments, that have the effect of excluding amounts, or (ii) includes amounts, or is subject to adjustments that have the effect of including amounts, that are included in or excluded from, as the case may be, the most directly comparable GAAP measure in the registrant’s statement of income, balance sheet, or statement of cash flows (or equivalent statements).

<sup>5</sup> Remarks before the 2017 Baruch College Financial Reporting Conference: “Advancing Our Capital Markets with High-Quality Information,” Wesley R. Bricker, Chief Accountant, U.S. Securities and Exchange Commission, May 4, 2017.

<sup>6</sup> “Recent Trends in Reporting Non-GAAP Income – An Example from Social Media Companies,” *CPA Journal*, July 2017; “Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility,” Keynote Address at 2015 AICPA National Conference, December 19, 2015, <http://1.usa.gov/1XIOGKz>.

<sup>7</sup> “SEC Staff Warns about Non-GAAP Financial Measures,” *KPMG Defining Issues*, May 2016, No. 16-20.

# Danger zones

The table below sets out some of the SEC's key concerns with respect to the calculation and reporting of non-GAAP financial measures. Similarly, it's our view that these key concerns noted by the SEC on the non-GAAP financial measures also apply

to reporting of operational measures. In the words of Wesley Bricker, Chief Accountant of the U.S. SEC, "much of the recent experience with non-GAAP financial metrics also provides lessons for other kinds of reporting by companies."

Equal or greater prominence	Non-GAAP financial measures are presented more prominently than corresponding GAAP measures
Reconciliation	Non-GAAP financial measures are not reconciled to the most comparable GAAP measures
Usefulness	No disclosure of why the non-GAAP financial and operational measure provides useful information to investors
Calculation	Incorrect calculation or use of a defined term (e.g., EBIT, EBITDA, FFO, per share liquidity measure, etc.)
Defined terms	Lack of explanation of how a non-GAAP financial or operational measure is defined or calculated
Tax adjustments	Non-GAAP financial measure does not correctly show its tax impact, or show the adjustments "net of tax" without a clear explanation of the tax adjustments
Non-recurring adjustments	Non-GAAP financial measure classifies items as nonrecurring when there were similar charges in the past two years, or such charges are reasonably likely to recur within two years
Exclusion of normal, recurring, cash operating expenses	Non-GAAP financial measure excludes normal, recurring, cash operating expenses necessary to operate a registrant's business
Exclusion of items requiring cash settlement from liquidity measure	Non-GAAP financial measure excludes charges or items that require, or will require, cash settlement from liquidity measure
Forward-looking information	Non-GAAP financial measure excludes a quantitative reconciliation with respect to a forward-looking non-GAAP measure based on "unreasonable efforts" without prominently disclosing that fact and its probable significance
Constant currency or currency-neutral	Non-GAAP financial measure is presented in a constant currency, but there is no disclosure of the process for calculating the constant currency amount nor the basis of its presentation
Inconsistency between periods	Non-GAAP financial or operational measure is inconsistently presented between periods
Presentation on a segment basis	Adjusted measure of segment reporting disclosed, but measure is not identified as a non-GAAP financial or operational measure and required information is not presented
Tailored accounting	Non-GAAP financial measure includes adjustments to tailor recognition and measurement methods from GAAP rules
Exclusion of charges but not gains	Non-GAAP financial measure excludes charges, but does not exclude any gains

Source: Securities and Exchange Commission





**“ ...much of the recent experience with non-GAAP financial metrics also provides lessons for other kinds of reporting by companies.”**

— Wesley R. Bricker, SEC Chief Accountant

# Four key steps to take now

In light of the SEC's guidance, senior management and finance leadership, along with the audit committee, should evaluate non-GAAP financial and operational measures and how they are used in communications to the public and other investors. Here are four key steps to take now:

1

Identify the non-GAAP financial measures you are reporting that are covered under SEC regulations, as well as operational measures being reported. Consider factors such as:

- The use of the financial/operational measure reports
- The importance of such measures to investors and other users.

2

Assess the processes, procedures, and controls that apply to your non-GAAP financial and operational measures (non-GAAP measures fall under Disclosure Controls and Procedures and require officer certification). For example:

- Formalize and document the process of calculating and reporting these non-GAAP financial and operational measures similar to the way you would treat internal controls over financial reporting (ICOFRR) or SOX controls (e.g., process narratives or flowcharts). Consider establishing internal policy to document and ensure how the non-GAAP financial and operational measures are transparent, consistent, and comparable.
- Identify and document key risks, corresponding internal controls, and/or gaps to address the risk (e.g., risk and controls matrices).
- Design controls over non-GAAP financial and operational measures so they address compliance with regulations and completeness and accuracy of source data, reconciliation to GAAP or comparable measurement, consistency between periods, review and monitoring by the appropriate level of management, and monitoring of related IT systems and applications.

3

Ascertain whether internal controls over the calculation and reporting of non-GAAP financial and operational measures are appropriate.

- This includes non-GAAP financial measures that are disclosed in earnings releases furnished on Form 8-K.

4

Perform controls testing on a periodic basis (e.g., quarterly) to gain insight to the operating effectiveness of these controls related to the calculation and reporting of non-GAAP financial and operational measures.

# How KPMG can help

What differentiates KPMG is the dedication and commitment of our professionals, and the hands-on approach we take in working with clients like you. We focus on understanding your business, the way you operate, and where you want to go in the future. This philosophy lets us offer you customized guidance and a cohesive implementation strategy designed to deliver tangible results to your company.

- We can help your organization assess internal controls over the calculation and reporting of non-GAAP financial and operational measures—from readiness assessments to documentation, remediation, and testing assistance.
- Our professionals work closely with you to identify key risks and the applicable internal controls you have in place—or need to implement—to address those risks. Once we identify the appropriate set of controls, we can work with you to implement them and determine the best mix of resources to conduct testwork in a cost-effective manner, with minimum interruption to your business.

- We can also help you reduce costs and improve quality through access to skilled professionals who provide a fresh perspective and an increased level of objectivity. By providing key subject matter resources in areas such as technical accounting, financial management, IT, or industry-specific processes on an “as-needed” basis, we can help you gain scalability and flexibility.

We also offer access to industry-leading technology and innovation capabilities that enable you to operate and leverage your resources—people, vendors, and legacy platforms and equipment—more efficiently.

In addition, you can benefit from our global strength and capabilities. Our global network of member firms includes professionals located in all of the world’s commercial hubs, enabling us to serve you wherever you do business—now or in the future.

In May 2016, the SEC staff issued updated Compliance & Disclosure Interpretations (C&DIs) that provide additional guidance about how companies are allowed to use non-GAAP financial measures, specifically listing prohibited practices. Today, the SEC staff is actively commenting to companies about their use of non-GAAP financial measures in communications and financial reporting. The majority of these comments are intended to point companies to the C&DIs to remind them of their obligation to comply with SEC rules and interpretations.

Though it would be logical to expect a decrease in the number of non-GAAP financial measures following the SEC’s crackdown, as companies shy away from potential noncompliance, the opposite has proven to be true. Non-GAAP financial measures are flourishing. Companies increasingly believe that non-GAAP financial measures play a critical role in their communication with investors, and that investors rely on that information to understand a company’s performance and liquidity.

Against this backdrop of perceived importance, KPMG’s Non-GAAP financial measures in-depth overview outlines our understanding of the SEC requirements related to non-GAAP financial measures.



# Contact us

For more information on developments in non-GAAP financial and operational measures and how we can help you, please visit our Web site ([www.kpmg.com](http://www.kpmg.com)), or contact one of the KPMG professionals below.

**Chad Poplawski**  
**Managing Director**

**T:** 415-794-2995

**E:** [cpoplawski@kpmg.com](mailto:cpoplawski@kpmg.com)

**Sriprasadh Cadambi**  
**Partner**

**T:** 408-367-1382

**E:** [scadambi@kpmg.com](mailto:scadambi@kpmg.com)

## About KPMG LLP

KPMG LLP, the audit, tax and advisory firm ([www.kpmg.com/us](http://www.kpmg.com/us)), is the independent U.S. member firm of KPMG International Cooperative ("KPMG International"). KPMG International's independent member firms have 200,000 professionals, including more than 10,000 partners, in 154 countries and territories.

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates.

## [kpmg.com/socialmedia](http://kpmg.com/socialmedia)



*Defining Issues* is a registered trademark of KPMG LLP in the United States.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2018 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG network is a registered trademark and logo trademarks of KPMG International Cooperative ("KPMG International") and its member firms. KPMG is a registered trademark of KPMG LLP. NDPPS 717648