Bridging the GAAP

Financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP) don't always tell the whole story of a company's performance. To bridge the gap, your company—like many companies today—probably supplements reported earnings under GAAP with "non-GAAP financial measures" (such as EBITDA, adjusted earnings, and free cash flows) that the company believes more accurately reflect the results of operations and are better indicators of future performance. While many investors find non-GAAP financial measures helpful (and have come to expect it), news headlines and regulatory scrutiny continue to highlight concerns about the overuse and the expanding variety of non-GAAP financial measures—"Tailored Accounting at IPOs Raises Flags," *The Wall Street Journal*, Jan. 2015; "How Much Do Silicon Valley Firms Really Earn?" *Baron's,* June 2015; and in 2014, non-GAAP financial measures continued to be a common topic of SEC Staff comment letters.

Indeed, the SEC Staff continues to scrutinize non-GAAP financial measures—particularly the consistency of the information—that companies disclose in their SEC filings, earnings releases, conference calls, and other public statements, and challenge the use of non-GAAP financial measures in any context when considered to be materially misleading. Is management presenting an overly optimistic view of the company? Do the non-GAAP financial measures help investors understand the company's performance and prospects? (The SEC has detailed regulations regarding disclosure of non-GAAP financial measures to ensure that investors are provided with information that is fulsome and not misleading.)

In this environment, it is critical that non-GAAP financial measures have a prominent place on the audit committee agenda, and that the committee have a robust dialogue with management about the process by which management develops non-GAAP financial measures, and their correlation to the actual state of the business and results. We recommend the following areas for the committee's consideration:

Remember that non-GAAP financial measures are not audited by the external auditor. Non-GAAP financial measures are included in the MD&A—not in the audited financial statements; as a result, the auditor's responsibility is limited to consideration of whether the information is materially inconsistent with information appearing in the financial statements. Of course, the company may engage the auditor to perform an attest engagement of the MD&A, but this is a review or examination rather than a full audit of the information presented in the MD&A.

What is the process by which the company decides whether to present non-GAAP financial measures—and which ones to provide? Who drives the process? What is the role of management's disclosure committee? What is the role of the audit committee? Are we satisfied that non-GAAP financial measures are being used to improve transparency and not to distort results? What is the difference in the operating results under GAAP and non-GAAP financial measures? Are there changes in the non-GAAP financial measures used from period to period? Have we obtained the input of the external and internal auditors? How frequently does management reassess the adequacy of the company's disclosure controls and procedures?

Benchmark the company's non-GAAP financial measures against its peers. Consider the types of non-GAAP financial measures others in the industry disclose, and whether these metrics provide important insights into the company's financial performance and operations. Also, monitor SEC Staff comment letters regarding non-GAAP financial measures being used by peers, as these letters can help identify emerging issues that will be the focus of SEC attention for your industry.

Would disclosure of nonfinancial metrics—in lieu of, or in addition to, non-GAAP financial measures—improve transparency into the company's future operational and financial prospects? In its interpretive guidance on the MD&A, the SEC stated that companies should identify and discuss key performance indicators, including nonfinancial indicators that management uses to manage the business and that would be material to investors. (Some argue that companies should not use non-GAAP measures, and should instead use forward-looking, nonfinancial metrics. See "Non-GAAP Nonsense: Fixing the Problem Once and for All," Strategic Finance, October 2014.)

Finally, given the complexity of disclosures associated with non-GAAP financial measures—as well as the increasing complexity and range of MD&A disclosure requirements more broadly—it is essential that the company have appropriate legal advice on these issues.

About the KPMG Board Leadership Center

The KPMG Board Leadership Center champions outstanding corporate governance to help drive long-term corporate value and enhance investor confidence. The Center engages with directors and business leaders to help articulate their challenges and promote continuous improvement. Drawing on insights from KPMG professionals and governance experts worldwide, the Center delivers actionable thought leadership—on risk and strategy, talent and technology, globalization and compliance, financial reporting and audit quality, and more—all through a board lens. Learn more about the Board Leadership Center's programs, resources, and insights for directors at KPMG.com/BLC.

Audit Committee Institute

Part of the Board Leadership Center, KPMG's Audit Committee Institute focuses on oversight of financial reporting and audit quality and other issues of interest to audit committee members, including risk oversight, internal controls, and compliance. Learn more at KPMG.com/ACI.

kpmg.com