NATIONAL DIRECTORS INSTITUTE

NDI Checkpoint Web Conference

Current Landscape of Reporting Non-GAAP Measures

Lessons learned from 2016

June 21, 2017

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Today's Presenters

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Partner

- 18 years as Foley & Lardner LLP securities and disclosure attorney
- Practice also focuses on M&A, corporate governance and activist/takeover defense
- Four years as an auditor with Arthur Andersen

Chris Hodges, Alpha IR Group

CEO and Founder

- 20+ years in IR consulting
- Previously co-founded Ashton Partners, led Industrials practice at FTI Consulting
- Recognized industry expert: investor activism and IR best practices
- Specialties: IR Measurement, IPO and M&A engagements, Activist Counsel

Bobby Winters, Alpha IR Group

Senior Managing Director

- 13+ years on buy-side as portfolio manager for Zesiger Capital Group
- 10+ years as a sell-side analyst, 9 of which with Bear, Stearns & Co.
- Board Member of several private/venture capital investments
- Specialties: IPO and M&A engagements, Activist Counsel

Agenda

- The Basics
  - What is a Non-GAAP measure?
  - History: Reg G and New C&DIs
- Importance & Drawbacks of Non-GAAP Measures
- Usage Realities
- Recent Disclosure Trends
- The Real Audience: Wall Street's Perspective
- Recent Comment & Enforcement Actions
- Conclusion & Practical Advice
- Q&A

Basics: What is a Non-GAAP Financial Measure?

- Non-GAAP financial measure: A numerical measure of a registrant's historical or future financial performance, financial position or cash flows that:
  - Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the issuer; or
  - Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented

Basics: What is a Non-GAAP Financial Measure?

- Does not include operating and other financial measures and ratios or statistical measures calculated using exclusively one or both of:
  - Financial measures calculated in accordance with GAAP
  - Operating measures or other measures that are not non-GAAP financial measures
- Does not include financial measures required to be disclosed by GAAP, commission rules, or a system of regulation of:
  - A government
  - Governmental authority
  - Self-regulatory organization that is applicable to the registrant

Common Examples

Adjusted Revenue

Same Store Sales

Adjusted Operating Income

EBITDA

EBIT

FFO

Free Cash Flow

Adjusted Net Income

Adjusted EPS

More Basics: Reg. G and Item 10(e) of S-K

- Adopted by SEC in early 2003
- Rule was directly aimed at investment bankers and corporations that had aggressively used non-GAAP metrics (i.e., internet company statistics) to sell deals during the Internet Bubble
- Regulation G applies <u>to all public disclosures</u> of material information containing non-GAAP financial measures, even if such information is not part of the registrant's SEC filing
- Requirements:
  - Non-Misleading: A non-GAAP financial measure must not misstate a material fact or omit to state a material fact necessary to make the presentation of the non-GAAP financial measure not misleading
  - Disclosure Requirement: A non-GAAP financial measure must be accompanied by:
    - Presentation of the most directly comparable GAAP financial measure; and
    - Quantitative reconciliation between the non-GAAP financial measure and the most directly comparable GAAP financial measure

More Basics: Reg. G and Item 10(e) of S-K

- Oral Disclosures: If a non-GAAP financial measure is disclosed orally, telephonically, by webcast, by broadcast, or by similar means:
  - Post the comparable GAAP measure and reconciliation on the registrant’s website; and
  - Disclose the location and availability of that information during the oral presentation
- Item 10(e) of S-K applies when a non-GAAP financial measure is included in a filing with the SEC
  - Also applies to earnings releases (Item 2.02 of Form 8-K)
  - Requirements:
    - Non-Misleading: A non-GAAP financial measure must not misstate a material fact or omit to state a material fact necessary to make the presentation of the non-GAAP financial measure not misleading

More Basics: Reg. G and Item 10(e) of S-K

- Disclosure Requirements: A non-GAAP financial measure must be accompanied by:
  - Presentation, with equal or greater prominence, of the most directly comparable GAAP financial measure;
  - Quantitative reconciliation between the non-GAAP financial measure and the most directly comparable GAAP financial measure;
  - Statement disclosing the reasons why management believes the non-GAAP financial measure provides useful information to investors; and
  - To the extent material, a statement disclosing the additional purposes for which management uses the non-GAAP financial measure

More Basics: Reg. G and Item 10(e) of S-K

- Certain non-GAAP practices are prohibited, including:
  - Excluding cash settled items from liquidity measures
  - Identifying adjustments as non-recurring, infrequent or unusual if reasonably likely to recur within two years
  - Presenting non-GAAP measures on the face of financial statements or pro formas
  - Use titles or descriptions for non-GAAP financial measures that are confusingly similar to GAAP measures
- Exceptions:
  - M&A disclosures
  - Registered investment companies

New C&DIs: Focus on Placement & Prominence

- The C&DIs make it clear that the following disclosures of non-GAAP measures are more prominent and therefore noncompliant:
  - Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures;
  - Using a non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption);
  - Presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure;

New C&DIs: Focus on Placement & Prominence

- Describing a non-GAAP measure as, for example, “record performance” or “exceptional” without at least an equally prominent descriptive characterization of the comparable GAAP measure;
- Presenting a full income statement of non-GAAP measures or presenting a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures;
- Providing tabular disclosure of non-GAAP financial measures without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table;
- Excluding a quantitative reconciliation with respect to a forward-looking non-GAAP measure in reliance on the “unreasonable efforts” exception in Item 10(e)(1)(i)(B) without disclosing that fact and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence; and
- Providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence

New C&DIs: Be Careful with Liquidity Measures

- Non-GAAP liquidity measures that measure cash generated <u>must not be presented on a per share basis</u> in documents filed or furnished with the Commission, consistent with Accounting Series Release No. 142
  - Prohibition depends on whether the non-GAAP measure can be used as a liquidity measure, even if management presents it solely as a performance measure
  - Staff focuses on the substance of the non-GAAP measure and not management's characterization of the measure
- The three major categories of the statement of cash flows should be presented when a non-GAAP liquidity measure is presented
- Free cash flow is a liquidity measure that must not be presented on a per share basis

New C&DIs: Tax Impacts Required Too

- Tax effects: A registrant should provide income tax effects on its non-GAAP measures
  - If a measure is a liquidity measure that includes income taxes, it might be acceptable to adjust GAAP taxes to show taxes paid in cash
  - If a measure is a performance measure, the registrant should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability
  - In addition, adjustments to arrive at a non-GAAP measure should not be presented "net of tax"
  - Rather, income taxes should be shown as a separate adjustment and clearly explained

Why are Non-GAAP Measures Good/Important?

- Can convey a clearer picture of a company's operating performance, financial position, liquidity position, and future free cash flow expectations than GAAP when done properly
  - Can reduce noise (e.g., non-recurring, non-cash items) that can obscure core business trends
- Can enhance comparability across companies in an industry, especially if their application of GAAP is not consistent across their industry and/or peer group
- Can provide transparency into non-GAAP debt covenant compliance
- Many investors and analysts want non-GAAP measures – allow for better model building
- Certain sectors (e.g., REITs) have special situations and GAAP can actually cloud understanding of some performance indicators
- The media tends to only read headlines and thus often doesn't acquire a full understanding of the core results in a rush to "get the news out"
- Sell-side analysts and investors are increasingly stretched; given the ongoing transformation of Wall Street, they need assistance with better understanding a company's core performance

Why use Non-GAAP Measures? A Practical Example

	XYZ	Peer A	Peer B	Peer C	Peer D	Peer E	Peer F
Stock-based Compensation		✓	✓	✓	✓		
M&A: Integration Costs		✓	✓				✓
Restructuring Charges		✓				✓	✓
Amortization of Intangibles			✓	✓	✓		
Foreign Exchange	What Should XYZ Disclose?			✓			
Litigation Costs							✓
Pension Costs		✓					✓
Noncash Interest Expenses			✓		✓		
Revenue Deferral						✓	

Competing for Capital Every Day!

Why are Non-GAAP Measures Problematic?

Non-GAAP 5% Higher!

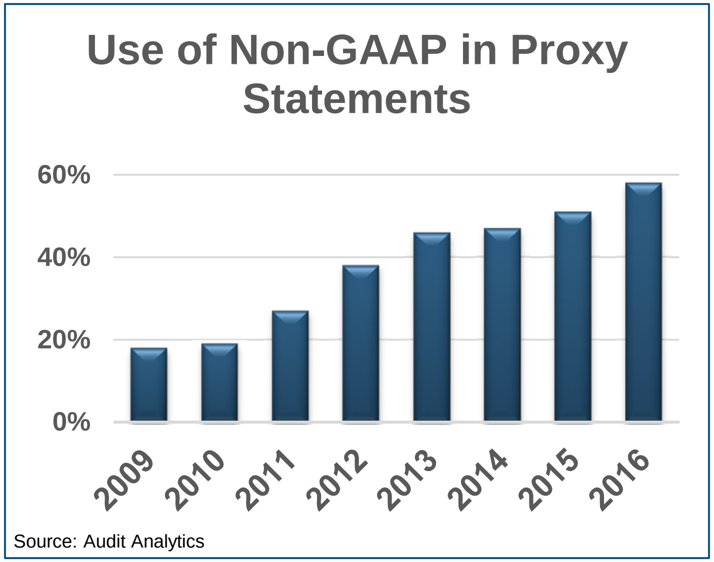
- Reality: there is a significant divergence between GAAP and Non-GAAP results (see example in table)
- Historically, some companies have highlighted non-GAAP measures and not disclosed GAAP measures in an effort to “make the number” (i.e., hit expectations)
- Can be an incentive to exclude “bad” things and not “good” things, especially when they impact performance based compensation
- If they are too aggressive and/or inconsistent, both the company and the management team can lose credibility
  - In some cases, provides ammunition for short sellers or a path for activists

Ten S&P Mega Caps: Fiscal 2016

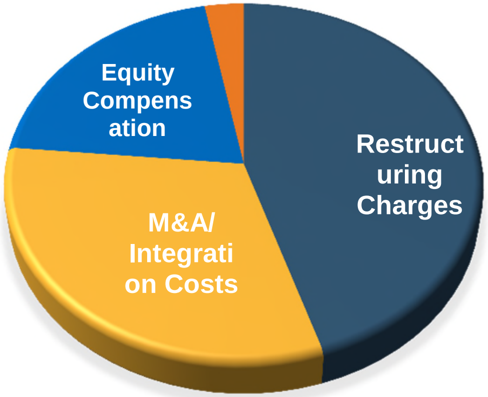
Co.	GAAP EPS	Non-GAAP EPS	Difference
A	$ 9.76	$ 9.76	0.0%
B	$ 4.00	$ 4.10	2.3%
C	$ 2.90	$ 3.18	9.7%
D	$ 1.70	$ 1.78	4.5%
E	$ 4.55	$ 4.72	3.6%
F	$ 4.42	$ 4.41	0.0%
G	$ 2.43	$ 2.94	20.9%
H	$ 3.99	$ 4.02	0.8%
I	$ 6.71	$ 7.15	6.5%
J	$ 4.15	$ 4.17	0.3%

Today's Non-GAAP Realties

- Use of Non-GAAP is actually increasing, not decreasing
  - 96% of S&P 500 companies used a non-GAAP metric during Q4'16 (Source: Audit Analytics)
  - This compares to 75% in 2006 and 88% in fiscal 2015
- Usage trends in non-earnings materials is increasing as well (see bar chart)
- Three core focus areas drive majority of adjustments (see pie chart)



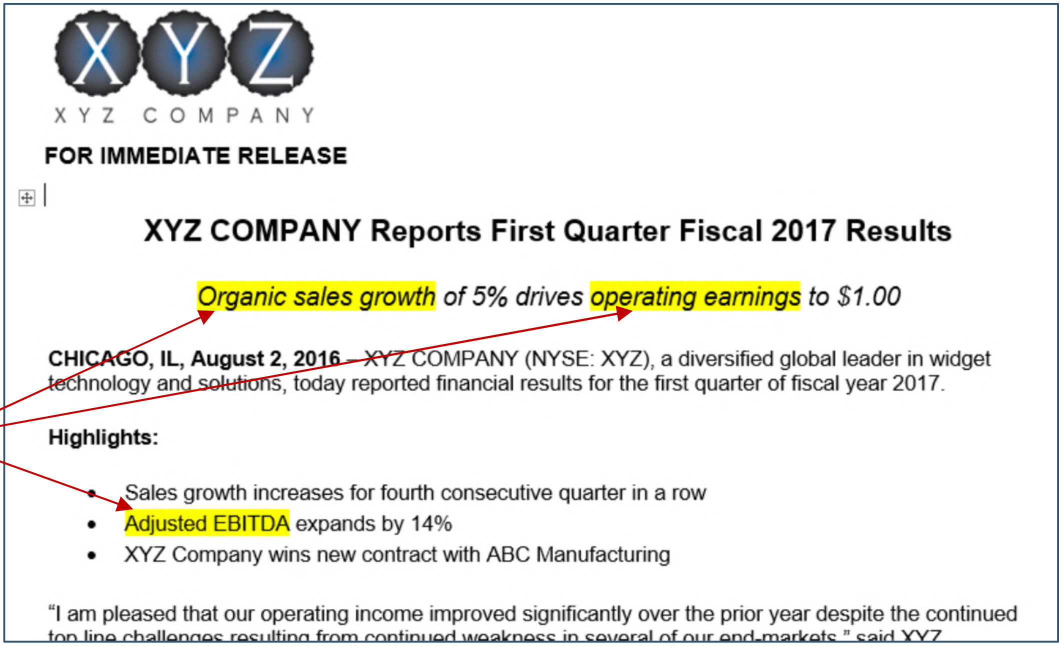
Top Reasons Cited for Non-GAAP Usage



Recent Trends: Earnings Releases Big Changes

- Most noticeable impact has been on the earnings release where equal prominence and placement have been focus
  - Sub-titles much trickier today given the requirement for GAAP lead
  - Bulleted highlights now usually include GAAP, even if not meaningful to core understanding of story
- Some companies have eliminated non-GAAP focused tables as they felt addition of applicable GAAP table made release too long

Not Anymore!



XYZ COMPANY

FOR IMMEDIATE RELEASE

XYZ COMPANY Reports First Quarter Fiscal 2017 Results

Organic sales growth of 5% drives operating earnings to $1.00

CHICAGO, IL, August 2, 2016 – XYZ COMPANY (NYSE: XYZ), a diversified global leader in widget technology and solutions, today reported financial results for the first quarter of fiscal year 2017.

Highlights:

- Sales growth increases for fourth consecutive quarter in a row
- Adjusted EBITDA expands by 14%
- XYZ Company wins new contract with ABC Manufacturing

"I am pleased that our operating income improved significantly over the prior year despite the continued top line challenges resulting from continued weakness in several of our end-markets," said XYZ

Minimal Impact on Other Docs; Sentiment Mixed

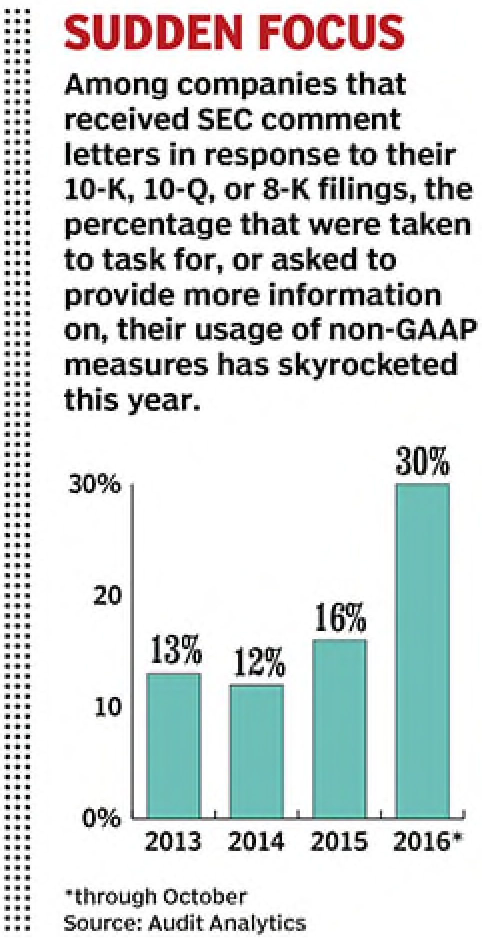
- Other earnings communication impacts:
  - **PowerPoints:** most have added new disclosures and reconciliations; however, many have stopped 8K'ing these so they aren't registered with the SEC
    - Note: Reg. G covers use of non-GAAP across all materials, not just those filed with SEC
  - **Scripting:** in general, we've seen only minor shifts in approach to earnings scripting, usually focused on the addition of GAAP net income and earnings if it wasn't reported before
  - **Guidance:** very little impact; if you used EBITDA in the past, you likely still guide to EBITDA today
    - The SEC allows companies to exclude a GAAP reconciliation if that information is not available without "unreasonable efforts," and most companies use this reason to avoid GAAP guidance
    - However, under certain circumstances and if you're a company with serial adjustments, may need to consider adding GAAP guidance
- Sentiment one year later
  - The large majority of Investor Relations Officers in several studies across the country believe that these rules have hindered rather than increased transparency
  - But here to stay!

The Real Audience: Wall Street's Perspective

- From a buy-side perspective, investing is about the future, whereas accounting (GAAP) is generally focused on the past
  - History (GAAP) helps frame the past and present in a uniform way, but investing (long or short) is about the future where the first step is a disagreement with the present
- Gets to the core function of "active" management on the buy-side; they will include or exclude different items based on their underlying investment thesis
  - Hence, the buy-side, who generally control 90% of your stock, are already doing this
  - If you do it well and anticipate their needs, they will appreciate it and you will build credibility
  - If you do it poorly, and adjust items that the Street disagrees with, you can risk a significant impact to your management's credibility (and usually the stock's valuation as well)
- The sell-side also will look to non-GAAP measures to understand your "true" earnings power
- They also are building models and must understand both GAAP and non-GAAP drivers
  - They are also more stretched than ever given the ongoing transformation of their business model, and thus the more education and transparency you can provide them the better
- Activists generally only care about this issue if it adds support to their investment thesis (e.g., management credibility problem), but this is rarely an issue that leads to a hostile engagement

Recent Corporate Finance Comment Letters

- SEC has allowed companies to include non-GAAP earnings measures that arguably are prohibited
  - Companies made case why these measures are important for investors
- SEC has not been flexible about non-GAAP revenue measures
- Don’t expect the SEC to waive compliance with Item 10(e) or Regulation G requirements, such as “prominence”



Recent Enforcement Activity

- Rare to see a “pure” non-GAAP enforcement action
- CFO and chief accountant of REIT manipulated the calculation of the company’s adjusted funds from operations (non-GAAP) by using a fake “plug” number, which boosted the measure and misled investors
  - Chief accountant resigned and pled guilty to one count of conspiracy to commit securities fraud and other offenses
  - CFO resigned and pled not guilty; trial is pending
- MDC Partners, a marketing company, used the term “organic revenue growth” without providing a clear reconciliation to GAAP measures, which prevented investors from making meaningful comparisons
  - Company also failed to disclose some personal benefits in CEO compensation
  - Company agreed to pay a $1.5 million penalty to settle all charges

Conclusion & Practical Advice

- From a legal perspective, these new directives have made disclosure decisions much more black and white and have provided clear guideposts; however, from an investor communications perspective, they have somewhat clouded and made the process more complex
  - Companies need to balance the legal need against investor need for transparency and clear communication
- While Wall Street wasn't clamoring for this change, in fact it's very rare to see investors publicly call out a non-GAAP metric unless it's self-serving (i.e., activism) or a credibility issue
- Given the transformation that both the sell-side and active buy-side is going through today, we believe this issue needs to be taken seriously and handled with care (make easier for them)

Conclusion & Practical Advice

- Key questions to ask when you make these choices and during each annual review of your disclosure policies:
  - What is the intent of using the measure and what are you trying to communicate?
  - Does it truly provide investors with a better understanding for your investment thesis?
  - Do you use the measure consistently?
  - Do you use the measure internally (e.g., for incentive compensation)?
  - How does the company's non-GAAP measure differ from approaches taken by other companies?

Q&A

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We look forward to seeing you at the next NDI Checkpoint!

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