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CAQ Publishes a Roadmap of Non-GAAP Financial Measures for Audit Committees

On March 16, 2018, the Center for Audit Quality (the “CAQ”) published Non-GAAP Financial Measures: A Roadmap for Audit Committees¹ (the “Roadmap”) to provide guidance to audit committees on advancing their oversight and involvement with non-GAAP financial measures. The Roadmap summarizes the common themes on the presentation and use of non-GAAP financial measures that emerged from a series of roundtable discussions held by the CAQ in 2017 and attended by a variety of stakeholders, including audit committee members, management, investors, securities lawyers and public company auditors. The CAQ hopes that the Roadmap will prove useful for audit committees and will ensure greater transparency and consistency in the use of non-GAAP financial measures.

The CAQ’s guidance comes at a time of heightened focus of regulators on the issue of use of non-GAAP financial measures. Since 2002, the Securities and Exchange Commission (the “SEC”) has raised concerns about these measures, using a range of methods to convey such concerns, from rule-making, to the comment letter process and to formal and informal guidance. In May 2016, the SEC issued updated guidance on non-GAAP financial measures, and, over the course of the next few months, sent over 150 comment letters to SEC reporting companies following the review of a number of earnings releases that showed what the SEC characterized as incomplete and incorrect presentations and use of such measures. In addition, the SEC initiated a number of enforcement actions related to non-GAAP financial measures. In response to SEC comments, reporting companies revised and updated their presentations of non-GAAP financial measures, which led to the levelling off of related SEC comments by the end of 2017. At the December 2017 AICPA conference on SEC and PCAOB developments, members of the SEC staff expressed satisfaction with the general response to the 2016 guidance on non-GAAP financial measures, but also added that the SEC will continue to monitor compliance with the guidance and expects companies to remain focused.

We summarize below the key points raised in the Roadmap.

Non-GAAP financial measures are defined as numerical measures of historical or future financial performance, financial position or cash flows that exclude or include (or are subject to adjustments that have the effect of excluding or including) amounts that are included or excluded, as applicable, from the most directly comparable measure calculated or presented in accordance with generally accepted accounting principles (which for this purpose could include US GAAP or International Financial

¹ A copy of the report is available [here](#).

Reporting Standards). Common non-GAAP financial measures include EBIT, EBITDA, adjusted EBITDA, free cash flow and net debt. The use of certain non-GAAP financial measures may be particularly common among companies in a specific industry to provide for significant adjustments from GAAP financial measures due to the nature of the industry.

As discussed in the Roadmap, non-GAAP financial measures can, when presented appropriately, be helpful to investors and the market by providing additional insight as to a company's results of operations, financial position or liquidity, offering potentially useful information on the company's overall strategy and management's evaluation of the company's performance. Properly presented non-GAAP financial measures can help foster a better understanding of underlying business performance and help in preparing proprietary models that forecast long-term value. At the same time, non-GAAP financial measures can present challenges. In the view of the SEC, investors may be challenged by the lack of consistency in the calculation of non-GAAP financial measures from one company to next, which can make difficult the comparison of such measures across companies and industries.

Similar challenges in evaluating non-GAAP financial measures can be faced by audit committees as they attempt to understand the reasons behind management's presentation of selected measures and how such measures compare with the information presented by peer companies. The Roadmap also notes that compensation committees should be closely involved with the application of non-GAAP financial measures in the determination of incentive compensation.

Given the complexities involved in the use of non-GAAP financial measures, decisions as to how to treat one-time transactions in non-GAAP financial measures and how to present and disclose them properly require management and audit committees to exercise significant judgment and rigor. Audit committees can promote such rigor and oversee the use of non-GAAP financial measures by maintaining a dialogue with management and internal and external auditors and by assisting with the establishment of appropriate policies, procedures and controls. In light of the foregoing, the CAQ sets out a possible roadmap of items for an audit committee to consider in respect of non-GAAP financial measures. Audit committees should:

- **Put themselves in the investors' shoes** when evaluating if the presented non-GAAP financial measures and related disclosures align with the company's overall strategy and performance;
- **Engage with investors directly or through investor relations** to ensure that the presented non-GAAP financial measures aid investors' understanding of the company's performance;
- **Ask management whether it has an internal policy** that provides guidelines for determining how non-GAAP financial measures are generated, calculated and presented, including the rationale for the measures and adjustments that it presents and excludes. If there is no policy, encourage management to create one;

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- **Discuss with management how the company makes changes to non-GAAP financial measures it presents** and the rationale for why it would or would not make changes;
 - **Seek the perspective of counsel** on non-GAAP financial measures;
 - **Ask management to compare or benchmark** their non-GAAP financial measures to those of the company's peers;
 - **Determine what disclosure controls and procedures are in place** as they relate to non-GAAP financial measures that are presented;
 - **Ask the external auditor what its responsibilities are for non-GAAP financial measures**, and whether that responsibility is different depending on where non-GAAP financial measures are presented;
 - **Ask the external auditor for perspectives** on how non-GAAP financial measures that the company presents generally compare with those of other companies; and
 - **Discuss with the external auditor what its views are on the company's non-GAAP financial measures**, including whether the measures are consistent with the auditor's understanding and knowledge of the company's performance.

The Roadmap identifies the following as some of the leading and recommended practices that should guide companies in their presentation of appropriate non-GAAP financial measures.

- **Disclosure controls:** Companies should strive to establish robust disclosure controls specific to non-GAAP financial measures as this will help mitigate risks and support sound decision-making about the metrics reporting. The disclosure controls should be documented and should facilitate their testing.
- **Non-GAAP policies:** Management should have policies and guidelines in place that could guide preparation and presentation of non-GAAP financial measures as they will help promote consistency in how the measures are presented and calculated.
- **Audit committee disclosure:** Companies may benefit from audit committees disclosure regarding the existence of non-GAAP policies (even if the policies themselves are not disclosed) as this could serve as helpful evidence for investors that the company has adequate policies to ensure the non-GAAP financial measures are used consistently, transparently and comparably.

Non-GAAP financial measures can provide investors and others key, additional insight into companies' results of operations, financial positions or liquidity. However, the benefit of presenting these measures is

dependent on proper presentation, which in turn means they should be presented in compliance with applicable SEC rules, transparent and calculated consistently, and comparable among companies, at least in the same industry. Audit committees are well positioned to play an important role in ensuring quality reporting of non-GAAP financial measures, and the Roadmap can be a valuable resource to help inform and guide audit committees' interactions with management teams and the external auditors.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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