Securities Regulation Daily Wrap Up, TOP STORY—PCAOB's Investor Advisory Group offers recommendations on use of non-GAAP financial measures, (Oct. 27, 2016)

Securities Regulation Daily Wrap Up

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By Jacquelyn Lumb

PCAOB Chair James Doty said the Investor Advisory Group's discussion on non-GAAP financial measures was perhaps the single most productive session the Board has held. He took note of IAG member Gary Walsh's warning that a day of reckoning will come as the gap between generally accepted accounting principles and non-GAAP numbers grows. Doty said it is the PCAOB's charge to determine whether auditors are giving non-GAAP numbers sufficient attention. Non-GAAP numbers are not subject to the audit, but auditors are required to read and consider information outside of the financial statements to determine whether it is consistent with the financial reporting and does not reflect a material misstatement.

SEC Chair Mary Jo White attended the opening of the IAG meeting where she credited the PCAOB for all that it has achieved in its 14 years of existence. While good work is being done abroad with respect to the auditing profession, she said it is nothing like what the PCAOB is doing. On the subject of non-GAAP financial measures, White said it continues to receive a lot of attention at the Commission. Investors want this information, she said, but it must be presented in the right way.

Report from the working group. Tony Sondhi, president of financial advisory services company A.C. Sondhi & Associates, LLC, presented a report from the working group on non-GAAP financial measures. He reported that the use of these measures has grown significantly since 2010. He also cited a report that the gap between non-GAAP and GAAP earnings per share in a group of companies in the Dow Jones Industrial Average increased to 30.7 percent in 2015, compared to 11.8 percent in 2014. The proliferation of these measures is in response to demands from the investor side, he said, and also dissatisfaction with GAAP measures of profitability, operating performance, and liquidity. However, regulators have expressed concern about the increasing use of non-GAAP measures.

As Sondhi pointed out, there is no common definition of non-GAAP numbers, so they are inconsistently applied. The reconciliations to GAAP are not always helpful. As an analyst, he said he does not want to limit its use because it provides insight about management's perspective. In the committee's view, GAAP and non-GAAP measures together can provide a more comprehensive perspective on how management runs a company and how the board governs the business. The committee concluded that non-GAAP measures should be audited given the extent of investors' reliance on these numbers.

The committee recommended the development of robust and dynamic definitions for non-GAAP measures, but concluded that limiting the number and use of the measures could result in a significant loss of information for investors. The committee also explored whether the measures should be independently validated through self-regulation but said it was unclear whether this would be a viable approach.

The committee believes the measures should be presented in the financial statements to ensure that they are consistently calculated and audited, and should be included in supplementary information subject to Auditing Standard 17, *Auditing Supplementary Information Accompanying Audited Financial Statements*.

Heightened concerns. Walsh, the principal and portfolio manager at Luther King Capital Management, said few companies report any concerns about the differences in GAAP and non-GAAP reporting, but in his view, it is disconcerting as an investor to know there is a widening gap, which led to his remark about the day of reckoning to come. Mary Bersot, the CEO and chief investment officer for Bersot Capital Management, agreed. She said

the numbers are taken for granted—they go into models and they drive stock prices. Investors may not be giving enough credence to GAAP numbers, she said.

Doty applauded the SEC for issuing guidance on the use of non-GAAP measures and said the panel discussion provided a tremendous incentive to keep thinking about this issue rather than deciding that it is someone else's problem to resolve.

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