

# Deloitte Fireside Chat XII: Financial Reporting of Non-GAAP Measures

October 19, 2016

**Dr. Mark E. Peecher:** Good afternoon and welcome to today's Deloitte Fireside Chat, broadcast on [www.sechistorical.org](http://www.sechistorical.org). I am Dr. Mark Peecher, Associate Dean of Faculty and Deloitte Professor of Accountancy at the University of Illinois at Urbana-Champaign, and moderator for today's program.

The Deloitte Fireside Chat series is made possible through a partnership between Deloitte LLP and the SEC Historical Society. Deloitte is the brand under which tens of thousands of dedicated professionals and independent firms throughout the world collaborate to provide audit, consulting, financial advisory, risk management and tax services to select clients.

The SEC Historical Society, through its virtual museum and archive at [www.sechistorical.org](http://www.sechistorical.org), shares preserves and advances knowledge of the history of financial regulation. The virtual museum and archive is the preeminent source for original and primary material on the regulation of the capital markets. Today's broadcast is the 12<sup>th</sup> in a series that began in 2009 to address current issues in financial regulation of interest to the accounting and auditing professions.

The Deloitte Fireside Chats are now the longest continuous running program series in the museum. All past broadcasts, ranging from disclosure effectiveness to the role of professional judgment, are available in the Deloitte Fireside Chats section under Programs in the virtual museum and archive. I had the privilege of moderating three previous chats, in 2011 on the role of the auditor, 2012 on the profession's look at the Sarbanes-Oxley Act, and on 2014 on financial reporting. I can share that more than 55,000 visitors to the virtual museum and archive have accessed one or more of these chats since the broadcast. I encourage those joining us today to check out the Deloitte Fireside Chats section at the conclusion of the broadcast. I think the series will be well worth your time.

Today's program will look at financial reporting of non-GAAP measures. I am joined today by Christine Davine, Brian Lane, and Jon Lukomnik. Christine is a partner with Deloitte & Touche LLP in its national office in Washington, D.C. and serves as National Director of SEC services for Deloitte & Touche LLP. She previously worked as Associate Chief Accountant in the Office of the Chief Accountant for the SEC's Division of Corporation Finance. Brian is a

partner with Gibson Dunn & Crutcher, LLP in Washington and previously served as Director of the SEC's Division of Corporation Finance from 1996 to 1999. Jon is managing partner of Sinclair Capital LLC in New York and served as Deputy Controller for the City of New York in the 1990s. He is the author of the recently released *What They Do With Your Money: How the Financial System Fails Us and How to Fix It*.

Let's begin our discussion by turning to Christine. Let's start the conversation by explaining what is considered to be a non-GAAP measure versus a metric or a key performance indicator, and maybe in the course of that can you describe for us what are some commonly used non-GAAP measures?

**Christine Davine:** Sure, happy to do that. Thanks for that introduction. When I describe a non-GAAP measure I think of it as a measure of performance that's different than what's presented in the income statement. So that would be an example that's a derivation of income, so it could be adjusted net income, adjusted earnings per share, core earnings. Some type of adjusted operating income and you would adjust it for perhaps things like restructuring charges or impairments or what companies consider to be non-recurring. You can also have a non-GAAP measure that's a measure of liquidity and then it would be something that's based off of the statement of cash flow. So an example of that would be free cash flow that is operating cash flow less capital expenditures.

To the technical definition, it excludes or includes amounts that are included in the most directly comparable GAAP amount, and whether that's from the income statement or the statement of cash flow or the balance sheet, as examples that I walked through and helped to illustrate.

So you're taking these commonly understood GAAP amounts, income or cash flow, and you're removing a component of that amount and that component would typically be required to be included under GAAP. You can always articulate the components and quantify those components and explain what their impact is. It's just when you do the math, as we call it. You do the math and you say adjusted income or adjusted cash flow, that's when it becomes a non-GAAP measure. It is important to actually identify what non-GAAP measures a company uses because then they're subject to this disclosure framework and the SEC's rules and regulations.

There are some subtle non-GAAP measures so when I work with companies on non-GAAP measures sometimes I'll say "you didn't define this measure as a non-GAAP measure." Maybe it's something subtle like net debt, but net debt would be a non-GAAP measure because that's borrowing less cash, which again is not a GAAP recognized number. You want to make sure as a registrant that you've identified your whole population of non-GAAP measures that you used.

Now in contrast, Mark, you asked what about a key performance metric and what are those and how are they envisioned in the rules. Some key performance metrics are not part of the non-GAAP rules. They're scoped out, although they have a similar framework and the SEC expects clear disclosure around them in that sense and you'd want them to be transparent and defined and described. Examples of those would be unit sales or number of employees or number of subscribers or occupancy rate, or number of likes is a big one in the technology type space. They could be a statistical measure that illustrates your size or your growth, and they may not be included in the financial statements. So these numbers may not be derived from the financial statements amounts, like I said the number of likes isn't necessarily translated back into your financial statements. Those are just a brief description of some of the differences.

**Dr. Mark E. Peecher:** I think that's very helpful and I particularly liked, no pun intended, the comment about likes, and I thought there's "tweets".

**Christine Davine:** Same type of thing, yes.

**Dr. Mark E. Peecher:** When you think about non-GAAP measures, are these things primarily substitutes for GAAP measures or are they complements to GAAP measures?

**Christine Davine:** They are supposed to be supplements, they are not supposed to supplant. They're not supposed to replace the GAAP measures and a lot of the focus right now by the SEC really is on prominence, which is a connected issue to that, in that they are not supposed to be more prominent than the GAAP measure and that runs to the replacing versus supplement.

**Dr. Mark E. Peecher:** That's helpful and we'll talk a little bit more about prominence in a while, but I want to pivot to Jon and the basic question is, why do companies given they have so many GAAP measures to deal with already, why do they use non-GAAP measures?

**Jon Lukomnik:** First off, I want to thank you and the SEC Historical Society and Deloitte for inviting me. I think it's nice that you have an investor here, because in theory all this is for our benefit, something that issuers know but in the rush to prepare financials lose sight of is why, they're doing all the compliance work.

Investors have a love-hate relationship with non-GAAP measures. We like them because they tell us more about the way the company is actually being run. There is sort of a kabuki dance that goes out every quarter and a large kabuki dance that goes on every year as companies close the books and try to put things into GAAP format. There are very few companies that actually run their companies according to generally accepted accounting principles. They run it for operating efficiencies and for operating metrics.

Investors want to understand how the companies run, and so to the extent that companies give us more information about the metrics that they actually care about, that gives us good information: how is the company being run, what do they care about? Often these non-GAAP metrics are embedded in their executive compensation plans, and so to us they are more relevant information in some ways or as Christine said, they complement the relevant information from GAAP measures with relevant information about what the company itself thinks is important. Obviously they can be misused, I'm sure we'll get into misleading GAAP disclosures, but in the best of all possible worlds they provide additional relevant information.

Investors are also very concerned with what the future will be. Accounting is ex post transaction-based. When you exclude non-recurring onetime charges or onetime expenses you get a better idea of what the baseline is, and so it's useful to understand again what the actual state of the company and what is likely to be going forward. The KPIs that Christine said and sustainability metrics and other things that aren't non-GAAP financial measure but are technically non-GAAP, just provide a broader set of information for investors to look at.

So that's one of the reasons we like it. The reasons we hate it are obvious. They can be misused, and the more tools you have at your disposal, the more creative you can be in misusing them. When someone excludes non-recurring expenses but includes non-recurring revenues, it makes the company look much better than it is. It gives a false sense of baseline and that is a problem. And so the need as Christine said, to reconcile and explain what's going on is very important for investors because in the end the GAAP measures become the touchstone against which we can say yes, these non-GAAP measures are being used in a rational and informative way instead of an irrational and misleading way.

**Dr. Mark E. Peecher:** That's very helpful and it is good to have an investor perspective. In some ways that could have been the question. Brian, do you have anything to add in this particular area, adding a little more color about why companies choose to use non-GAAP measures.

**Brian Lane:** I think that companies want to use them because they believe, like Jon says, that it sets forth a baseline and in their lingo it would be the core operations. In essence they're saying when you measure our performance quarter to quarter or year to year you should not hold against us onetime losses or credit us with onetime gains, or special items. So we sold a business, we made a lot of money on it. It will go into other income or wherever it shows up, but don't think you should expect that every year.

Isn't that really the purpose of MD&A which is to look and say please describe to investors why the financial statements shouldn't just be read at their face value, help them understand what you might expect in the future, so they could likewise sell a business and lose money and have a \$200-million loss. Does that mean that when selling widgets that it's

not as profitable as it was the year before? They would say no, you should exclude that in looking at what our results were.

They also like to adjust for non-cash items, depreciation, amortization, because it's not coming out of their pocket. GAAP recognizes there are two costs, your equipment ages and it will have to be replaced so amortization is a totally appropriate thing to take into account, but if you look at what banks do for example. They lend off of EBITDA, Earnings Before Tax Depreciation Interest Amortization, and this is how any small business in the world today borrows money from a bank. They're going to show their cash flow numbers, they're going to show their EBITDA. The banks don't even ask for what your net income is under GAAP, it's not important to them because that's how you're measured. So if you're a company and you're having to give those numbers to the bank, why wouldn't you give those numbers to investors as well? I think that's what the company take is on non-GAAP measures.

**Dr. Mark E. Peecher:** That's very helpful. I like coming to do these talks in part because I always learn, and investors care about what banks care about. That makes a lot of sense.

Given that there's really good ways to use non-GAAP measures and that it can really help users of financial statements better understand what you said Brian, core operation, more consistent, but there's also an ability to abuse these. There must be a set of regulations that the SEC or other parties may have out there for companies to follow. Christine, what are some of these key regulations and interpretations that govern non-GAAP measures? Maybe you could highlight those and some of the most significant disclosure requirements for companies that use non-GAAP financial measures.

**Christine Davine:** Sure, thanks Mark. Brian, keep me honest because Brian's the one attorney in the room here who probably knows the rules much better than I do. I will say I'm going to be very brief because I know you have a lot more interesting questions to go through than me talking about what the rules are. I also want to give a shameless plug for our non-GAAP measure roadmap that Deloitte put out that's about 80-pages long that goes through excruciating detail about all these rules, SEC comment letter focus and disclosure controls and procedures. Everything you ever wanted to know is in that book; it is on [deloitte.com](http://deloitte.com) so feel free to access that.

I'll give my very brief description of the rules so you can understand what the framework is. In 2003 pursuant to SOX, the SEC issued the non-GAAP measure rules and Reg G is the rule you most often and frequently hear about and that regulates and covers your oral statements and all statements that you make that have non-GAAP measures in there. When you use a non-GAAP measure under Reg G, it cannot be misleading so that's the overarching most important rule as I think about it. Again, it cannot be misleading and you have to present the comparable GAAP measure and reconcile to it.

Then after Reg G for your filed documents and for disclosures in your furnished document, you have Item 10 of Regulation SK that was also part of the same 2003 rules. For your furnished documents and your filed documents it has to be equal or greater prominence and you have to disclose the purpose and usage. Again, that's press releases that are furnished and filed documents, and on top of that for file documents you have additional prohibitions that exist; prohibitions on the use of certain adjustments for a liquidity measure and prohibitions that exist for certain adjustments for a performance measure.

After that also in 2003 the SEC issued about 33 FAQs, those are Frequently Asked Questions that interpreted the rules. About seven years later they replaced those with what we call Compliance and Disclosure Interpretations. Then that brings us to present day the next significant/guidance interpretation that came out was updated compliance and disclosure interpretations in May 2016. Those really dealt with better guidance defining and describing what measures are considered to be misleading and then a lot of really good information on prominence and gave some examples that were pretty thorough about what was considered too prominent in the non-GAAP space versus GAAP. Brian, did I leave much out there?

**Brian Lane:** I think that's a good summary. I don't think anybody wants to go rule by rule, and you certainly can and the Deloitte book is one place, but I think that's a good flyby.

**Dr. Mark E. Peecher:** Jon, any investor perspective to add to that, or no?

**Jon Lukomnik:** Let me take the flipside of this which I know you were going to get to later, which is how can you get into problems and how can they be misleading, because that's the flipside of Christine's how not to be misleading. Sometimes it doesn't even intended to be misleading, it's just misleading to investors who may read for instance the same term, like free cash flow, in different earnings releases and not understand that the two companies actually measuring something totally different.

The real question is how not to be misleading, which is as Christine and Brian said is the overarching mandate; all the rest is commentary. That's the overarching mandate, and I would add from an investor point of view, it's not only don't be misleading. It's be informative. There are a couple things, first consistency. You probably ought to calculate these things the same way from period to period and if you don't you ought to highlight and explain what the changes are and why you made it. The second is that the audit committee has in my mind some obligations around how these nine GAAP measures are disclosed. Disclosure control procedures should exist for public companies in terms of what they see; many audit committees ask their external auditors, for instance to give a read. I use that word deliberately; we'll get into what that means, of the earnings releases for instance.

How careful a read that is often varies by what the agreement is by the audit committee and the external auditor. But I think audit committees have a role here to understand why management is using non-GAAP measures, why the specific non-GAAP measures were chosen, how they're being calculated and to make sure there are controls around the way they are being calculated and disclosed.

I think the other interesting aspect of why things are confusing is a policy question. It's perhaps broader than we want to go into but GAAP by definition is an accounting standard propagated by FASB. For whatever reason there are things FASB could have spent the last eight years defining that it has chosen not to. It could have defined a way to calculate EBITA; it has chosen not to. It could have tried to define some sustainability metrics, it is now a not-for-profit private sector called SASB, the Sustainability Accounting Standards Board, that's tried to define that on an industry by industry basis.

FFO, Funds Forum Operation, is a standardized accounting term now but it's not promulgated by FASB, it's propagated by the real estate industry. So I do think there's a policy vacuum here. You're never going to not have non-GAAP measures because the world changes. Technology as Christine said, is an example, but there are some very frequently used non-GAAP measures that you would think that FASB could undertake a project and get their arms around and minimize the amount of confusion that's out there.

**Dr. Mark E. Peecher:** That's very helpful. There's this proliferation on non-GAAP measures and you've given some really good reasons why they exist. The investors are demanding it, creditors will demand it, so they're very useful and we've seen recent regulatory action in May 2016, as Christine said. Brian what I hope you might be able to do for us is to give us a little historical context about when did non-GAAP measures launch into being a very popular way to better communicate or in some cases maybe paper over some performance that is not as strong as one would like.

**Brian Lane:** Some measures like EBITDA have been around forever. I think that if we get to what the adjusted income numbers and that sort of thing, in my view that really came into prominence in the 1990s while I was the director in Corp Fin. I was there, but I had no control for lots of reasons.

It was really the internet bubble that fueled it because the internet bubble created phenomena where people were questioning whether accounting was the right way to measure performance. People were suggesting that the number of eyeballs on a website and visits and such were more important than revenue numbers, or that revenue numbers were more important than earnings numbers, because a lot of the internet companies in the 90s were not making money, although their stock was doubling and tripling with regularity.

The other phenomena that developed in the 90s and actually there were three contributing factors to what came out of that, so you had non-GAAP measures which I'll go back to in a second. You had whispered earnings, they were helping companies meet analyst estimates and that gave rise to Regulation FD, then you had earnings management. Companies were punished heavily for missing their earnings estimates by a penny, and so if you're in a world where you're punished for missing your estimates by a penny what are you going to do as management? You're going to either whisper to the analyst so they'll lower their numbers so that you meet them and everybody is happy, or you create a non-GAAP measure to say this is how you should measure whether we met the quarter's performance or the year's performance.

That really gave birth to the non-GAAP metric. A lot of internet companies were not profitable as I said but if they adjusted for or knocked out some of their expenses, one of the hot topics at the time was expensing stock options for example. In the technology space that's huge, that was a huge issue when I was there.

They had APB 20 at the time which you didn't really have to expense options except in extraordinary circumstances, but ultimately you had to expense those options. There were a lot of companies that felt that was not appropriate that you run that through their income statement. It's not really costing me anything and yet my earnings are in the dumps because of that, so don't hold that against me so they would adjust for that sort of thing, but they would also adjust for impairment or if they bought a company. Tech companies were buying companies all the time and then they found out they were not all that were advertised and they turned out to be dogs and they impaired the whole amount. That can really screw up an income statement on what your core business is.

There were some excesses that went on and that's why it came into Sarbanes-Oxley in 2002 is that companies were basically taking out regular items that were misleading investors, calling an impairment a onetime event. It was the most popular thing, they took big bath account hits, remember those? In the 90s it's like let's roll everything in the kitchen sink and take a giant accrual. Then they say these are onetime things, so the stock would go up when they'd take these big baths. These are the things we observed inside the Commission, Christine remembers. This defies logic, you take this huge write off, the stock goes up and then you use non-GAAP measures to say this was all a one-time thing and then your numbers look really great. And then of course there is earnings management, you can reverse that accrual and bleed it into the income statement. So all kinds of problems developed in the 90s and it really showed up when the bubble burst in 2000, and then when WorldCom and Enron came along in 2002 and collapsed, it got the regulators attention and they went to the SEC and said, okay what's the problem here and non-GAAP was one of those identified.

I also told you about selective disclosure, I already told you about earnings management, we were already taking enforcement cases on earnings management in the 90s before I left in 2000. So I think that's what gave rise to the non-GAAP and has since, and I'll give kind of the postscript on why it's become interesting now. Christine mentioned the FAQs that came out about 2006 and they were pretty harsh, going into everything that Jon listed. Say why you use them, why they're important for investors, what do they show you that GAAP doesn't show you, and what it did is it led to a lot of boiler plate disclosure that companies put into their reconciliation section. Was it useful? I think initially yes, though you can question about whether they are. And so the SEC pulled those FAQs in about 2010 because everybody was using non-GAAP measures, everybody had – I won't say it's boiler plate that criticizes the work of us lawyers and accountants and that sort of thing, but let's just say it wasn't dynamic.

**Jon Lukomnik:** Certainly not particularized for an individual company.

**Brian Lane:** But it was true every quarter, so if that's true every quarter and you keep the same disclosures, is it really boiler plating or is it each quarter you look at it and say it's still true. But anyway, what happened is not many comments were issued by the SEC, by 2010 by certainly 2012 the number of comment letters that came from the SEC on non-GAAP was very small.

What changed? Well about 2015, 2016, some academic studies come along to say look at these statistics about people using non-GAAP numbers. Mark, I'll defer to you to go into some of the details at what the academic studies said, but then there are firms like audit analytics and such, started publishing studies that 85% of the people are using non-GAAP. The thing that got them is that the vast majority of the non-GAAP measures enhanced the performance rather than detracted from performance, so it gave rise to suspicion. Are people using non-GAAP measures only because they make things look better than the GAAP numbers, and so that drew scrutiny back, put some political overlay now in Congress, putting pressure on the SEC Chair about what are you going to do about, did you see these studies, what are you going to do? The SEC comes out with new guidance in May 2016 that cracks down again back to where they were in 2006. But there are no rules in this area, it's just an interpretation, like in the May interpretation they say you must lead with a GAAP number and then you can have the non-GAAP number. That was never the rule before, they said equal prominence, and SEC was always fine with leading with a non-GAAP number as long as the GAAP number accompanied it. So they really did change the rules through this interpretation but that's the crackdown. So I'll stop there, Mark if you want to add anything on the academic studies.

**Dr. Mark E. Peecher:** No, I think it is very interesting and somewhat rewarding to hear the interplay between academic research and not necessarily rule making but new

interpretations. Christine I want to pivot to you, I've seen that you've been taking notes. A couple of things, there's a big difference in the way, things that led to the initial launch of a non-GAAP performance measures in the 1990s and leading up to the late 1990s and early 2000s of the bubble. Brian has given us some good context about what happened recently. It seemed like you were almost saying while the cat's away the mice will play. There was a slow risen non-GAAP measures and then some attention was brought to that. There is new interpretations, so I don't know if you have something to add about either popular measures that are sometimes presented in different ways with either free cash flow, if you have a slightly different perspective about why, or have seen so much attention given to non-GAAP performance measures today, or not?

**Christine Davine:** I'll add a couple thoughts. Certainly as Brian described there has now been a proliferation of non-GAAP measures and the other issue that some of these studies has focused on is the disparity between the GAAP number and the non-GAAP number has increased dramatically. So you can take a significant loss and turn it into a very significant income and again there's lots of numbers that are flown around by what the differential is, and so I think that's certainly another factor that you see, and prominence has become more of an issue.

For all those reasons the SEC certainly has focused on it. As far as the titling issue you mentioned where you could have a measure called free cash flow that could be defined dramatically different by two different companies. You definitely see that and that gets back to the transparency issue and it's important to define what your non-GAAP measure is. If it's free cash flow and how it's calculated, and the SEC has guidance that says it can't be confusingly similar to a GAAP title and it needs to be descriptive of what it is.

If you have free cash flow and it's anything other than operating cash flow less capital expenditures, consider calling it adjusted free cash flow, if you've got five other things that are being adjusted. The same thing, don't call it EBITDA if it takes out restructuring charges and impairments and other types of charges, it would be adjusted EBITDA. So I do think it's important to get the title correct and then measures like operating income which are GAAP you shouldn't call a non-GAAP measure operating income since that's a GAAP accepted term. You would call it adjusted operating income or segment income or something to that effect.

**Dr. Mark E. Peecher:** One version of non-GAAP performance measures is that you can simultaneously have your cake and eat it, too. You can have a big bath for GAAP purposes but then you can use a non-GAAP measure and say pay no attention to this big bath. Brian, can you describe any particular non-GAAP measures that actually may have implications for the company's ability to generate longer term value? Are there conditions under which non-GAAP measures are really helpful for investors, even sophisticated investors?

**Brian Lane:** I think what we're seeing really today is currency fluctuations. The ruble collapsed, the euro really adjusted significantly as are other currencies, and so it's quite common for any global company to give a constant currency measure. The SEC staff has never given my clients a hard time on a constant currency measure because they find that it is helpful, and it does give you an idea into what the core sales are if there weren't currency fluctuations. You can calculate what the exact impact of currency is and so I'm thinking that Jon and other investors would find that particularly useful. Is that for short term, is that for long term? I think it's for both, but I think non-GAAP measures are probably, if I'm speaking fairly, more short term, because I think Wall Street has become such a short term world that an impairment that happens in one quarter or restructuring charge, or something like that, they basically want to say don't hold this against us.

In whatever modeling you do take that into account, and usually the investors are wise enough to do it. I think what they really fear, they don't fear the investors, they fear the press, because the press if they just saw what the GAAP number was, the headline is big name company loses, has a loss for the quarter or something like that and people are like "I'm selling my stock!"

**Jon Lukomnik:** They also fear the investors.

**Brian Lane:** The investor, you're right. Ultimately the investor reads the headline from a journalist that doesn't really understand what was behind the loss, and so by having the non-GAAP measure, and this is why a lot of companies I think did it, and some of them did it for the wrong reasons. But I think some companies put in their highlights, little bullets they had "record EBITDA growth" but "net loss" on the quarter that they wanted the journalist to basically see, maybe it was a mixed quarter. It wasn't like head for the exits type of thing, which let's face it some investors do that. They read a story and they think if I'm the fastest one out the door, I'm not going to lose as much or something, and that's a bad investment philosophy. Not what institutions do, but hopefully that's helpful.

**Dr. Mark E. Peecher:** That's very helpful.

**Brian Lane:** Whether it's long term, short term.

**Dr. Mark E. Peecher:** To what you were saying, and Jon jumped in there about ultimately it's the investor. Because even the sophisticates have to think about how will the unsophisticated investor respond to these headlines?

**Jon Lukomnik:** Sometimes it's the very sophisticated investor response. We talk about investors as if they're A) monolithic, and B) as if it's 1992. There are a lot of algorithmic traders now which have machine language reading that read those headlines and trade off of it. Even if it's a temporary one day/one hour/one minute drop, it can add to the volatility

in that security. I agree with Brian that's one reason the headlines are written that way. I'm not saying that's a good thing, in fact I think it's a bad thing. It's just reality today. I don't think we consider machine language, algorithmic traders non-sophisticated but they do react to that stuff very quickly and that's a problem.

I think to your other question, I'm not going to call it long term but future insight. It often depends when you dig into it if you're sort of a forensic type of investor; there are certain situations in which the non-GAAP measures are helpful. Sometimes they're the opposite of the company trends, so when people adjust out reserves for legal or environmental or whatever and there are specialty investment research houses that will make a judgment about the adequacy or inadequacy of those reserves. As Brian said, they may get reversed in the future so in effect you have a pool of non-disclosed or non-GAAP disclosed revenues that one can think about in the future.

Then there are specific situations. So, for instance, in IPOs you often get non-GAAP, you get pro-forma statements of what would happen after the use of proceeds from the IPO and that gives you a very good idea of what would happen to debt loads to marketing. Again non-GAAP measures have a valid place in the world and smart investors do take advantage of them, sometimes in ways that issues intended, sometimes in ways issuers don't intend.

**Dr. Mark E. Peecher:** That was a very insightful point about the new version of the sophisticated investor being speed trading and even though it may not have longer-term implications for the fundamental value of the company there is still an arbitrage. There's still a chance there, even if like you said it's hours or even minutes.

I want to shift gears a little bit and talk a little bit about, as Christine pointed out earlier, is really a key performance indicator that might not even qualify today as a non-GAAP measure. There are some users, investors and other users who have been pushing for more integration of environmental, social and governance measures into financial reports. That way we're talking about a separate report that tells you about these things, I'm talking about integrating it into financial reports.

Jon, you're a little bit on a roll so I'll keep with you for a second and maybe pivot after you've given some thoughts. But what do you see today and what do you think the future holds with regard to the integration of ESG, Environment Social and Governance measures into financial performance as a non-GAAP measure?

**Jon Lukomnik:** Let me guilty as charged to being some of those investors who think we should have more of these reports. Let me just give you a state of the world as I see it today and then tell you what I think of the future.

Brian went back to the 90s but I'll go back to the 70s in South Africa where investors realized their investments could have broad social impact and could be affected by broad social and environmental trends. But it was very much a stakeholder type disclosure so the type of reports that you're talking about that companies do -- sustainability reports are not necessarily solely geared towards investors, they're geared towards stakeholders -- it could be investors certainly but NGOs, suppliers often read these sort of things, customers, the press, regulators and there is some really good information in them. The first set of disclosure regimes were designed around that sort of stakeholder period. The Global Reporting Initiative, for instance, and it's done a really good job, but they're not geared for the type of disclosures we're talking about which are aimed at investors and financial materiality only. They may contain financial material but they're broader than that.

There is an increasing belief by three quarters of all investors, as judged by the CFA Society survey, that environmental, social and governance factors have impact on financial bottom lines of companies. The question is - that's nice but we don't have any standard metrics to use.

There are three initiatives going on right now that I think within the next five years will have impact on what sort of metrics get disclosed. The first is there is something called the Sustainability Accountings Standards Board, or SASB, this, as I mentioned before, is a private sector not for profit initiative. It has gone through, on a sector by sector basis, industry by industry and with industry input and investor input tried to define a limited number of KPIs by sector, and is trying to use the current materiality definitions that the SEC uses. It is trying to get industries to voluntarily adopt this sort of disclosure. Too early to tell how successful they're being, but their watch word is materiality.

The second major issue is a global one, which is the Financial Stability Board; Mark Carney, chair of the Bank of England, has charged a special commission, headed by some heavyweights, Mike Bloomberg and former SEC chair Mary Schapiro, to try to come up with universally applicable environmental disclosures which would be integrated. They have continuously said that they would come up with those measures by the end of this year, and they would recommend them to various listing agencies, stock exchanges around the world, and as well some regulators and they would expect some material adoption of them within the next couple of years.

Now there are already stock exchanges, notably the Johannesburg Exchange in South Africa and the Bovespa in Brazil, which require some level of integrated reporting. They are not trying to reinvent the wheel, they are not trying to have a stakeholder-driven sustainability disclosure regime but they're trying to come up with metrics which would be material for investors. I think those two, SASB here in the United States and the FSB for international, will result in a coalesce around materiality as a standard for these sort of disclosures. By

the way that will not necessarily please a lot of the other stakeholder groups which is an interesting phenomenon. Investors who think this is material may get what we want but the coalition has been asking for it may have some factures in the future.

The third thing that's happening that actually I find quite interesting is the AICPA has a draft document out on sustainability attestation. It is in draft and they have asked for comments and it's quite a technical piece of work, I would say. But the fact that the AICPA has devoted so much time and effort to creating this says that they are seeing at least the beginnings of a market for attestation around these issues.

Now that same CFA survey that I mentioned, three quarters of CFAs around the world want some sort of ESG reporting. They ask an interesting question which is: should it be attested to, and how much are you willing to pay for it, which is a key issue because we investors are cheap. We want it all and we don't want to pay for it. A third said they just didn't know, a third say attestation should be at the level of a major audit firm, and a third said it could be somewhat less than that and they said that the cost of it -- there were a lot of different ranges, but the 50% of the people who wanted some level of attestation said it should only cost between 10-25% of what a financial audit costs.

Those are the big picture, where we are, the changes that are coming which are SASB and FSB, and perhaps a further down the road change which is the potential for real attestation as the AICPA has put out there a disclosure draft.

**Dr. Mark E. Peecher:** Some of the interesting things to me in part are a lot of what you talked about was actually not only North American-centric but US-centric which traditionally would think these sorts of ESG measures would be much more European, as one example, or even other parts of the country. The whole idea that it's a very good way to figure out whether the performance measure being reported is valuable, is whether people want it to be reliable measure or not, and that's where the attestation comes in. Thanks for talking about that.

As you said, not everyone has that view that you sort of articulated there, Brian can you give a counter point to this position about how desirable it is to integrate environmental, social and governance measures not as a separate report but into the financial reports.

**Brian Lane:** Let me start with Jon's last point which is the attestation point. I happened to write the release in 1997 which the then Big Six recommended that MD&A that there would be attestation, the SEC put out a concept release. I wrote it, and it did not go over well. It's hard to audit MD&A when it has forward looking information and I think the sustainability by its very nature is forward looking. So I think it would be a challenge. I frankly don't know how it happens but let me go to the other two points about the cross section of sustainability with the financial statements and with disclosure.

I'd like to think that we have two requirements, one MD&A which takes into account all kinds of future developments and contingencies and known uncertainties and I would put to you that a lot of these sustainability issues are known uncertainties. We also have ASC 450 and that model works pretty well. It's got its own shortcomings, not that we couldn't fix it up, but the notion is it's got to be probable and it's got to be estimable, and I think a lot of the sustainability challenges are how estimable they are.

I have clients that have actuaries that sit down and calculate some of this stuff, especially if their industries are greatly affected by environmental issues. But it's already the law that there are environmental risks or other risks that are material. I agree with Jon that it really comes down to materiality in analysis and so I think that the rules are there, I would find it curious if there was any further development by FASB to try and fold in something into a line item on a financial statement, on a GAAP financial statement that reflects it. But I don't think that's what Jon was pushing for, I think it was really more disclosure if I understood him correctly, and I think the disclosure mechanisms are there.

There is some danger in the attestation and I think like some things there just sort of politics, but again go back to when I was a director, Y2K, I had to attend Senate hearings why we didn't have to have separate line items disclosure for Y2K. I said we don't need them; we have MD&A that already requires this, but Congress insisted for political reasons we put out a legal bulletin. It's always something, one year it's this the next year it's that.

**Jon Lukomnik:** I don't think line disclosure is it; I agree. But there's a sensitivity to the issues particularly as you say as – and you were right on the MD&A. But, I think there's a certain sensitivity in the short term trading markets that we have. So it's what's material to a reasonable investor and the problem as I said investors are not monolithic. Is climate change material to a trader? Probably not. Is it material to an index fund that's going to be a universal owner forever? Yes. And so there's a sensitivity there, and I would not compare this to Y2K which was a come and go, I might compare this more to cyber security where there has been an emphasis by the SEC on what sort of disclosures you have to make and to be fair it's actually perhaps the most particularized disclosure that is done by companies.

I do hold out a fair amount of optimism around this materiality by industry sector approach, because I would hope being a fundamentally optimistic person that we would follow the route in disclosure that cyber security disclosures have taken as opposed to the sort of generic risk disclosure that we've all seen far too often.

By the way Mark I agree you, in general, Europe and Asia are way ahead of the US on carrying out these issues; many companies there do have some form of integrative reporting. I think that the reason that I was concentrating on North America and the United States-centric events is because I do think it's going to be a little different here and it's going to be more narrowly scoped to get around the materiality. There's much more of a

shareholder bottom line approach here than the stakeholder approach that takes place elsewhere in the world.

**Dr. Mark E. Peecher:** Very helpful and it is always fun to think about what fundamental changes to our reporting models could occur. But I want to shift a little bit back to what's happening today in the area of non-GAAP performance measures. Christine, let's talk about what's happening today in terms of comment letters that are being released or that are likely to be released in the near term. What sorts of things are catching SEC staff eyes and other regulators eyes that result in these types of letters?

**Christine Davine:** We are seeing a ton of non-GAAP measure comment letters coming out of the Division of Corporation Finance, and a lot of those are starting to get posted to the EDGAR system. There's a delay obviously in when a company receives a comment letter and clears it and then it gets posted on the EDGAR system. It's a minimum of 20 days after a comment letter is cleared that it gets posted publically, but many of our clients have received these letters and the vast majority of letters here today deal with prominence issues. Is the non-GAAP measure less prominent than GAAP and disclosure related issues? Is the reconciliation there, is the reconciliation correct, do they have the appropriate disclosure about why it's useful and the purpose that it's used for, how it's calculated, how it's defined?

That bucket is what I call prominence and disclosure related, what you're also seeing and more so in the last month, is comments that are focusing on the nature of the adjustments, and so right after the C&DI's you saw some of that, you saw lots of comments on adjusted revenue metrics which the guidance prohibits in certain cases, companies from using adjusted revenue if it's considered what they describe as an individually tailored accounting principles. We also saw a lot of comments asking about how the income tax provision was calculated or recalculated once the non-GAAP measure number was different. So your effective tax rate could be very different since maybe you had a loss before and you now have income, and I'm also seeing comments that are asking questions about restructuring charges, is that an appropriate adjustment or impairments because in the case of a restructuring charge is that considered normal and recurring, is that a cash operating expense for the types of restructuring charges that are in fact cash.

More migration to actually questioning the underlying appropriateness of the calculation of a particular non-GAAP measure. Brian, you and I were talking about this over lunch. Gibson Dunn had an analysis of some comment letters that were recently issued as part of the non-GAAP measures and I think it fairly backed up what I said, but certainly keep me honest to where I went astray.

**Brian Lane:** Absolutely. You touched the high points. I think one maybe false narrative just going in Christine is I've seen some accounting firms, not yours, put out word that because

some of the comment letters challenge some restructuring charge, litigation particularly, a litigation expense as being unusual that they challenged that and what the accounting firm said was, oh now you can't back out litigation expenses. That's not right, what they were really doing in that letter was criticizing the company that called it non-recurring.

That was not a message that you can't adjust for litigation it's just a warning that don't call it non-recurring because you have litigation expense routinely. The other thing to mention, I know we're cutting short on time here Mark, is the enforcement division at the SEC has ginned itself up as of late on non-GAAP. There was a non-GAAP case prior to Reg G that involved the Trump Hotels, about backing out onetime losses but not backing out onetime gains. That was an example that Jon gave at the outset here. But there really hasn't been much before; there are currently a couple dozen open cases most people out there don't know this right now. But a lot of law firms and accounting firms know that the Philadelphia office of the SEC is issuing a series of investigations into non-GAAP.

Now I can say in the limited time that we have without getting into client privilege or anything like that or confidentiality, that the focus is primarily on prominence, interestingly, not on what you would think like the Trump Hotel situation or if somebody was using a GAAP term like operating cash flow. Anyway, is this cash flow from operations or is this operating cash flow, are they the same? I find myself asking that of clients. They're like oh no it's different. Well, that could be misleading you need to say this is not cash flow from operations.

I could understand a problem if somebody did that, but this is like you led with the non-GAAP number and then you followed it with a GAAP number and please, in light of the guidance, tell us why you didn't violate the law, and oh by the way tell us every other time you violated the law on Reg G, which is unheard of for lots of reasons. As a lawyer I'm appalled, number one, but number two is there is no requirement. There never was a requirement that you lead with a GAAP number, it was only interpretation of a rule that changed. One good question is whether the SEC needed to engage in rulemaking to put out what it did in May, but we'll humor that a being a former director, I took some flexibility at some time so we'll honor that, but still you can't unleash the enforcement division off of May interpretations and apply it retroactively.

**Dr. Mark E. Peecher:** So nothing controversial here at all.

**Brian Lane:** No, of course not. There's a little moment of passion.

**Dr. Mark E. Peecher:** No, if that didn't come through I'm not sure what will.

Thank you all of you, Brian, Christine and Jon for this discussion. We are coming to the end of our discussion. I know these have been useful insights and I think there are a variety of

audiences out there, including students, that could probably play us more than once. I hope you as the audience have found it to be informative. The audio of today's broadcast will be available soon in the virtual museum and archive, both under Programs and in the Deloitte Fireside Chats section, and a transcript to be added later.

On behalf of the SEC Historical Society I'd like to thank Deloitte LLP for their assistance in making today's broadcast possible, and for the generous sponsorship over the years for the dozen series of quality programs. Good afternoon.