The Growing Menace of Non-GAAP Measures

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Firms have become increasingly brazen in their use of alternative metrics which cast their financials in a favourable light.

How do you transform a loss of US$420 million into a profit of US$60 million? Easily enough. You do like Groupon did in 2011 before its highly anticipated IPO. Simply take your 2010 income statement loss and exclude your marketing expenses, stock-based compensation and acquisition-related costs. Voilà! Your new “adjusted consolidated segment operating income” looks good.

For decades, companies have supplemented their official financial statements with custom metrics that don’t conform to generally accepted accounting principles (GAAP). Examples of such metrics – e.g. free cash flow, adjusted earnings per share and net debt – abound in press releases, earnings-call summaries and third-party reports based on such company-issued communications. Since companies devise their own methods of calculation, there is often no way to compare the metrics from company to company or, in many cases, even from one year to the next within the same company. Lately, we have seen a troubling trend: These alternative metrics, once used sparingly, have become more ubiquitous and further disconnected from reality. We observed this trend in the course of examining the financial statements and communications of thousands of public companies in a dozen countries.

Why is this trend worrisome?

Needless to say, the vast majority of these alternative metrics are “clearly designed to present results in a more favourable light”, to quote the chairman of the International Accounting Standards Board in a 2016 address. Take PepsiCo’s net revenue for 2015, which was 5.4 percent lower than the previous year. On page 2 of its annual report, the company nevertheless argued that “organic revenue growth” – a non-GAAP number adjusted for, among other things, the effect of foreign currencies and the impact of acquisitions and divestitures – **went up, not down**. The argument might have been stronger if not for the fact that PepsiCo had taken an entirely different view on such adjustments in previous years, when the effect of foreign exchange and acquisitions had worked to its advantage.

Between January 2013 and December 2015, LinkedIn reported net operating losses of US$180 million in its official income statements. But it told analysts that its “adjusted EBITDA” for 2014 and 2015 amounted to US$1.37 billion. How? By removing depreciation and amortisation charges as well as the cost of stock-based compensation. Twitter did much the same when it excluded stock-based compensation from its earnings calculations from 2014 through 2015. It was then able to transform a negative earnings report into positive “pro forma” earnings. Not quite the same story!

The proliferation of alternative metrics not only poses a problem for befuddled investors, but can also harm the companies themselves by clouding their financial health, exaggerating their growth prospects and rewarding executives beyond logic. Take the example of BP CEO Bob Dudley. Like most executives, his remuneration package is based on “adjusted” earnings. In 2015, Dudley received US$20 million in pay (a 22 percent increase vs. the previous year) even though the company reported its worst loss ever. Shareholders showed their dismay by voting down the company’s report on director pay, but the shareholder resolution was nonbinding.

Questions to ask

Since the calculation of custom, non-GAAP metrics can change from year to year, stakeholders should be prepared to use several sources – and keep their eyes peeled – to form an accurate picture of the company’s performance and make meaningful comparisons.

However, the main responsibility for ensuring non-GAAP metrics are properly used lies with firms’ audit committees. To prevent embarrassing and potentially costly problems due to SEC violations, members of these committees should not be afraid to ask questions along the following lines:

- Why has management chosen to communicate custom metrics to investors? What information do these alternative performance measures convey that the official numbers don’t?
- Do the calculations result in a fair and unbiased picture?
- Are the non-GAAP metrics calculated the same way every year?
- Is the firm communicating earnings and other performance measures in a consistent way throughout all its materials, e.g. annual reports, press releases, webcasts?
- Are the official figures always presented alongside the unofficial ones in press releases and investor presentations?
- Are alternative metrics used to calculate the remuneration of key executives? If so, which adjustments are used and how are they justified?

Management has the right – and even the responsibility – to adopt metrics that enable it to accurately report the performance of the business to shareholders. In certain situations, custom metrics can help stakeholders better understand a business. But there’s a difference between non-GAAP measures that add value and measures that mislead, deliberately or otherwise. As the saying goes, trust takes years to build, seconds to break and forever to repair.

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