CFO

CFOs are dismayed and discouraged by the SEC's approach to non-GAAP reporting.

Sarah Johnson - CFO Magazine

March 1, 2010

Lawrence Hyatt knew when it was time to give up. "Maybe I'm a good enough poker player that I know when to hold 'em and when to fold 'em," says the CFO of O'Charley's Inc., which runs three well-known restaurant chains.

To be sure, his opponent — the Securities and Exchange Commission — had a natural advantage in this game. More than a year ago the regulator had sent Hyatt a letter about O'Charley's 2007 annual report, asking him to justify why the company used certain financial measures in the management discussion and analysis that didn't jibe with generally accepted accounting principles.

Under Regulation G and related SEC rules, companies are permitted to use non-GAAP numbers in SEC filings as long as they are not misleading, are reconciled to the most relevant GAAP numbers, and are meaningful to investors. The regulator objected to O'Charley's non-GAAP on that final point. "We do not believe your disclosure clearly demonstrates the usefulness of the cited non-GAAP measures specific to you," wrote SEC branch chief Lyn Shenk in a letter to the CFO. "Therefore, we believe you should discontinue use of such measures."

Rather than prolong the dispute (the back-and-forth with the SEC lasted two months), Hyatt pledged to stop putting non-GAAP measures in future filings. But he isn't happy about it. "The SEC has gone from what appeared to be the original intent of Reg G, which was to regulate how companies disclose information, to attempting to regulate what information is disclosed," he says.

Hyatt's reaction is echoed by other CFOs who have dealt with SEC queries regarding non-GAAP metrics. "If management believes a non-GAAP measure is meaningful to investors and users of the financial statements, they should be able to use it as long as they have adequate disclosures around why they find it meaningful and they reconcile it to GAAP," contends Thomas Olinger, CFO of AMB Property Corp., a real estate investment trust. Other finance chiefs have found the SEC's comments on their non-GAAP numbers to be discouraging and inconsistent.

The SEC has acknowledged such criticisms and says it is working to address them. For its part, the regulator is walking a fine line between allowing companies to provide numbers not fully blessed by GAAP and preventing the use of misleading calculations. After all, "non-GAAP measures can be less consistent, less transparent, and less comparable," says Sandra Peters, head of the financial reporting policy group for the CFA Institute.

The Pros of Pro Forma

Companies cite a variety of reasons for using non-GAAP numbers (also called adjusted or pro-forma numbers). Probably the most common reason is to exclude the effect of unusual or one-time events during a reporting period. Doing so shows investors "how you are going to perform under a normal situation," says Matthew Natalizio, CFO of Tix Corp., which provides ticketing services.

In O'Charley's case, Hyatt says the four financial ratios in question (such as total debt to EBITDA, or earnings before interest, taxes, depreciation, and amortization) gave additional insight to the company's debtholders by showing the same calculations (plus the required GAAP reconciliations) that O'Charley's bank requires for the covenants of a credit line. Moreover, some investors wanted the metrics, without which

they have to make their own calculations. "The elimination of these disclosures makes my work less precise and therefore less accurate," says Bryan Elliott, a senior restaurant analyst at Raymond James & Associates who covers O'Charley's.

Rather than abandoning non-GAAP measures, some companies are promising to provide better disclosures about the figures next time around. That was the response of Hawaiian Electric Industries CFO James Ajello last summer when the SEC questioned the two non-GAAP figures that his company uses. These numbers, called adjusted noninterest income and adjusted noninterest expense, apply to HEI's subsidiary, American Savings Bank, whose financial results are dwarfed by those of its parent company.

The adjusted figures highlight the results of an improvement program at the bank, Ajello says. They show the improvement by eliminating one-time expenses, such as the cost of terminating the lease of a bank branch that in the long term will provide savings. HEI uses the non-GAAP numbers so that "investors can cross-compare banks of similar types or size," says Ajello. "It's hard to do that in a small conglomerate."

Other CFOs have taken a different approach: keep non-GAAP numbers out of SEC filings but disclose them elsewhere, such as in earnings releases and conference calls (which are still subject to Reg G, though). The SEC's comments have driven "management to take what they consider to be an important presentation out of the SEC report entirely and move it into the press release, which is a bad result if we're trying to prove the SEC report is meant to provide the best or most meaningful disclosure," says Jeffrey Hochman, partner at Wilkie Farr & Gallagher.

Easing Up or Cracking Down?

The SEC says it wants to prevent such bad results. "I want to make sure

that we aren't commenting in ways that are inconsistent with the rules or that lead to valuable information being left out of filings just to avoid having to deal with comments from the staff," said Meredith Cross, director of the SEC's Division of Corporation Finance, during a conference in December.

In mid-January, the SEC published a 12-page update to previously issued guidance on Reg G. Some interpreters believe the new guidance actually encourages companies to disclose more non-GAAP financial measures in their filings. For example, the update says that companies can disclose non-GAAP measures even if they're not used for managing the business. Also, the regulator eased up on what was perceived as restrictive language.

But others believe the new leniency shown by the SEC serves as a warning, not an encouragement. Tom Murphy, partner at McDermott Will & Emery, suggests the guidance is, in effect, the SEC's second reminder in as many months that it takes Reg G seriously. "Whenever the SEC puts out a new series of interpretations, it shows an area of focus by the SEC and focuses people's attention on it again," he says.

And some experts say the SEC's renewed attention to Reg G suggests that it will be paying more attention to earnings releases and investor conferences, to see how the information presented there differs from that in 10-Ks and 10-Qs. The regulator wants to know, "Are you telling your investors the same things in all your external communications?" says Bridgette Hodges, partner in charge of SEC regulatory matters at Grant Thornton.

Another warning sign came last November when the SEC made its first-ever Reg G enforcement action since the rules were adopted in 2003, against SafeNet and five of its former employees, including CFO Kenneth

Mueller. The SEC accused them of mischaracterizing and excluding recurring operating expenses from the data-security company's non-GAAP earnings results. "You can't take an ordinary ongoing expense and call it a one-time expense," comments Hochman. All parties settled without admitting or denying the allegations. As part of the settlement, Mueller will pay $125,561 and cannot serve as an officer or director of a publicly traded company for five years.

Double Jeopardy

CFOs who have gone through the comment-letter process with the commission doubt that the new guidance will make a difference, and those who have stopped using non-GAAP numbers in their filings aren't likely to start up again. "The problem is with uneven and unpredictable enforcement," Hyatt says.

Tix's Natalizio has firsthand experience with the phenomenon and, in fact, experienced déjà vu last summer when the SEC questioned his use of EBITDA. Natalizio defended the practice, saying other entertainment companies disclose the same "supplemental information" and that Tix uses the metric internally to measure management's performance. Moreover, as he noted in his response, the SEC supported Tix's use of EBITDA during a previous review. "I pointed out to them that they had signed off on this approach and the wording," Natalizio says.

The SEC's Cross acknowledged at the December conference that "consistency can be a challenge" given the number of reviews the SEC conducts. She said the commission is "redoubling efforts" to address the problem. In the meantime, companies will have to wait and see whether the new guidance on non-GAAP numbers will result in more consistency and a lighter hand by SEC reviewers — or whether it will lead to more enforcement and feedback.

Sarah Johnson is senior editor for regulation at CFO.