
STANDING ADVISORY GROUP MEETING
COMPANY PERFORMANCE MEASURES AND THE ROLE OF AUDITORS
MAY 18–19, 2016

I. Introduction

At its May 2016 Standing Advisory Group ("SAG") meeting, SAG members will be asked for their views regarding auditor involvement with company performance measures. After an introduction on the first day of the meeting, SAG members and observers will form breakout groups to discuss the topic. On the second day of the meeting, a summary of the breakout discussions will be provided and all SAG members will have an opportunity to provide additional perspectives.

In preparation for these discussions, this paper provides descriptions of types of company performance measures, specifically "non-GAAP financial measures" (as defined under SEC rules) and other operating measures, and an overview of relevant auditor responsibilities in this area. The paper also includes several discussion questions for SAG members to consider.

II. Background

At its November 2015 SAG meeting, SAG members discussed several topics—identified by SAG members—that could affect audits, auditors, or the PCAOB.¹ One of the topics discussed was the auditor's role regarding non-GAAP measures. The specific issue identified by SAG members was that reporting, use of, and reliance on non-GAAP measures have increased over time, but the auditor's responsibilities with respect to such measures have not changed.² Some SAG members expressed an interest in continuing the discussion on this topic.

The topic of non-GAAP measures has continued to receive attention in the

¹ See agenda and related meeting materials for the November 2015 SAG meeting available on the Board's website.

² Current auditor responsibilities are outlined in Section IV of this paper.

This paper was developed by staff of the Office of the Chief Auditor as of May 6, 2016, to foster discussion among the members of the SAG. It is not a statement of the Board, nor does it necessarily reflect the views of the Board or staff.

business press since the November 2015 SAG meeting.³ It was also mentioned in several SEC public statements, expressing concerns about, among other things, customized adjustments to GAAP numbers and a growing use, by the media and analysts, of non-GAAP measures as the primary performance metrics for a company.⁴ One of the statements also raised a question about the auditor's role in relation to these types of measures.⁵

III. Company Performance Measures

Many public companies supplement their communication of financial information prepared under GAAP with company performance measures that they believe are informative to investors and other users in assessing the company's performance and future prospects. These company performance measures could be included in a company's annual reports, registration statements, earnings releases, or other communications, such as calls with analysts and information on the company's website. For purposes of this paper, company performance measures are grouped into two categories: non-GAAP financial measures and operating measures.

A. Non-GAAP Financial Measures

Under SEC rules, a non-GAAP financial measure is a numerical measure of an issuer's historical or future financial performance, financial position or cash flows that (as applicable) excludes amounts that are included in, or includes amounts that are excluded from, the most directly comparable measure calculated and presented in

³ See, e.g., Theo Francis and Kate Linebaugh, *U.S. Corporations Increasingly Adjust to Mind the GAAP*, Wall Street Journal, Dec. 14, 2015 and Interview with Joseph Ucuzoglu, Chairman and CEO, Deloitte & Touche LLP, *Driving Innovation in Audit*, Wall Street Journal, Apr. 11, 2016.

⁴ See Mary Jo White, Chair, SEC, *Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility"* (Dec. 9, 2015); Kara M. Stein, Commissioner, SEC, *Statement on the Commission's Consideration of the Public Company Accounting Oversight Board's Proposed 2016 Budget and Accounting Support Fee* (Mar. 14, 2016); and James V. Schnurr, Chief Accountant, SEC, *Remarks before the 12th Annual Life Sciences Accounting and Reporting Congress* (Mar. 22, 2016).

⁵ See Stein, *supra* note 4.

accordance with GAAP in the issuer's financial statements.⁶ Examples of non-GAAP financial measures include:

- Earnings before interest, taxes, depreciation, and amortization ("EBITDA") and earnings before interest and taxes ("EBIT"),
- Measures of operating income that exclude one or more expense or revenue items identified as "non-recurring," and
- Measures of operating margin calculated by dividing revenues into operating income, where either revenue or operating income, or both, were not calculated in accordance with GAAP.⁷

In addition to general anti-fraud requirements, SEC rules impose specific limits and conditions that apply when an issuer publicly discloses or releases material information that includes a non-GAAP financial measure. The extent of regulation depends on whether the non-GAAP financial measure is included in an SEC filing, such as a registration statement or annual report on Form 10-K,⁸ or in another public statement, such as an earnings call or "glossy" annual report.⁹ While non-GAAP financial measures must be reconciled to the most directly comparable GAAP measure in all cases,¹⁰ non-GAAP financial measures included in SEC filings are subject to

⁶ See Item 10(e)(2) of Regulation S-K, 17 CFR 229.10(e)(2) and Item 101 of Regulation G, 17 CFR 244.101.

⁷ See SEC, *Conditions for Use of Non-GAAP Financial Measures*, Securities Act Release No. 33-8176 (Jan. 22, 2003) ("SEC Non-GAAP Measures Release").

⁸ See Item 10(e) of Regulation S-K, 17 CFR 229.10(e).

⁹ See Regulation G, 17 CFR 244.100 *et seq.*

¹⁰ For example, for non-GAAP financial measures included in an SEC filing, the reconciliation must be included in the filing. See Item 10(e)(i) of Regulation S-K, 17 CFR 229.10(e)(i). A company that releases non-GAAP financial measures orally, telephonically, by webcast, by broadcast, or by similar means may satisfy Regulation G by posting the required reconciliation on its website and disclosing the location and availability during the presentation. See Note 1 to Item 100 of Regulation G, 17 CFR 244.100; see *also* SEC Non-GAAP Measures Release at II.A.2.b.

additional limitations, including on the manner of presentation and the types of adjustments from GAAP that are permitted. Further, non-GAAP financial measures included in SEC filings are subject to certain disclosure requirements; for example, the most directly comparable GAAP measure must be presented with equal or greater prominence. Non-GAAP financial measures frequently appear in documents that are not filed with the SEC, such as earnings releases, rather than in SEC filings. As discussed in more detail below, auditors' responsibilities under current PCAOB standards are limited to information included in SEC filings.

B. Operating Measures

There are many performance metrics included in company communications that do not meet the SEC's definition of "non-GAAP financial measures." In this paper, we refer to these as "operating measures." Examples of operating measures include:

- Unit sales, numbers of subscribers, or numbers of advertisers, and
- Ratios or statistical measures that are calculated using exclusively one or both of (i) financial measures calculated in accordance with GAAP and (ii) operating measures or other measures that are not non-GAAP financial measures. Examples of these include:
 - Sales per square foot or same store sales, where sales figures are calculated in accordance with GAAP, and
 - Measures of operating margin calculated by dividing revenues into operating income, where both revenue and operating income are calculated in accordance with GAAP.¹¹

IV. Overview of Auditor's Responsibilities for Information Outside of the Financial Statements, Which May Include Company Performance Measures

A. Other Information in Annual Reports Containing Audited Financial Statements

Annual reports, whether filed with the SEC (like Form 10-K) or not (like a "glossy" annual report mailed to shareholders or posted on the company's website), include information in addition to audited financial statements and the auditor's report. Under PCAOB standards, this additional information is referred to as "other information." Some

¹¹ See SEC Non-GAAP Measures Release.

of the "other information" in an annual report, such as management's discussion and analysis of financial condition and results of operations, may include company performance measures.

The auditor's responsibilities with respect to other information in annual reports are governed by AS 2710 (currently AU sec. 550), *Other Information in Documents Containing Audited Financial Statements*. Under AS 2710, the auditor is required to:

- Read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.¹² The existing standard does not specify the procedures that the auditor should perform when considering the other information.
- If there is a material inconsistency, determine whether revisions are required in the financial statements, the auditor's report, or both; request any necessary revisions to the other information; and, if the other information is not revised, communicate to the audit committee and consider other specific actions, such as including an explanatory paragraph describing the material inconsistency in the auditor's report.
- If, while reading the other information for a material inconsistency, the auditor becomes aware of information that the auditor believes is a material misstatement of fact (but not a material inconsistency), the auditor is required to discuss the matter with management and, if the material misstatement remains, to communicate in writing to management and the audit committee and consider further actions as appropriate.¹³

In August 2013, the Board proposed a new standard on other information that would enhance the auditor's responsibility with respect to information outside the financial statements that is contained in documents that include the audited financial statements and the related auditor's report.¹⁴ The staff is continuing to evaluate the

¹² See paragraph .04 of AS 2710.

¹³ See paragraph .05 of AS 2710.

¹⁴ See *Proposed Auditing Standards—The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; the Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited*

proposed other information standard in light of comments received and anticipates making a recommendation for next steps to the Board at a later date.

B. Responsibilities Regarding Filings Under Federal Securities Statutes

AS 4101 (currently AU sec. 711), *Responsibilities Regarding Filings Under Federal Securities Statutes*, describes certain of the auditor's statutory responsibilities when the auditor's report is included in an SEC filing. However, it only specifies procedures for auditor's reports included in Securities Act registration statements. In those circumstances, AS 4101 refers the auditor to Section 11 of the Securities Act.¹⁵ AS 4101 requires the auditor to read the portion of the prospectus naming the auditor as an expert to make sure that (1) the auditor's name is not being used in a way that indicates greater responsibility than intended, and (2) the prospectus does not imply that the financial statements have been prepared by the auditor.¹⁶ AS 4101 does not otherwise require specific procedures with regard to the registration statement, and does not address the auditor's responsibilities with regard to company performance measures.

C. Earnings Releases and Other Communications

Under current PCAOB standards, auditors do not have responsibilities to perform specific procedures related to corporate earnings releases, investor presentations, or other communications, such as calls with analysts and information on the company's website.

Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards, PCAOB Release No. 2013-005 (Aug. 13, 2013).

¹⁵ See 15 U.S.C. 77k(a)(4). Under Section 11, an auditor may have liability for material misstatements and omissions in a registration statement in which it, with its consent, is named as having prepared or certified any part of the registration statement or any report used in connection with the registration statement.

¹⁶ See paragraph .08 of AS 4101.

V. Discussion Questions

Note: While these questions are primarily focused on potential expansion of auditor responsibilities, they should be considered in the broader context of the roles and activities of all relevant parties. As part of the discussion, a representative from the staff of the SEC will share some observations on non-GAAP measures, including as related to preparers and audit committees.

1. What are company practices in developing and disclosing company performance measures? How are investors using company performance measures?
2. What procedures, if any, are companies and audit committees asking auditors to perform on company performance measures? Are the procedures different depending on where the company performance measures are located?
3. Should auditor responsibilities be expanded to include specific procedures for company performance measures? If so, what should auditor's responsibilities be and should such responsibilities vary depending on where the information is located? Should auditors report the results of their work? If so, how much specificity would be necessary to explain what was done and on which measures?
4. What obstacles, if any, exist to expanding auditor responsibilities to include specific procedures for company performance measures, including non-GAAP financial measures?
5. What unintended consequences might arise from expanding auditor responsibilities to include specific procedures for company performance measures?