The Latest Trend In Non-GAAP Reporting

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To attract and retain top talent, while facing cash constraints, many growing companies utilize stockbased compensation as an effective way to reward employees because it offers the potential for future stock appreciation, and thus helps justify lower cash salaries today.

Prior to 2006, companies were not required to treat stock-based compensation as an expense under generally accepted accounting principles (GAAP).[1] The rules were eventually changed by the Financial Accounting Standards Board to require stock-based compensation to be reflected as a cost to the company.[2] When reporting their GAAP results, companies have to expense stock-based compensation against earnings during the period in which the compensation was granted.

In the past 10 years since the rule change, growing companies, particularly if struggling to produce a GAAP profit, often reported non-GAAP numbers along with the required GAAP results and tended to refer to non-GAAP results when discussing their performance in earnings calls with investors. These non-GAAP numbers often added back stock-based compensation expense to adjusted net income or EBITDA (earnings before interest, taxes, depreciation and amortization) to support adjusted profitability. Aside from assessing profitability, analysts sometimes value companies on a measure of "free cash flow" and, for this purpose, exclude stock-based compensation, thereby increasing free cash flow for companies that compensate employees through stock relative to free cash flow of companies that pay employees in cash.

It appears that analysts and investors have been willing to not take into account the effect of stockbased compensation, and growing companies have continued to rely heavily on stock-based compensation. Many growing companies report growth, but have losses after adjusting for employee stock grants. Moreover, when stock prices have fallen, companies have typically granted additional stock-based compensation to employees, widening the gap between GAAP and non-GAAP results. In some cases, changes in value of stock-based compensation seem to have had an impact on merger and acquisition activities.[3]

The Recent Change

There has been negative comment on companies' deriving non-GAAP numbers from excluding stockbased compensation.[4] Companies have advanced various arguments for excluding restricted stockbased compensation as an expense, such as that the stock is "noncash." However, some commentators argue that the stock clearly has value and is desirable for employees for that reason. Moreover, companies usually get a tax deduction when restricted stock or restricted stock units vest. Another argument for subtracting stock-based compensation expense before reporting profit numbers is that stock options are difficult to value. But even though the medium of payment is stock, many people believe that it is still an expense.

Warren Buffet was famously quoted as saying, “If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And if expenses should not go into the calculation of earnings, where in the world should they go?” In addition, there has been a pronounced shift in recent years from stock options to restricted stock or restricted stock units, which typically vest over three or four years and thus are easy to value. The stock grants at many leading companies are now primarily made through restricted stock or restricted stock units.

Recently, some companies have been announcing that they are no longer providing non-GAAP results adjusted for stock-based compensation. For example, Facebook’s chief financial officer, David Wehner, said that from the first quarter of 2016 onward, he would talk about the company’s results and other metrics based on GAAP, which includes stock-based compensation. “We view it as a real expense,” he said. In the same vein, Amazon started breaking out stock-based compensation in the results of its different businesses in the first quarter of 2016. This is “the way we now evaluate our business performance and manage our operations,” Amazon’s chief financial officer, Brian Olsavsky, told analysts after the first-quarter earnings report. Some companies, such as Microsoft, Netflix and Intel, have already been including equity awards made to employees as costs when reporting non-GAAP earnings. It seems that when growing companies mature, they are more willing to align their practices with

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those of more established companies.

The SEC’s Current Stance

Adding complexity to this practice, the U.S. Securities and Exchange Commission on May 17, 2016, announced its latest compliance and disclosure interpretations of its rules and regulations on the use of non-GAAP financial measures. Most notably, the SEC takes the position that certain adjustments could violate securities law if they cause the presentation of the non-GAAP measure to be misleading. To illustrate its position, the SEC provided one specific example: excluding normal, recurring, cash operating expenses necessary to operate a registrant’s business could be misleading.[5]

The reference to “normal, recurring, cash operating expenses” seems not to affect companies’ practice of excluding stock-based compensation expense when reporting non-GAAP results, since that is a noncash item. However, given the SEC’s broad rule-making authority and because this reference only functions as a nonlimiting example, it remains feasible that the SEC may in the future include the exclusion of normal, recurring, cash-equivalent operating expenses as one of the misleading ways to present non-GAAP measures and treat stock-based compensation as the economic equivalent of cash salaries.

While the SEC has not sought to ban non-GAAP measures that exclude stock-based compensation, under Item 10(e) of Regulation S-K, whenever a non-GAAP figure is used in an SEC filing or an earnings release, the most directly comparable GAAP measure must be presented with “equal or greater prominence.” In addition, the non-GAAP financial measures C&DIs provided a detailed list of specific disclosure practices the SEC believes improperly make a non-GAAP measure more prominent than the most directly comparable GAAP measure, including presenting a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures, and providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence.[6] This new guidance is likely to make it more burdensome for companies to use non-GAAP metrics in their earnings releases, and in combination with increasing opposition from investors, could further dissuade companies from excluding stock-based compensation when reporting operating results.

In addition, non-GAAP financial measures C&DIs clarified that non-GAAP liquidity measures, which measure cash generated, must not be presented on a per-share basis in documents filed or furnished with the SEC.[7] Whether per-share data is prohibited depends on whether the non-GAAP measure can be used as a liquidity measure, even if management presents it solely as a performance measure. If the SEC believes that certain non-GAAP measures, such as adjusted EBITDA, can be used to measure liquidity, this could present challenges for presenting such measures adjusted for stock-based compensation on a per-share basis in an SEC filing.

Conclusion

In light of the increasing scrutiny from investors and regulators,[8] we believe a gradual shift from the practice of excluding significant stock-based compensation, when reporting earnings, seems to be occurring at more established companies, while growing companies may continue to struggle with balancing the need to keep and expand internal talent pool and the desire to demonstrate their strong growth through non-GAAP measures that exclude stock-based compensation.

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[1] Disclosures in the footnotes of financial reports, however, were required, so investors weren't completely in the dark, but stock-based compensation had no effect on the bottom line. Stock-based compensation also increases the total number of outstanding shares, making each share represent a smaller ownership stake in the company.

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[2] In December 2004, the FASB issued Revised Statement of Financial Accounting Standards (FAS) No. 123, Share-Based Payment (FAS 123R), an amendment to FAS No. 123, Accounting for Stock-Based Compensation, and a replacement of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and its related implementation guidance. FAS 123R, which became effective Jan. 1, 2006, requires public entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award and to recognize that cost over the requisite service period.

[3] According to the New York Times, LinkedIn's struggling stock price and its "overreliance" on stock-based compensation are the unspoken reasons behind its proposed sale to Microsoft. http://www.nytimes.com/2016/06/14/business/dealbook/linkedin-stock-based-compensation.html?ref=dealbook&_r=2.

[4] The Society of Corporate Secretaries and Governance Professionals, which represents company executives and other managers, sent a memo to members last month highlighting comment from SEC Chief Accountant James Schnurr, who encouraged executives and directors on boards' audit committees to ask why non-GAAP numbers are an appropriate way to measure performance and probe whether they're really useful to investors.

[5] See Question 100.01 of the Non-GAAP Financial Measures C&DIs.

[6]See Question 102.10 of the Non-GAAP Financial Measures C&DIs.

[7] See Question 102.05 of the Non-GAAP Financial Measures C&DIs.

[8] For example, SEC Chairman Mary Jo White made clear at a conference of finance and business lobbyists in Washington march this year that regulators know how much better earnings look when some costs are backed out of them. "Your investor relations folks, your CFO, they love the non-GAAP measures because they tell a better story," she told the conference sponsored by the U.S. Chamber of Commerce, "It's something that we are really looking at — whether we need to rein that in a bit even by regulation .... We have a lot of concern in that space." Similarly. SEC Deputy Chief Accountant Wesley Bricker warned in a recent speech that any adjusted revenue non-GAAP measures will likely receive a comment from the SEC staff, and any justification for the adjustment provided in response will be scrutinized "closely, and skeptically." Remarks before the 2016 Baruch College Financial Reporting Conference (May 5, 2016), available at https://www.sec.gov/news/speech/speech-bricker-05-05-16.html.

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