Measuring Non-GAAP Metrics:

A Look at Adjusted Net Income

Introduction

The U.S. Securities & Exchange Commission and other influential voices in the financial reporting community have raised repeated concerns this earnings season about the use of "non-GAAP"—financial metrics that companies tout to investors, but are not calculated according to Generally Accepted Accounting Principles.

Federal securities law does allow a company to report non-GAAP metrics that it believes are useful to investors, so long as the company can explain why the non-GAAP metric is useful and reconciles that metric to the closest matching GAAP metric. (For example, reconciling non-GAAP net income to "traditional" net income.) Where companies have relied on non-GAAP metrics too much or devised metrics that seemed more cosmetic than useful, the SEC has disallowed their use.

In several speeches this year, SEC officials have said the use of non-GAAP metrics has become too common—so Calcbench and Radical Compliance set out to investigate exactly what non-GAAP metrics corporate filers are reporting, and how much those metrics diverge from traditional accounting. We reviewed the non-GAAP disclosures that 816 firms included in their earnings releases for fiscal 2015, and examined:

From a sample of 816 firms, those companies made 4,632 adjustments to GAAP net income that inflated non-GAAP net income by $164.1 billion.

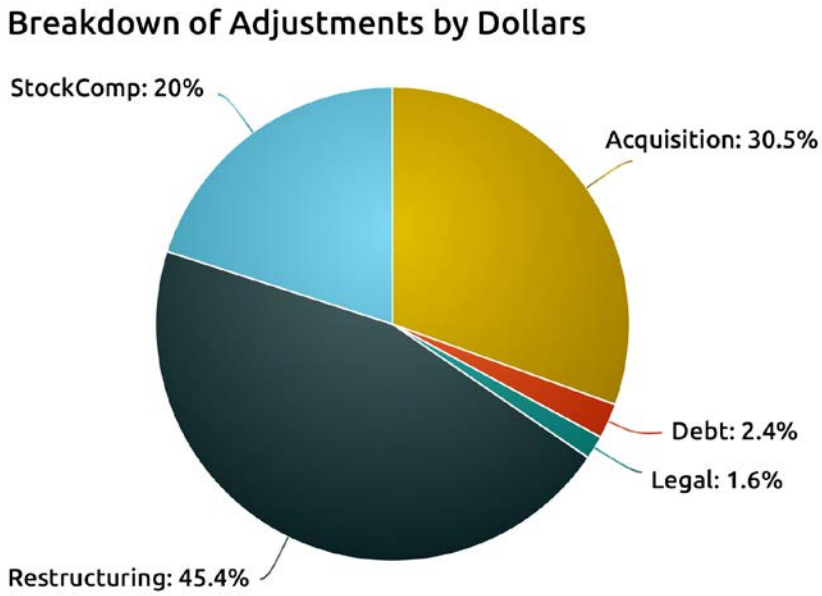
- Which adjustments are used most often, and which ones cause the largest differences between GAAP and non-GAAP net income;
- The differences among business sectors in how they reconcile GAAP and non-GAAP net income, and the size of differences within those sectors
- The specific non-GAAP reporting of 13 large filers, to give examples of the size and nature of non-GAAP financial metrics today.

This paper focused on metrics for net income only; companies also file numerous non-GAAP metrics for revenue, cash flow, and other financial items. A complete discussion of our methodology can be found at the end of this paper.

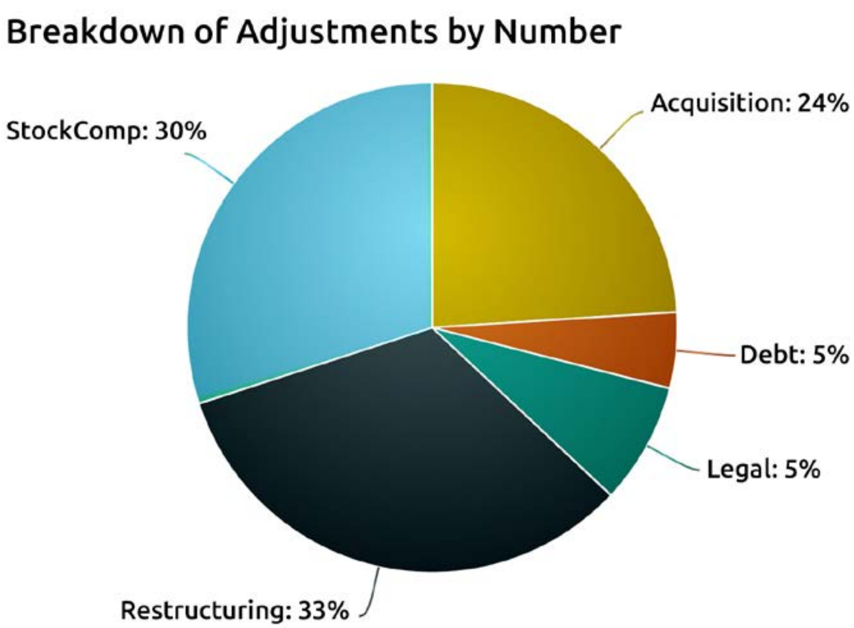
Findings

The 816 firms in our sample group made a total of 4,632 adjustments to their GAAP net income numbers. Those adjustments led to non-GAAP net income $164.1 billion higher than the traditional net income numbers those firms also reported under GAAP.

While the specific reasons cited for adjustments were diverse, they could be grouped into five major categories: acquisition costs; debt; legal costs; restructuring charges; and equity compensation costs. As one can see from the following charts, restructuring, equity compensation, and acquisition-related items make up the lion's share of non-GAAP adjustments, both in dollars adjusted and in number of adjustments made.



The patterns diverge more when examining non-GAAP net income by industry. In dollar terms, the financial services sector reported the largest difference between GAAP and non-GAAP net income: $40.8 billion. Next were the IT sector ($34.3 billion in total adjustments) and energy ($26.7 billion). Each sector, however, had different drivers behind those numbers. For example, most of the non-GAAP difference in the financial sector stemmed from acquisition costs, while IT's adjustments were driven by equity compensation adjustments, and the energy sector's by restructuring costs.
(See page 3 for details.)



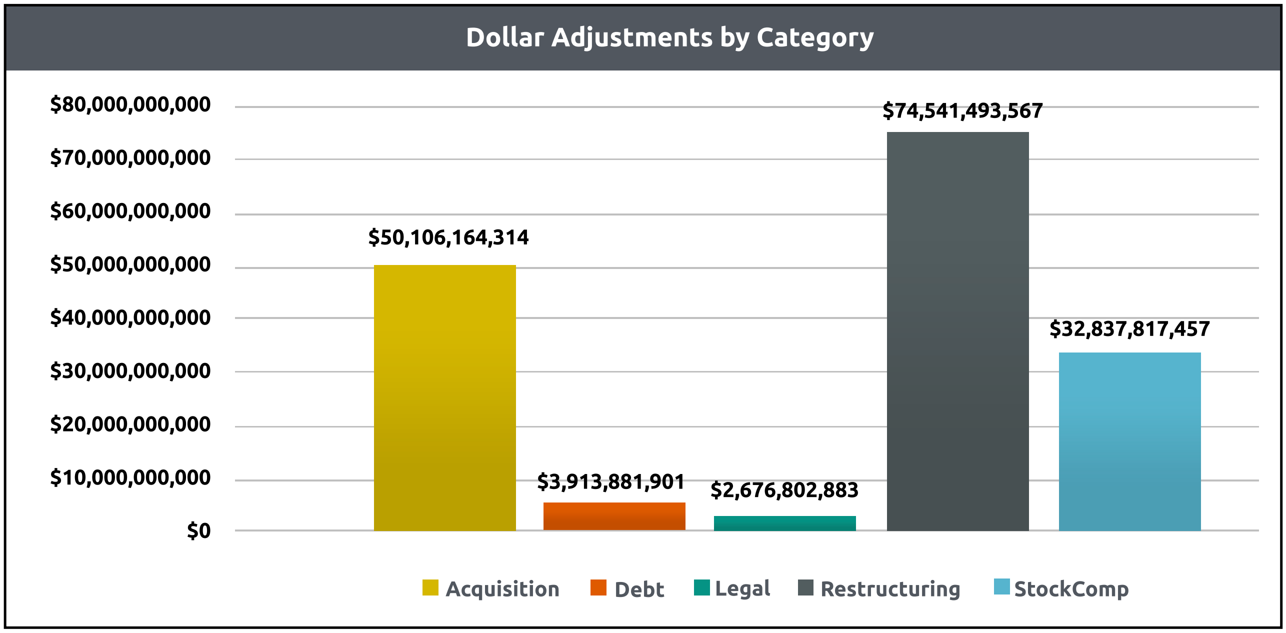
The table below shows the breakdown of non-GAAP adjustments across nine major industries in our sample group.

Adjustments in Dollars, per Sector						
	Acquisition	Debt	Legal	Restructuring	StockComp	TOTAL
Financials	$ 28,144,194,779	$ 550,142,915	$ 118,453,908	$ 6,913,519,819	$ 5,049,936,005	$ 40,776,247,427
Information Technology	$ 3,724,099,478	$ 78,718,010	$ 260,425,764	$ 9,301,920,080	$ 20,947,330,221	$ 34,312,493,554
Energy	$ (28,390,632)	$ 78,360,001	$ (63,856,579)	$ 26,276,714,190	$ 494,793,741	$ 26,757,620,721
Consumer Discretionary	$ 11,962,479,455	$ (183,402,328)	$ 944,656,618	$ 7,611,014,296	$ 4,424,082,351	$ 24,758,830,393
Industrials	$ 2,342,219,784	$ 1,146,845,123	$ 116,540,705	$ 8,522,676,060	$ 568,441,830	$ 12,696,723,502
Consumer Staples	$ 211,467,915	$ 754,015,020	$ 128,267,693	$ 11,195,421,290	$ 284,159,819	$ 12,573,331,737
Materials	$ 979,030,000	$ 1,337,887,000	$ 1,561,106,856	$ 4,799,781,497	$ 103,592,814	$ 8,781,398,168
Healthcare	$ 2,218,372,925	$ 106,190,159	$ (375,649,093)	$ (380,232,306)	$ 678,245,085	$ 2,246,926,771
Telecommunication Services	$ 549,868,440	$ 45,126,000	$ (1,315,960)	$ 145,677,090	$ 255,074,590	$ 994,430,160
Other	$ 2,822,170	$0	$ (11,827,030)	$ 155,001,550	$ 32,161,000	$ 178,157,690
Grand Total	$ 50,106,164,314	$ 3,913,881,901	$ 2,676,802,883	$ 74,541,493,567	$ 32,837,817,457	$ 164,076,160,121

When one looks at non-GAAP adjustments by number of adjustments made, however, different patterns emerge. For example, the IT sector had more adjustments for acquisition costs than the financial sector (396 compared to 117), even though the dollar value of those 396 adjustments was far smaller than the dollar value for the financial sector's 117 adjustments. In other words, the financial sector made fewer acquisition-related adjustments that were far larger in size. Likewise, the energy sector had 111 adjustments related to restructuring costs, while consumer discretionary had 364—but those 111 energy sector adjustments totaled $26.3 billion, while the 364 in consumer discretionary added up to only $7.6 billion.

Adjustments in Numbers, per Sector						
	Acquisition	Debt	Legal	Restructuring	StockComp	TOTAL
Information Technology	396	12	86	282	742	1,518
Consumer Discretionary	225	80	89	364	268	1,026
Industrials	136	22	46	267	107	578
Financials	117	47	17	111	85	377
Consumer Staples	73	7	18	144	68	310
Healthcare	78	15	33	96	49	271
Materials	36	21	38	105	17	217
Energy	18	9	12	111	38	188
Telecommunication Services	24	3	4	23	29	83
Not Categorized	16	0	6	35	7	64
Grand Total	1,119	216	349	1,538	1,410	4,632

Broadly speaking, those dollar amounts make sense given the conventional wisdom about each of these sectors. The energy sector, for example, suffered severely in 2015 from plummeting oil prices, so it is no surprise that restructuring costs there would be higher. The IT sector routinely offers stock options or restricted stock units as compensation to employees, so one would expect that sector to report high adjustments related to those costs.



Company Examples

The PowerPoint presentation that accompanies this paper includes 13 examples of specific companies' reconciliation between non-GAAP and GAAP net income. We will present three of those companies here—Facebook, HP, and Merck—that demonstrate particularly significant examples of non-GAAP reporting.

Facebook reported GAAP net income of $3.688 billion in 2015 and non-GAAP net income of $6.518 billion—an increase of $2.830 billion, or 76.7 percent. Almost all of that increase is due to an adjustment for equity compensation expenditures.

GAAP net income	$3,688
Equity compensation expense	+2,969
Payroll taxes related to equity compensation	+77
Amortization of intangible assets	+730
Income tax adjustments	-946
Non-GAAP net income	$6,518

GAAP requires companies to include equity compensation costs as part of operating expenses before calculating net income. Facebook argues that its non-GAAP net income, which excludes equity compensation costs, is a better metric because the accounting standard to determine those costs (ASC 718, Stock Compensation) allows so many valuation methodologies and subjective assumptions that comparisons across companies are too difficult. As the company says in its earnings release:

> *[W]e believe that excluding this expense provides investors and management with greater visibility to the underlying performance of our business operations, facilitates comparison of our results with other periods, and may also facilitate comparison with the results of other companies in our industry...*

HP Inc. (the successor company to Hewlett-Packard Co.) reported GAAP net income of $4.554 billion and non-GAAP net income of $6.592 billion—a difference of $2.038 billion, or an upward adjustment of 44.7 percent. The upward adjustments were largely due to restructuring charges and separation costs.

HP announced in 2015 that it would separate into two publicly traded companies, and the company attributes its $1.259 billion separation charge and its $927 tax adjustment to that separation. In its earnings release, HP argues that since the separation will occur only once, adjusting net income for those one-time charges helps investors to better understand its long-term financial operations.

The $1.017 billion restructuring charge is a different matter. HP has reported $8.6 billion in restructuring charges since 2008, and has reported a restructuring charge every year since 2009. What's more, HP's restructuring plans change over time. In 2012, for example, the company announced a three-year plan to trim 29,000 jobs at an estimated cost of $3.7 billion. By the time that plan was completed in 2015, however, it had eliminated 55,800 jobs and cost $5.5 billion. And when HP announced the completion of that restructuring plan in 2015, it also announced a new restructuring plan that would run from 2015 through 2018.

GAAP net income	$4,554
Amortization of intangibles	+931
Restructuring charges	+1,017
Acquisition-related charges	+90
Separation costs	+1,259
Pension plan settlement charges	+168
Impairment of data center assets	+136
Separation costs in interest & other	+167
Adjustment for taxes	-(927)
Valuation allowances	-(803)
Non-GAAP net income	$6,592

Merck & Co. reported GAAP net income of $4.442 billion and non-GAAP net income of $10.195 billion—a difference of $5.753 billion, or an upward adjustment of 129.5 percent. The upward adjustments were largely due to acquisition costs, plus restructuring costs, litigation settlements, and foreign exchange losses due to Venezuela operations.

The bulk of Merck's adjustments for non-GAAP net income are due to mergers and acquisitions activity in recent years. (Merck has acquired at least a half-dozen companies since 2013.) Most of the costs are related to amortizing intangible assets, impairment charges for intangible assets, and integration expenses.

The Venezuela adjustment stems from an accounting rule adopted in 2010 that requires companies doing business in "inflationary economies"—and Venezuela certainly qualifies as such—to convert results of operations there to the parent company's currency.

GAAP net income	$4,442
Acquisition & divestiture costs	+5,398
Restructuring charges	+1,110
Vioxx-related litigation	+680
Foreign exchange loss on Venezuela	+876
Gain on divestiture of certain assets	-(397)
Other	-(34)
Income tax benefit	-(1,880)
Non-GAAP net income	$10,195

Recent SEC Guidance on Non-GAAP Metrics

The SEC published new guidance about using non-GAAP metrics on May 17, and several SEC officials gave speeches on the subject earlier this year. The guidance came in the form of Compliance & Disclosure Interpretations (C&DIs) that are meant to answer questions companies might have about their corporate reporting duties.

Some of the guidance addresses how non-GAAP metrics appear in the earnings release and whether they are over-emphasized compared to GAAP metrics. For example, companies should not present non-GAAP metrics in a bolder style or use strong adjectives ("record performance") without giving equally prominent treatment to comparable GAAP metrics. Likewise, companies cannot present any tabular analysis of a non-GAAP metric unless they also do the same for the comparable GAAP metric.

Restructuring costs, equity compensation, and acquisition-related items make up almost all (95 percent) of non-GAAP adjustments in dollar terms.

Most of the SEC guidance, however, addresses the substance of non-GAAP metrics. Specifically, the SEC does not want companies to devise non-GAAP metrics that mask underwhelming financial performance; or to change the reporting of non-GAAP metrics so often that investors cannot easily compare results from one period to the next. Most relevant to this paper, the SEC does not want companies to create non-GAAP metrics that allow "one-time adjustments" that really should be routine operating expenses.

For example, some might argue that Facebook's adjustment for equity compensation expenses should not be permitted, because GAAP has required all filers to expense equity compensation costs since the mid-2000s; whether companies agree with that rule or not, it is an accepted part of GAAP. On the other hand, Facebook argues that calculating equity compensation costs is so subjective, that GAAP net income numbers including those costs aren't necessarily comparable—and therefore, including a non-GAAP metric without that subjective item enhances comparability. Which argument is better? How many investors will notice, comprehend, or even care about the difference? Those questions could be debated for some time.

Financial services firms had the largest difference between GAAP and non-GAAP net income: $40.8 billion.

Likewise, HP has made the reporting of one-time adjustments for restructuring charges into an annual event. Its stock price has plodded downward for nearly six years (from the low $50s then, to the low $10s today), and critics will argue that HP's constant restructuring has become part of its struggle to find a viable operating strategy. Are HP's restructuring charges akin to one-time pivots that lead to future growth, or are they de facto operating expenses for a company plagued by strategic missteps?

Acquisition costs, meanwhile, are likely to be a mainstay of corporate reporting while interest rates remain low and organic growth remains elusive. And as intangible assets continue to grow as a portion of companies' balance sheet, amortization of intangibles and goodwill are likely to be popular elements of non-GAAP net income metrics.

Other issues addressed by the SEC guidance include per-share non-GAAP liquidity measures (prohibited); individually tailored accounting principles (also prohibited, although this warning focuses on revenue rather than net income); and free cash flow (permitted, but a company must explain how free cash flow is calculated and reconcile to GAAP).

Possible SEC Enforcement of Non-GAAP Metrics

Improper use of a non-GAAP metric violates Regulation G, adopted as part of the Sarbanes-Oxley Act. The SEC has imposed only one enforcement action under Regulation G: in 2009, the agency imposed a $1 million fine against SafeNet Inc. and barred its senior officers from public companies for five years. SafeNet had re-classified several operating expenses as non-recurring items and published a non-GAAP net income metric, the SEC said, to mask SafeNet's inability to meet earnings targets.

That said, the SEC has directed other companies to cease using or promoting non-GAAP metrics, without taking the step of imposing penalties. In 2011 the agency told Groupon to stop using its "adjusted consolidated segment operating income" just before Groupon's IPO. More recently, OM Asset Management had to delay its 2015 Form 10-K because of ongoing conversations with the SEC about its use of a non-GAAP metric it called "economic net income."

The SEC does not want companies to create non-GAAP metrics that include 'one-time adjustments' that really should be routine operating expenses.

So the financial reporting community can safely assume that even if the SEC does increase scrutiny around non-GAAP metrics, its first response is likely to be comment letters or cease-and-desist demands, rather than outright sanctions as seen with SafeNet.

Methodology

Calcbench selected 816 corporate filers in its databases that had already filed earnings releases for fiscal 2015 and used both GAAP and non-GAAP net income metrics. We then measured the difference between GAAP and non-GAAP net income in dollar terms.

We also reviewed the reconciliations those 816 companies included in their earnings releases to reconcile their non-GAAP net income back to reported GAAP net income. A complete list of companies' description of the line items in those reconciliations is available in an Excel file that contains the raw data for the 816 companies. We took that range of line-items and grouped them into five categories: acquisition-related costs, debt, equity compensation, legal costs, and restructuring costs.

Companies were assigned to the nine business sectors used in this study based on the SIC codes they report to the SEC.

About Calcbench

Founded in 2011, Calcbench is the first company of its kind to fully harness the power of the new interactive data standard XBRL, yielding an unprecedented direct line into the SEC's corporate financial data repository.

Calcbench provides a completely new experience researching financial and accounting data. Covering more than 9,000 US listed public companies, we make data easier to use, faster, and in more detail than ever before.

Investors, financial analysts, auditors, economists, and academics instantly access, research, and share data, both online and through our Excel add-in. Our accessible and intuitive platform can aid in better understanding competitor financials, identifying potential risk areas, analyzing trends across industry sectors, or conducting more effective due diligence.

Learn more at http://www.calcbench.com

About Radical Compliance

Radical Compliance is operated by Matt Kelly, an independent compliance consultant who studies corporate compliance, governance, and risk management issues. He maintains a blog, RadicalCompliance.com, where he shares his thoughts on business issues; and speaks on compliance, governance, and risk topics frequently.

Kelly was named as 'Rising Star of Corporate Governance' by Millstein Center for Corporate Governance in inaugural class of 2008; and named to Ethisphere's 'Most Influential in Business Ethics' list in 2011 (no. 91) and 2013 (no. 77).

Kelly previously was editor of Compliance Week, a newsletter on corporate compliance, from 2006 through 2015. He lives in Boston, Massachusetts, and can be reached at mkelly@RadicalCompliance.com or on Twitter at @compliancememe.