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Modern Perspectives on Financial Disclosure

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FASB Criticized for Materiality Changes

FASB came under fire for its plan to harmonize the accounting world's approach to materiality with legal definitions developed in the courts and validated by the Supreme Court

by Joe Mont

It is probably fair to say that business leaders often pay more attention to the Securities and Exchange Commission's efforts to "facilitate capital formation" and "maintain fair, orderly, and efficient markets," than the third pillar of its mission statement: investor protection. These mandates, however, are blurring and connecting in ways that could substantially change how companies approach financial reporting and raising capital.

An area where investor advocacy will either compliment or conflict with business concerns is the subject of overhauling disclosure regimes. While the SEC slogs through its own ambitious review of Regulation S-K and S-X disclosures, accounting standards are ripe for retooling. Simmering tensions came to a boil in January 2016 during a meeting of the SEC's Investor Advisory Committee as members took the Financial Accounting Standards Board to task for proposals that would redefine its approach to materiality.

FASB, tasked with establishing and improving General Accepted Accounting Principles, came under fire for its "Concepts Statement No. 8," a plan to harmonize the accounting world's approach to materiality with legal definitions developed in the courts and validated by the Supreme Court. In short [and for a detailed explanation see Tammy Whitehouse's Nov. 17 story, "FASB Ideas on Materiality Reform Draw Heat, Questions"], the proposal would strike existing language:

"Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report."

The excised text would be replaced with a new approach that borrows heavily from language used by the Supreme Court in interpreting the antifraud provisions under the securities laws:.

"Materiality is a legal concept. In the United States, a legal concept may be established or changed through legislative, executive, or judicial action. The Board observes but does not promulgate definitions of materiality. Currently, the Board observes that the U.S. Supreme Court's definition of materiality, in the context of the antifraud provisions of the U.S. securities laws, generally states that information is material if there is a substantial likelihood that the omitted or misstated item would have been viewed by a reasonable resource provider as having significantly altered the total mix of information."

FASB would also change the definition of materiality as it applies to financial statement footnotes.

That plan found little favor with the Investor Advisory Committee when it met on Jan. 20, 2016. Near the end of that day-long session, it approved a letter expressing numerous concerns. "The changes set out in the proposals are not clarifications, but entail a significant and substantive alteration to the current definition," it says. "The approach taken in the proposals is explicitly designed to reduce disclosure and in doing so has the potential to adversely affect the quality of financial disclosure."

"Granting issuers greater latitude to use discretion in evaluating the materiality of disclosures in the absence of a framework is fraught with the risk that disclosures that are unfavorable to the issuer are disproportionately viewed as immaterial and as a result excluded from the financial statements," the letter adds. "Such a result is not in the best interest of investors and is anathema to investor protection, capital formation, and the efficient functioning of the capital markets."

> "We are not trying to say that more disclosure is always better. The right disclosures and the right level of disclosure is what we are trying to get to."
>
> Steven Wallman, CEO, Foliofn

An approach based on legal precedent creates a need for comparability, said committee member Roy Katzovicz, chairman of Saddle Point Group, a private investment firm. "If and when the Supreme Court does change the prevailing legal standard for fraud it is something that would be embedded over time," he said. "We don't think lawyers' analysis should be the touchstone of whether or not something ought to be disclosed. We prefer the accounting profession have its own standard and it could be higher and better than the legal standard, even if it is articulated by the Supreme Court."

The letter says the proposal does not adequately discuss the impact of the change on the disclosure process, including increased costs. By clarifying the legal nature of the definition, issuers seeking greater comfort on the proper application of the legal concept of materiality "will presumably have an increased incentive to seek the views or opinions of counsel."

The Committee also argues that: "The Supreme Court's interpretation of materiality has arisen in the context of the antifraud provisions under the federal securities laws. We believe that the existing terminology used by FASB provides a better framework for determining the content of financial

disclosure."

The letter provides two primary suggestions for addressing the "flawed" proposals: maintain FASB's current definition of materiality; or withdraw the proposals and "precede any future proposals with a more complete record that sets out both the concerns requiring any changes to the definition of materiality and the implications of any such changes, and that more clearly alerts the public to the consequences of such revisions."

Kurt Schacht, chairman and managing director of the CFA Institute, described the current definition of material information—if omitting or misstating it could influence decisions users make—as a "very elegant" solution. "Why are they changing it? To reduce disclosure," he said.

Members of the committee stressed that these concerns should not suggest a perpetual demand for the status quo.

"We are not trying to say that more disclosure is always better," said Steven Wallman, chairman of the Market Structure Subcommittee and CEO of Foliofn, Inc. "The right disclosures and the right level of disclosure is what we are trying to get to. We can fine tune disclosure because the world continues to change and we need to make sure the rules can be updated as well."

There were hopes expressed that FASB would develop a more inclusive process as debate on these, and future proposals, unfolds. "This is huge and hasn't been thought about carefully," Damon Silvers, associate general counsel for the AFL-CIO said of the materiality framework. "They haven't been, in a serious way, in front of the accounting and auditing world. If you look back over the past couple of decades of securities regulation and accounting and auditing, this is precisely the sort of thing that people profoundly regret later if it hasn't been thoroughly processed upfront."

Other discussions at the meeting may may be a barometer of where the SEC devotes energy in the weeks and months ahead.

Crowdfunding, the JOBS Act mandated darling of small business capital formation advocates, is much closer to being a reality, according to SEC Chairman Mary Jo White. Regulation Crowdfunding was finalized in October and is effective in May; funding portals can begin to register with the Commission later this month. Also on the horizon is a possible update to the SEC's longstanding accredited investor definition. A review, mandated by the Dodd-Frank Act, analyzed various approaches for modifying the definition, a process in the midst of a public comment period.

White

There may also be consideration, and likely debate, over whether rules pertaining to fixed income markets need to be reconsidered, possibly aligned more closely to regulations that guide equity markets.

Both the Municipal Securities Rulemaking Board and Financial Industry Regulatory Authority have proposed rules, and a common approach, for requiring the disclosure of markups and markdowns on so-called riskless principal transactions. "It is my hope that the positive momentum created by these two developments will carry over to an additional area of the fixed income markets where enhancements are needed: pre-trade transparency," SEC Commissioner Michael Piwowar said. "Issues related to transparency in the fixed income markets are precisely where the Commission should focus its attention." ■

MATERIAL ISSUES

The following is an excerpt from a comment letter by the Securities and Exchange Commission's Investor Advisory committee to the Financial Accounting Standards Board, urging rejection of proposed changes to concepts of "materiality" embodied in FASB's Conceptual Framework for Financial Reporting and FASB's guidance on Notes to Financial Statements.

The "Conceptual Framework" proposal raises a number of concerns.

First, the proposal characterizes the changes as an effort to "clarify" the concept of materiality. In fact, the proposal does not clarify but substantially alters the definition in a manner that will narrow its application. The proposal strikes the reference to "relevance," leaving application of the concept entirely unclear, focuses on "resource provider" rather than "user" and replaces the need to determine whether information "could influence decisions" with the need to determine whether the information "would" have "significantly" altered the "total mix."

Second, the "Conceptual Framework" proposal does not adequately discuss the impact of the change on the disclosure process, including the increased costs that will likely result. In particular, the proposal does not sufficiently take into account that, by "clarifying" the legal nature of the definition, counsel will likely have an increased role in the process. Whatever the current role, issuers wanting greater comfort on the proper application of the "legal concept of materiality" will presumably have an increased incentive to seek the views or opinions of counsel. Particularly if this type of review becomes common, the additional costs may be significant. Beyond costs, the risk exists that, by replacing the current, differentiated professional accounting standard with a case-law driven legal standard, close questions of judgment will ultimately devolve to lawyers rather than accountants.

Third, the proposal justifies the revision as necessary to "eliminate inconsistencies" between the current definition with the one developed by the Supreme Court under the antifraud provisions. The proposal does not explain the basis for this determination of inconsistency. To the extent that "inconsistent" means incompatible, the current definition is not inconsistent. The current definition is broader than the one used in the antifraud provisions. Thus, information captured by the Supreme Court's definition is captured in the existing definition

Source: SEC

Accounting Standard Impacts Financial Reporting

Biggest change from new standard involves accounting for investments in equity securities

by Tammy Whitehouse

A new accounting standard on how to recognize and measure financial instruments provides a handful of key provisions that will have widely different effects for public companies.

"Clearly the new standard is going to make some changes," says John Althoff, a partner with PwC. "But the extent of change and whether it impacts you or not will depend on the nature of your business and the nature of the financial assets and financial liabilities you have. It's hard to give that all-encompassing summary that the world is changing or nothing has happened. It changes some things but not others."

The biggest changes with Accounting Standards Update No. 2016-01, experts say, involve how to account for investments in equity securities, how to treat credit risk for certain liabilities recognized at fair value, and how to arrive at certain disclosures. The final standard represents a significant step back from the board's original idea in 2010 to require all instruments to be reported at fair value, or even the compromise proposal in 2013 to focus measurement on the business purpose for holding a particular instrument.

With the rule now final, financial institutions are perhaps most tuned in to changes around debt they have elected to mark at fair value, says Mike Gullette, vice president at the American Bankers Association. Changes in those values will be reflected in "other comprehensive income" rather than net income under the new standard, removing a long-criticized allowance in GAAP that enabled banks with deteriorating credit to improve their reported earnings.

The Financial Accounting Standards Board set a 2018 effective date for the new standard, but it made an exception for the credit risk provision, allowing that to be adopted early. "Banks will probably try to do that quickly," says Gullette. It's a common topic of discussion in earnings calls, he says, where banks routinely exclude the impact of the fair-value adjustment in explaining results to investors.

Aside from financial institutions, for public companies

MAIN PROVISIONS

Below, the Financial Accounting Standards Board offers a summary of the new financial instrument standard.

The new ASU:

- Requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. However, a reporting organization may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment (if any), plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.
- Simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, the reporting organization is required to measure the investment at fair value.
- Eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for reporting organizations that are not public business entities.
- Eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet.
- Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.
- Requires the reporting organization to present separately in other comprehensive income (OCI) the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.
- Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements.
- Clarifies that the reporting organization should evaluate the need for a valuation allowance on a deferred tax asset related to available-for- sale securities in combination with the organization's other deferred tax assets.

Source: FASB

across all sectors experts say the most significant change is the requirement in the new standard to measure equity securities at fair value if they are held as available for sale or if their fair values are not readily determinable. Changes in the value of such securities will be reflected in net income under the new standard.

> "You can be big and have a great risk management approach, with board-level compliance and risk committees. That's where you do the work that will protect your institution in an economic downturn or crisis."
>
> James Kaplan, Partner, Quarles & Brady

"If you have investments in loans or debt securities, this standard is not changing that accounting," says Althoff. "If you have equity instruments you are holding in a trading account, that hasn't changed. But if you have a lot of equity investments that you are holding as available for sale, or if they do not have readily determinable fair values, this will be a big change for you."

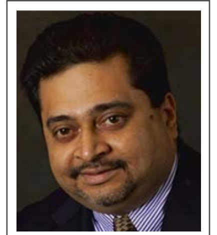
Under existing GAAP, changes in the value of equity securities that are held for sale are reflected in other comprehensive income, a line item in the income statement that does not flow directly to earnings, says Faye Miller, a partner with audit firm RSM. "Companies will want to give some thought to what this is going to mean when they start experiencing income statement volatility by having to run changes in fair value through the income statement," she says.

The standard provides an alternative treatment if companies want to elect it, says Miller. Where equity investments do not have readily determinable fair values—for example where a company holds an investment in another private entity—companies can elect to measure those investments at cost minus impairment, plus or minus any changes resulting in more observable evidence. "Once you make that decision, you live with that for the life of each security for which you make that election," she says.

Miller

Making the election, however, would necessitate controls and procedures to identify indicators of impairment and observable changes that would have to be reflected, says Miller. "It's just a question of weighing the benefits and the costs," she says. "Either way, you will have some ongoing challenges."

While FASB is working on a separate standard on how to reflect credit impairment, companies should not overlook provisions in the new classification and measurement standard on impairment of equity securities, says Gautam Goswami, a partner with audit firm BDO USA. "This standard gets rid of other-than-temporary impairment" for equity securities, he says. Where companies have elected the alternative treatment to full fair-value measurement each period, the standard requires a qualitative assessment each reporting period to look for indicators of impairment, he says, with any difference between fair value and carrying value reflected.


Goswami

With respect to disclosures, the new standard requires public companies to use an exit price rather than entry price when measuring the fair value of instruments for disclosure purposes. Although fair value by definition relies on exit pricing, companies have followed an interpretation that for certain disclosures an entry price approach was acceptable, says Mo Vakili, a partner with Deloitte. "FASB is clarifying here if you don't carry it at fair value but you disclose it at fair value, it should be at an exit price," she says.

The new standard also reduces some disclosures. Where public companies measure the value of financial instruments at amortized cost on the balance sheet, the new standard will not require disclosure of the methods and significant assumptions used to estimate the fair value that must be disclosed. "It reduces the onus on disclosures," says Vakili.

Adoption efforts will vary for entities, depending on what's in their portfolio and how it's carried currently, says Miller. Compared with other major standards that are already published or expected soon, like revenue recognition, leasing, and credit impairment, the new requirements for classification and measurement of financial instruments will be easier to implement, she says.

In many cases, entities already have information they will need to comply with the new requirements, but they will change how it is reflected in financial statements, says Miller. It is perhaps the exit price notion required in footnote disclosures that may produce some of the greatest leg work for companies, she says. "For entities that have long-term receivable portfolios, if prior to this they were using an entry price notion to determine fair value, it could be a fair amount of effort to convert to obtaining exit pricing," she says.

As for financial statement metrics, banking experts are not expecting monumental change. "There should be very little change in the balance sheet," says Gullette. "In the income statement, a small number of companies will be having a difference in what's reported."

Miller says it's hard to project what will happen to income statements across all entities, given that some changes will add what flows to earnings and others will take earnings away. "I'm sure there will be some entities impacted by both, but I don't have a good feel for how extensive it will be," she says. ■

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SEC to Address Financial Reporting Questions

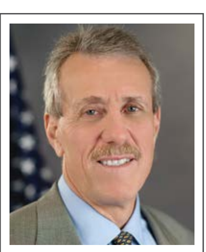
Biggest concern for Commission: Significant changes affecting revenue recognition standards

by Joe Mont

The Securities and Exchange Commission's pledge to simplify its disclosure regime gets plenty of attention these days. That project, alas, while welcome, may seem like a consolation prize for companies facing a complex and evolving financial reporting landscape.

In response, the SEC's Division of Corporation Finance and the Office of the Chief Accountant have taken steps, both internally and through issuer outreach, to address questions and concerns they see emerging in the months ahead—and, lord knows, financial reporting executives will have plenty of questions in the months ahead.

Most pressing are the substantial changes to revenue recognition standards that take effect in 2018, moving away from the rules-based approach of U.S. Generally Accepted Accounting Principles toward a more principles-based standard that will require much more judgment. The SEC now clearly wants companies to disclose at least something about their adoption efforts so far. Numerous studies suggest that for many companies the answer is some variation of "not much."



Schnurr

Another hot issue: long-stalled efforts to converge U.S. GAAP with International Financial Reporting Standards. SEC Chief Accountant James Schnurr announced a new plan of attack at the recent Current Financial Reporting Issues Conference in New York. His pending recommendation to SEC Chairman Mary Jo White will be that in addition to filing financials in accordance with U.S. GAAP, domestic companies should be allowed to provide supplemental information in IFRS. The proposal would be formalized through the rulemaking process, he explained. The initiative would be spearheaded by his office and Corporation Finance because it affects the disclosure regime.

Looking for Help

On revenue recognition, Schnurr says he and his staff are available to assist with pre-clearance consultations on company or sector-specific issues. More fundamental issues of implementation, however, might need more help.

He also pointed to a recent survey by PwC and the Financial Education Research Foundation that found 75 percent of companies haven't completed an initial assessment of the standard's effect. Nearly 27 percent of respondents haven't started the assessment process at all. Those results give rise to those who think more guidance will be needed from standard setters.

In December 2015, the Financial Accounting Standards Board and the International Accounting Standards Board convened the last session of their Transition Resource Group, an effort to smooth revenue recognition implementation pains through policy setting. Count Schnurr among those who say its work should continue.

"My hope is that there are not any more big issues that are going to require standard setting, but there are issues that will need more education to achieve consistency," he said.

Schnurr's advice to those seeking guidance from SEC staff is to evaluate whether your question is specific to your company, rather than a question that would apply across an entire industry group. "We will work with a company as it works through the accounting analysis," he said. "We will certainly respect reasonable judgments. The big issue is that we don't want to find out two to three years after the standard is implemented that there is substantial diversity in practice to a particular transaction that is material."

Given the shifting state of disclosure obligations, companies may want to avail themselves of pre-clearance consultations with Corp Fin's accounting staff or informal phone consultations. The latter comes with a variety of caveats.

> "Companies should let the auditors be involved and not do a separate process."
>
> Mark Kronforst, Chief Accountant, SEC Division of Corporation Finance

"We will talk to anyone, so feel free to call us," said Mark Kronforst, Corp Fin's chief accountant, but "phone duty," as it is known to staff, is intended to be an informal process and should be treated as such. "We usually give a disclaimer that the division is not bound by it. We are not doing any research. It is just a quick answer in contrast to the formal process where the division is bound by the advice."

Kronforst did warn companies not to use phone consultation as a means to dodge differences of opinion with your audit firm or more formal review of some issue. "Companies should let the auditors be involved and not do a separate process," he said. "We've seen companies get an answer from an auditor, come to us to get a different answer, and then go back and beat the auditor over the head with it." Corp Fin officials have a term for it: "opinion chomping."

Opinions may vary with an informal consultation because the staff doesn't have the time or insight to appreciate the subtleties and company-specific facts that underlie an issue. More nefarious, Kronforst said, are intentional efforts to manipulate staff advice by "sanitizing the fact set." His warning: "Once we figure out this is a difficult

question that probably wasn't intended for a phone review, we will put companies through the formal process."

Abusing "phone duty" is all too common, said Wayne Carnall, a partner at PwC and the division's former chief accountant. "What will happen is that legal counsel will say, 'Well, we just cleared that issue with the division's Chief Accountants Office, so there is no issue,' but they omitted significant points that were relevant to the decision," he explains. "If you have an issue that is a difficult issue, you are much better off going in with a formal consultation."

Brian Lane, a partner at law firm Gibson Dunn, says planned SEC consultations should start with a review of issues ahead of time with a company's auditor and legal counsel. This helps to set talking points ahead of the call. Also, he says, keep the histrionics to a minimum—don't be confrontational or panicked.

"The staff doesn't want to debate the letter on the phone," he says. "Everyone wants to get the Division of Corporation Finance on the phone to tell them how wrong they are, but the staff doesn't want to have that conversation. You have to characterize it as a clarification. You can call to say you don't understand what they're getting at and ask them to explain their concerns. Then you can start talking."

Changes at Corp Fin

Amid the many changes affecting financial disclosures and company reporting, Corp Fin has itself undergone some structural changes. For example, after reviewing the industry-specific examination groups assigned to public companies that file disclosure documents, the division consolidated banking groups that were split in 2010 between large and smaller institutions.

Kronforst sees benefits to this and similar efforts. "We've gotten questions about whether that means continuous reviews for large financial institutions will end. That is not the case," he said. "I don't think it really means anything from a registrant perspective. But as far as which group to contact there will no longer be confusion."

> "The big issue is that we don't want to find out two to three years after the standard is implemented that there is substantial diversity in practice to a particular transaction that is material."
>
> James Schnurr, Chief Accountant, SEC

Corp Fin is also focusing on technical issues, rather than strictly sector-based reviews by examination groups. "The change aligns us more closely with our colleagues in the Office of the Chief Accountant," Kronforst said. For example, instead of stock compensation issues that might sporadically emerge within specific industry groups and be reviewed by multiple SEC staff, one point person will now oversee that specific issue.

"One of the challenges the division has always had is having consistency with their comments," Carnall says. "When you have a focus that is not just by industry groups, but by the topical areas, it will help improve consistency and lead to having better comments going out. I think it is a win-win situation." ■

REVENUE STANDARD CONCERNS

The following is from a survey by PwC and the Financial Executives Research Foundation of 335 companies and their progress implementing the new principles-based revenue recognition standard Issued by the Financial Accounting Standards Board and the International Accounting Standards Board.

Companies Do Not Yet Have a Complete Understanding of How the Standard Will Affect Them

A majority (75 percent) of respondents have not yet completed their initial impact assessment, and almost 27 percent of respondents have not begun an assessment.

Only 5 percent of respondents have started to implement systems, process and controls changes, despite the fact that public companies planning to utilize the full retrospective method of adopting the standard will need 2016 information.

Reasons for Delayed Implementation

Key explanations cited for why companies have not begun to address the standard change include:

- Do not believe there will be a significant impact on our company's financials: 38 percent
- Resource constraints: 18 percent
- Waiting for clarification on additional accounting topics: 14 percent
- Waiting for finalization of the proposed amendments: 13 percent
- Expect to initiate efforts now that the FASB and IASB have voted on the effective deferral date: 8 percent

Only 9 percent of survey respondents are planning for adoption prior to 2018, with over 66 percent of respondents indicating that their company plans on taking advantage of the deferral.

Source: PwC Financial Executives Research Foundation

Five Fatal Flaws Killing Disclosure Management Process

INTRODUCTION

There are many ways to drive a business into the ground; erroneous disclosure is one way; producing hurried or manually generated disclosures are two more. It's one thing to have unideal numbers – product sales didn't quite make the cut or projected forecasts fell short, succumbing to outside forces. But it's another thing entirely when a finance team has exhausted its efforts on fruitless, manual tasks or when procedures have become a hazard more than a help.

Status quo disclosure is status quo because it barely scrapes by. Organizations who fit the "status quo disclosure" bill aspire only to pass regulatory requirements and avoid fines – but they also fail to recognize the strategic potential of financial reports as a means to communicate value bluntly to investors. These organizations have a Disclosure Management Cycle that is particularly susceptible to error. In fact, the effects of these poor processes may already permeate the reporting company's financial reports.

Five fatal flaws killing the success of disclosure management processes are:

1. Operational redundancies
2. Extraneous information
3. Disclosing without investors in mind
4. Errors in financial reports - narrative and data
5. Over qualified staff spending unnecessary time on menial tasks

Companies disclosing to meet the status quo often find they're stunted by these seemingly insurmountable issues. Often, these flaws are deemed, "just part of the job." With no time for analysis and even less time to incorporate strategic operational practices, these companies are stymied in logistics and cannot shift their focus beyond the manual production of reports.

Exploring the five fatal flaws killing disclosure management processes

1. Operational Redundancies: Monthly reporting, monthly re porting, monthly reporting – it's a little bit redundant. Every month, financial reports are turned in to managers. Every month, the same template gets updated with new numbers. Every month the words "increase" and "decrease" are traded, one for the other. Every month... you get the picture.

Operational redundancies prominently occur in a few ways: Manual updates to recurring reports are likely the most time consuming. If you're gathering analytics or financials manually and updating reports repetitively, there's a lot of time wasted re-entering and updating data – time that could have been used on analysis or making meaningful business decisions. Wasted time, wasted resources, wasted talent – one weak process. Other operational redundancies include unnecessary back and forth between various stakeholders, searching the web fruitlessly for benchmarks and scouring regulatory sites for event driven precedents.

If you're gathering analytics or financials manually and updating reports repetitively, there's a lot of time wasted re-entering and updating data.

2. Extraneous information: **Dr. Patricia Walters** said it best. "Why do we keep adding more rather than better disclosure? In one word: fear. Investors fear making bad decisions and litigation; regulators, standard-setters and legislators fear public outcries at the next market crisis; preparers fear competitive disadvantage; auditors fear increased oversight. I believe it's also sheer laziness. It's so much easier to increase the quantity of

information, than to expend the considerable effort it will take us to improve its quality and transparency[1]." What's the call to action? Cut the fluff. Extraneous information and overly complex explanations of, say, collateralized debt obligations, makes an already complex subject virtually inaccessible. You understand the impact of your decisions on financial statements and the bottom line – prove it.

> *"Close to 90% of spreadsheet documents contain errors [...] Spreadsheets, even after careful development, contain errors in 1% or more of all formula cells [...] In large spreadsheets with thousands of formulas, there will be dozens of undetected errors."*

3. Disclosing without investors in mind: Are you making investors search the world with a candle for a piece of quantitative information? Making investors work is one sure way to drive your business into the ground. Simple tactics - like using tables to represent quantitative figures, organizing note disclosures so they represent the explanation of the balance sheet or income statement in its totality – can go a long way with investor favorability.

One study by an investor relations firm defined successful CFOs as those who think like investors. Conversely, deficient CFOs were defined as disinterested, lacking strategic insight and failing to understand how investors assess and measure performance[2]. The lesson? Leaving investors in the disclosure dark might just turn the lights out on your company. Keep them on by thinking like your audience.

4. Errors in financial reports: The quickest way to kill your disclosure management process is by reporting incorrect data. After all, manual data entry leaves a lot of room for error. When processes are overburdened with manual intervention, the risk of error is high. This is especially true during financial reporting high season when accounting eyes are tired and missing that extra zero isn't outside the realm of possibility. "Close to 90% of spreadsheet documents contain errors [...] Spreadsheets, even after careful development, contain errors in 1% or more of all formula cells [...] In large spreadsheets with thousands of formulas, there will be dozens of undetected errors[3]." For accountants who've been trained to value accuracy, these statistics are unsettling; for financial reports that depend on precision, these statistics are unacceptable. When reports are inconsistent due to typos or because the numbers are outdated – missed during the update and the final review - it looks bad on the company and on the report manager.

What's the direct impact of these errors? One Deloitte study warned, "In addition to a loss of investor confidence evidenced by an associated share price decline, an organization may face a drop in credit ratings, and management changes may be effected. One study has suggested restatements can destroy up to 35% of an organization's worth[4]." The numbers speak for themselves.

5. Over-qualified staff spending unnecessary time on menial tasks: What happens to finance executives who use a reporting cycle on its last legs? They're always in a rush, maybe even slight panic, with a "get it done and get it out mentality" for every complex external or internal report. These are high value employees completing low value tasks. They're cutting and pasting data, spending countless hours scouring competitors' websites for "business intelligence needles" in "Big Data haystacks" along with their complex tasks. They simply can't do it all with the utmost attention. There's just not enough time.

The best employees want to make a material impact on the company they work for. They prefer to strategize and forecast, making meaning out of the numbers. These employees are quickly lost when they're tasked with unskilled work. Not only is staff

1 Walters, Patricia. "Full Disclosure: What Would Goldilocks Do?" DisclosureNet. Web. 4 June 2013. http://blog.disclosurenet.com/corporate-intelligence/full-disclosure-what-would-goldilocks-do/.

2 "What Makes a Great CFO?" G.A. Kraut Company. N.p., n.d. Web. 3 July 2013. http://www.gakraut.com/articles/WhatMakesAGreatCFO.pdf

3 Olshan, Jeremy. "88% of Spreadsheets Have Errors." MarketWatch. N.p., 20 Apr. 2013. Web. 25 Nov. 2013. http://www.marketwatch.com/story/88-of-spreadsheets-have-errors-2013-04-17

4 "Reducing Financial Reporting Risk." Deloitte.com. Deloitte, 2010. Web. 25 Nov. 2013. http://www.corpgov.deloitte.com/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/ CanEng/Documents/Risk%20 Oversight/ReducingFinancialReportingRisk.pdf

turnover a risk here, but having over qualified staff concentrate their time on menial tasks means your company is spending unnecessarily on things like data entry.

What's the solution?

Smart disclosure - also known as the perfect combination of workflow and quality. This two pronged approach brings to life your financial reports, without the fatal flaws discussed above. Smart disclosure is facilitated by an automated Disclosure Management Cycle: the systematic production of disclosures that provide investors with a thoughtful look at a company's earnings, linking numbers and narratives in a manageable and contextual way.

In The Difference Smarter Disclosure Makes, the winning disclosure management formula is described as a balance of the following:

1. Improved financial reporting efficiency and data accuracy for smooth reporting cycles

2. The attractive presentation of company results through quality disclosure

Everyone discloses, but the intention is different; some disclose to meet the regulatory end, while best-in-class companies see financial reports as an opportunity to appeal directly to investors – the smarter, investor-centric approach always wins.

So how do you get smarter disclosure?

1. Use a streamlined workflow to push the filing through the production phase with an understanding that there are likely multiple contributors, highly sensitive information and real-time changes.

2. Real-time data updates eliminate the need to re-key data, which only serves to bog down your finance department in logistics.

3. Accounting resources, like reporting standards, rules and regulations and peer filings, should be at your fingertips. These tools make for disclosures that are based upon regulatory successes and contextually rich with relevant information for stakeholders.

4. Communicate with investor's top of mind by having quality at the centre of your internal disclosure mandate. By focusing on the quality of your narratives and the accuracy of your data, the integrity of your company's work is not lost on deaf ears and is showcased with optimal results.

5. Give your staff the tools they need to succeed so they can spend less time in the trenches and more time making meaning out of the numbers.

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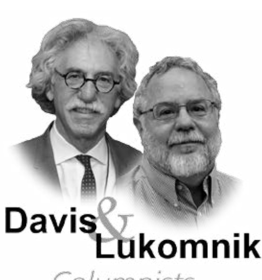
A Smarter Way to Address Disclosure Overload

Harvard professor wants firms to pursue a "Statement of Significant Audiences and Materiality" to help identify which stakeholders and time frames a board prioritizes in making crucial decisions

by Stephen Davis & Jon Lukomnik
Compliance Week **Columnists**

"I have never met a piece of information that investors don't want," the respected audit committee chair said, more in exasperation than in anger.

We had been having a conversation that ranged over the current ideas to improve corporate reporting, from the Securities and Exchange Commission's concept release on audit committee reporting to the Public Company Accounting Oversight Board's proposed new standards for auditors' reports to the non-governmental Sustainability Accounting Standards Board's proposals. And then there are the various rating agencies—credit, environmental, social, governance—and their questionnaires. And regulatory agency requests. And on and on and on.



Even as investor advocates, we have to admit that our exasperated audit committee chair has a point. But the reality of more demands for more information isn't likely to change anytime soon.

As a result, corporate officials have a choice. They can curse the inevitable prospect of more disclosure as creeping regulation, or they can channel the torrent of information so that it is a strategic asset.

Before understanding how to turn a compliance headache into a strategic communications advantage, first we have to understand why, despite more information being available than ever before, investors want even more. And how that opens an opportunity for companies that choose to take it.

Investors live and breathe information. How investors access and analyze information is the heart of their investment process. There are tens of thousands of variables in those processes. Literally. Every investor has a slightly different emphasis, from what information he looks at to how he weighs it to expected time frame for the information to be relevant.

At the extreme, high frequency traders need short duration (millisecond) price information, while long-duration buy-and-hold investors focus on corporate fundamentals and quality of management as they seek to divine trends that will last years. Then there are socially responsible investors, mutual funds engaged in quarterly relative return battles, liability-driven investors, quant investors, and a host of other types of investors. Each wants different data, and each analyzes that data through different sets of lenses.

With such heterogeneity, it's no wonder that no single cookie-cutter template of disclosures will satisfy all. Moreover, every one of those investors consumes incrementally more data every day: The omnipresence of computers and communications networks means they have the ability to analyze mass quantities of information.

Think about it: Barely a quarter century ago, investors were limited to accessing paper-based regulatory reports and sell-side research. Perhaps they added some of their own research, which tended to be a few telephone-based interviews. Even if they had access to more data, they probably couldn't analyze it all to turn it into actionable analyses.

It's hard to remember, but computers and the Internet didn't even exist when many of the current reporting requirements were established. Now we've advanced to the point where some investors use big data techniques pioneered by Google and Amazon. Today, information-processing technology is key for most institutional investors.

> Defining "your story" and crafting your disclosure both to meet regulatory requirements and to focus on the company's key performance indicators seems not only straightforward, but also beneficial to investors, stakeholders, and the company.

In such a world—tens of thousands of investors, each focusing on a slightly different set of data, and all with the ability to analyze it—we should not be surprised that the demand for data would explode.

And that is just the data demand from investors. Other stakeholders, from regulators to activists to local communities to workers to customers to suppliers, also want data so that they can analyze how a company is responding to their specific concerns.

Given such a diverse demand, the information requestors seek is sometimes in conflict as to form, time frame, and even substance. Companies aren't falling to paranoid hallucination when they feel caught between myriad competing demands for information. They are truly caught.

Perhaps it's for that reason that so much disclosure is anodyne: lawyerly and designed to fulfill compliance regulations without revealing too much. The problem is that

such un-particularized information leaves investors and other stakeholders feeling that they know little about how a company actually makes decisions. So a vicious circle is established. The more companies disclose defensively, the more information investors demand.

There is another way. Instead of trying to avoid picking favorites among the competing demanders of disclosure, companies could, in fact, do exactly that.

Setting Disclosure Priorities

Enter Harvard Professor Robert Eccles. He is calling for companies to issue a "Statement of Significant Audiences and Materiality," which would identify which stakeholders and which time frames a board of directors prioritizes in making its decisions. While we may not agree with some of Eccles' proposal, we do think it represents a common-sense approach to corporate communications. As super-lawyer Ira Millstein counseled some 25 years ago, "Tell your story."

For example, Sir Richard Branson of Virgin Group fame has a philosophy of "staff first, your customer second, and shareholders third," believing that everyone profits from such a hierarchy. A company practicing that credo might well feature extra disclosure—above that required by law—regarding worker training, employee benefits, turnover, and so forth. That is not to suggest that Sir Richard's philosophy is the only one, or even a preferred one. But the point is that he has an explicit set of normative guidelines that inform corporate decisions. That, in turn, allows investors and other stakeholders to understand corporate actions and achievements against an expectation of what the company stands for.

The truth is that every board and executive team has a philosophy to help them make decisions. Which constituencies do they prioritize? What is the time frame the board thinks about in making capital allocation decisions? How much does the company care about quarter-to-quarter earnings opposed to a multi-year total return targets? The list of such corporate preferences is long, and the last thing we want to do is add to the disclosure burden by suggesting a checklist. But understanding those corporate preferences can help you refine your disclosure regimen.

Investor relations professionals often talk about a company trying to select its investors. Letting markets know, for example, that a company is being run for long-term economic profitability, and that it is tolerant of interim market volatility, may attract similarly minded shareholders. Suggesting that capital allocation is paramount attracts a different type of investor than top-line growth focused companies. Stakeholder relations are also affected: A bank that is about growth will attract a different regulatory focus than one which doesn't innovate and is capitalized far beyond the regulatory minimums.

Adopting Eccles' suggestion in concept, even if not in his precise form of execution, could provide corporate executives with a "true north" in drafting disclosure. Defining "your story" and crafting your disclosure both to meet regulatory requirements and to focus on the company's key performance indicators seems not only straightforward, but also beneficial to investors, stakeholders, and the company.

Focusing disclosure that way would have one more benefit to companies, which our poor audit committee chair would appreciate. Much as a well-designed project management plan defines what is in or out of scope, to focus on what's important by eliminating certain things from consideration, having an explicit guiding disclosure philosophy would help companies know where to focus their reporting resources and where to say "being just compliant is good enough."

Much as a well-designed project management plan defines what is in or out of scope, to focus on what's important by eliminating certain things from consideration, having an explicit guiding disclosure philosophy would help companies know where to focus their reporting resources and where to say "being just compliant is good enough."

That may not mean that investors will stop demanding more and more information. But it would certainly provide companies with a starting point on which demands to meet. ■

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Banks Face Regulatory Risk, With Political Twist

With a presidential race underway, calls for breaking up big banks and reinstating the Glass-Steagall Act are once again getting louder

by Joe Mont

More so than any other business, the banking world has been overdosed on regulatory prescriptions.

The Dodd-Frank Act and international Basel III accord are just two landmark laws that in recent years have added to an ever-expanding list of rules intended to protect the safety and soundness of financial markets. These include, but are not limited to, heightened capital requirements, liquidity demands, restrictions on derivatives trading, pushback on on ventures that go beyond traditional and vanilla banking services, and stress tests.

In response, banks have not just ramped up compliance and risk management efforts, they have shuttered branches in risky geographies, retreated from market-making activities, cut formerly profitable correspondent banking relationships, and closed their doors to what some consider unsavory of high-risk businesses (from strip clubs to marijuana dispensaries).

Unfortunately for bankers, 2016 is likely to bring even greater regulatory scrutiny and rulemaking, with their inevitable demands for additional risk mitigation and controls. This year, however, there is a twist. As election-year politics heat up, so too are post-crisis calls to break up big banks, as are desires to resurrect the Glass-Steagall Act, a Depression-era law repealed by the Clinton Administration in 1999.

A modernized take on the legislation has a smattering of bipartisan support, initially introduced by Senators Elizabeth Warren (D-Mass.), John McCain (R-Ariz.), Angus King (I-Maine), and Maria Cantwell (D-Wash.). It would separate traditional banks—with savings and checking accounts insured by the Federal Deposit Insurance Corporation—from riskier financial institutions that offer services such as investment banking, insurance, swaps dealing, and hedge fund and private equity activities.

Enter the presidential candidates—specifically on Team Democrat—who are debating amongst themselves on the best way to bring the hammer down on still-vilified big banks.

Bernie Sanders, in particular, came out swinging in January. Pledging support for a new Glass-Steagall, he also laid out plans to, within the first 100 days of his administration, require that the Treasury Department establish a "Too-Big-to Fail" list of commercial banks, shadow banks and insurance companies whose failure would pose "a catastrophic risk to the economy" barring taxpayer bailouts. Within one year, these institutions would be "broken up."

"If a bank is too big to fail, it is too big to exist," he said. "If Teddy Roosevelt, the Republican trust-buster, were alive today, he would say 'break 'em up.' And he would be right."

His party rival, Hillary Clinton, has a similar, but far from identical approach. Clinton has been elusive on committing to a preemptive downsizing of the largest banks, but does pledge to let failing banks fail, dividing them into reasonable pieces through subsequent resolution proceedings.

Perhaps reacting to the fact it was repealed with her husband's signature, Clinton doesn't share Sanders' zeal for a return of Glass-Steagall, pointing out on the campaign trail that "shadow banks" like AIG and Lehman Brothers, contributing culprits of the financial crisis, were hardly the sort of big commercial banks that would be covered.

"It is election year, let's just hope to get out with as little damage as possible," says James Kaplan, a partner with the law firm Quarles & Brady. He frets that big-bank witch hunts are not exclusive to any political party in the current election cycle: "Banks provide a prime target for demagogues of every stripe."

The key to a safer banking system, Kaplan says, is not more regulation, but better risk management. "Clearly regulators, since the crisis, have been pushing the industry to make their compliance and risk management processes more robust," he says. "Certainly, because of Dodd-Frank, banks hold more capital, which is certainly a positive. Although it hasn't been tested, I think the Orderly Liquidation Authority is an advance. We at least have a resolution plan for failing banks now, and we didn't before."

"You can be big and have a great risk management approach, with board-level compliance and risk committees," he adds. "That's where you do the work that will protect your institution in an economic downturn or crisis. It should take place at the biggest bank, the smallest bank, and all of them in between."

A focus on compliance risk management will certainly be needed as the regulatory pressures on banks escalate in the New Year. In its Semiannual Risk Perspective, released in December, the Office of the Comptroller of the Currency itemized key concerns.

National banks and federal savings associations continue to face strategic challenges to growing revenues to meet target rates of return in a slow-growth, low interest rate environment, t he regulator warned. In response, many banks are easing credit underwriting standards and practices, and reaching for yield by loosening underwriting. Others have reached for yield to boost interest income with decreasing regard for interest rate or credit risk. Business operating models are under increasing pressure as bankers seek to launch new products, leverage technology, reduce staffing, outsource critical activities, and partner with firms unfamiliar with the bank regulatory environment. The OCC's warning: "Banks may not always adapt risk management and control processes to these changing business strategies."

Bank Secrecy Act, anti-money laundering controls, and the risks inherent with an expanded reliance on third-party relationships are perpetual, and increasing, concerns. And, lest they think otherwise, cyber-security sits near

the top of the risk pyramid. Banks may not be adequately incorporating resiliency considerations—including recovery from cyber events—into their overall governance, risk management, or strategic planning processes, the OCC report says.

"They understand that risk management is critical," Kaplan says of regulators (unlike the unnerving rhetoric of politicians). "Some of the things they are prescribing for the industry, like stress tests; enhanced capital and buffers; and better processes for risk assessment and compliance are all positive and should be done in the right way by banks." He is concerned, however, by what can easily become an onerous supervisory approach, especially in the hands of the Consumer Financial Protection Bureau.

"I'm worried that the prescriptive and punitive nature of their approach often casts too large a net," Kaplan says. "And, they may be susceptible to this new populism that says banks, particularly the big banks, are the problem and we have to ride hard on them. When they make the move into being too prescriptive in terms of what our business is like, especially the traditional banking business, it is damaging."

The CFPB, the youngest regulator and already one of the most important in the financial services industry, will be closely monitored by Benjamin Diehl of the law firm Stroock & Stroock & Lavan. Credit discrimination, mortgage lending disclosures, underwriting standards, and debt collection will continue to issues. In the coming months, despite an already aggressive enforcement posture, the CFPB could finally release comprehensive debt collection rules.

> "You can be big and have a great risk management approach, with board-level compliance and risk committees. That's where you do the work that will protect your institution in an economic downturn or crisis."
>
> James Kaplan, Partner, Quarles & Brady

The CFPB had expected that pre-rule activities for the two-year-old rule proposal would wrap up by the end of 2015.

"They will do something," Diehl says. "They have not forgotten about it and continue to pursue debt collection actions in the interim." He cites an additional concern: the continual blurring of the line between creditor and collector. The existing Fair Debt Collection Practices Act distinguishes between an original creditor and a debt collector.

California law, however, largely applies to both equally, an omen for what may come soon. "The industry is mindful of the need to monitor debt collection practices, but the distinction you see in the federal statutes is going to be increasingly diminished," Diehl says. That may be even more bad news for banks. ■

THE RISKS AHEAD

The following is from the Office of the Comptroller of the Currency's most recent "Semi-Annual Risk Perspective."

Primary supervisory concerns remain generally unchanged but evolve as competition for banking products and services increases. Strategic, underwriting, cyber-security, compliance, and interest rate risks (IRR) remain the OCC's top supervisory concerns. Risks associated with underwriting and cyber-security are increasing, while strategic, compliance, and IRR remain stable.

- Many banks continue to face strategic challenges growing revenues to meet target rates of return in a slow-growth, low interest rate economic environment. Many banks are reevaluating risk tolerances and business models.
- Banks are easing credit underwriting standards and practices, including structure, terms, pricing, collateral, guarantors, and loan controls in response to competitive pressures and growth objectives. This easing is particularly evident in high-growth loan segments, such as indirect auto, C&I, and multifamily CRE.
- The ongoing low interest rate environment poses additional concerns as banks reach for yield by extending asset duration trends. Deposit stability, a significant component of IRR modeling, is difficult to assess because of recent deposit inflows and the potential for increased competition for retail deposits. The low interest rate environment continues to pressure net interest margins as asset yields decline and the cost of funds has stabilized at historic lows.
- Cyber-threats, reliance on service providers, and resiliency planning remain concerns particularly in light of heightened global threats.
- Regulatory amendments and reliance on third parties continue to create challenges for bank consumer compliance functions. Bank Secrecy Act (BSA) risk also continues to increase as criminal behaviors evolve and criminals leverage technology innovations.

The OCC's NRC is monitoring several risks that warrant awareness among bankers and examiners. These risks have the potential to develop into broader systemic issues and may already raise concern at individual banks. The risks include:

- Exposure to oil- and gas-related sectors (e.g., service, office, and hotel sectors) as well as direct exposure to exploration and production firms.
- Increasing loan concentrations in multifamily CRE and non-depository financial institution sectors.
- The appropriateness of allowance for loan and lease loss (ALLL) levels and methods given loan growth, easing in underwriting, and layering of credit risk.
- Banks' ability to exit balance-sheet positions because of declining market liquidity.
- Implementation of the new integrated mortgage disclosure requirements under the Truth in Lending Act of 1968 and the Real Estate Settlement Procedures Act of 1974.

Source: Office of the Comptroller of the Currency

Non-GAAP Measures: The Pendulum Swings Back

by Scott Taub
Compliance Week **Columnist**

At a large financial reporting conference in December, several representatives of the Securities and Exchange Commission mentioned disclosures regarding non-GAAP financial measures as an area of concern. Over the past 15 years, the pendulum on how much enforcement was thought to be needed to regulate these measures has swung back and forth several times. It seems that once again, we are at a point where stronger regulatory actions may be coming.

Non-GAAP financial measures (also known as "Pro Forma" measures) are measures derived from the accounting records but calculated in a way that is not spelled out in Generally Accepted Accounting Principles. Perhaps the most common one is EBITDA (earnings before interest, taxes, depreciation, and amortization). SEC rules passed in 2003 require such measures be explained fully and reconciled to a relevant Generally Accepted Accounting Principles measure, but don't prohibit their use. The goal was to ensure that non-GAAP financial measures would only be used if they provided insight and were not used in a misleading manner, as such measures had sometimes been used prior to that time.

I have written about non-GAAP financial measures in this column, and I encourage companies to use them when they provide additional information beyond that which would be provided by GAAP measures. For example, the presentation of earnings excluding non-recurring items, earnings based on "products and services delivered" where revenue must be deferred due to uncertainties, and "core earnings" that exclude the effects of financing and investment of excess funds can all illuminate certain points that GAAP may not highlight quite as well. I hope (and believe) that it is not measures like these that are giving the SEC concern.

What I suspect the SEC is concerned about are non-GAAP disclosures that appear to have a large dose of "earnings as if things went better than they actually did" or "earnings as if certain things didn't happen, even though those things always happen." I have certainly seen plenty of both. If you recognize elements of your non-GAAP disclosures in the discussion that follows, think about making changes now, rather than waiting for the SEC to take action later.

Equal Prominence

SEC rules require that when non-GAAP financial measures are included in an SEC filing, presentation of the most comparable GAAP measure is required "with equal or greater prominence." While the "equal or greater prominence" provision does not explicitly apply to earnings releases, it is certainly a smart thing to do to avoid the perception that your measure is presented in a way that is meant to obscure GAAP results and thus mislead the markets.

Very often in press releases, and sometimes in periodic filings, the non-GAAP measure is clearly emphasized over the related Generally Accepted Accounting Principles measure. In fact, two minutes of clicking on Google search results while writing this column pulled up numerous press releases in which the non-GAAP measure was in the headline, but the GAAP measure was not. Once you've started like that, you aren't presenting the GAAP measure with equal prominence.

In other situations, the discussion of the non-GAAP results is several pages, while the GAAP results are covered in a paragraph that focuses only on the items adjusted out for the non-GAAP presentation. That implies that the non-GAAP measure is primary and the GAAP measure is secondary. Instead, I think companies would be wise to reverse the order and discuss everything in the analysis of GAAP earnings first, and then cover in the non-GAAP discussion those additional pieces of information that the non-GAAP financial measures highlight.

What's the Point?

The rules also require that when presented in an SEC filing (e.g., a Form 10-K or Form 10-Q), the disclosure must explain why management believes that the presentation is useful to investors. The idea here is to tell investors what insight the non-GAAP measure provides that GAAP measures don't. When the adjustments are for unusual items, this is pretty easy to do. But many companies routinely adjust for items that are recurring, and even predictable. The SEC staff has, in my view, been very flexible in terms of the explanations provided in the past, but I suspect that might change.

What I suspect the SEC is concerned about are non-GAAP disclosures that appear to have a large dose of "earnings as if things went better than they actually did" or "earnings as if certain things didn't happen, even though those things always happen."

For example, it is difficult to understand why a measure excluding normal, recurring, stock compensation expense is useful in most of the situations in which such a measure is presented. Why is it helpful to investors to know what your earnings would have been if you had been able to pay your managers and employees substantially less? Of course, some argue that this is an appropriate add-back because it is a non-cash item. But that's already handled by the operating cash flow section of the

Statement of Cash Flows.

I also see add-backs in non-GAAP measure calculations for things like consulting fees to private equity investors, amortization of debt discounts, losses on factoring of receivables, and other items that sound an awful lot like normal, recurring expenses. Adding these back typically sounds like a presentation of what earnings would have been if only expenses had been lower. Perhaps this might be appropriate if the company was receiving no benefit from the costs or losses, but that's rarely the case.

Don't sit back and wait. Now is the time to look at what kind of non-GAAP financial measures your company is using, and make sure the justification for them is well thought-out and fully-disclosed. Like many other areas of financial disclosure, improvements can be made without new edicts and rules.

It would not surprise me at all if the SEC staff began pushing harder on how these kinds of measures could possibly be useful. Moreover, if the SEC staff doesn't agree that the measures provide useful information, it isn't a big leap to consider them misleading, thereby exposing a company to other SEC action beyond just requiring that the non-GAAP measure be removed.

What's in a Name?

Next on my list, the rules require that non-GAAP measures be presented in a way that is not misleading. In the past, some companies have presented EBITDA as a non-GAAP measure, but defined that measure as something other than "Earnings Before Interest, Taxes, Depreciation, and Amortization." The SEC staff has pushed-back on non-standard usage of the term EBITDA, and now many companies use "adjusted EBITDA" as the name of the non-GAAP measure, excluding all of the things excluded from EBITDA plus other items. Since the adjustments often make this measure not comparable to EBITDA at all, it wouldn't surprise me if the SEC staff begins to object to using EBITDA in the name of a measure other than, well, EBITDA. At least this will make it easier for users of the financial information to know whether they are dealing with a "standard" non-GAAP measure or a customized one.

Too Many Adjustments

Combining the previous two topics, when a company presents "Adjusted EBITDA" or something similar, there are often many adjustments. In addition to interest, taxes, depreciation, and amortization, there is often stock compensation, restructuring charges, legal settlements, unusual items, merger costs, foreign exchange effects, and other items as well. Even if it were possible to explain why a measure of earnings without each individual item might be useful (some are non-recurring, some are non-core, some are due to market fluctuations instead of transactions, some are non-cash, etc.), it is extremely difficult, I think, to describe what the actual measure itself represents. It is not a substitute for cash earnings, since it adds back interest and taxes. It is not a measure that excludes non-recurring items, since it adds back depreciation and amortization. And so on.

I've come to understand that at least some analysts have no idea what to make of these measures. And if professionals who do this for a living are confused by measures that include so many different adjustments, I suspect that the SEC staff may take a harder look at them. I would advise companies that use these measures to be ready to explain not just why each individual adjustment is being made, but what the result actually measures. And if "Adjusted EBITDA" is the best way to describe it, I'm not sure you're there.

What's Next

While it is clear we should expect to hear more about non-GAAP financial measures from the SEC, I don't know in what form it will happen. Everything I have discussed here, though, is a concern that I think the SEC could raise under the existing rules, so I'm not necessarily expecting new rules.

Perhaps any Securities and Exchange Commission actions will just be in the form of additional comments and questions during routine filing reviews. However, I get the sense that it will be more than that. Perhaps some interpretative guidance from the Commission itself, rather than just staff action, or maybe even a concept release seeking input on what changes, if any, should be made to rules.

But don't sit back and wait. Now is the time to look at what kind of non-GAAP financial measures your company is using, and make sure the justification for them is well thought-out and fully-disclosed. Like many other areas of financial disclosure, improvements can be made to these financial measures without new edicts and regulations. ■

Scott Taub is the former deputy chief accountant of the SEC, and played a key role in the Commission's implementation of Sarbanes-Oxley and was responsible for the day-to-day operations in the Office of the Chief Accountant. Taub also served as the SEC observer on FASB's Emerging Issues Task Force and as chair of the accounting and disclosure standing committee of the International Organization of Securities Commissions.

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