uniqus

Point of View

Use of non-GAAP Measures

April 2023

Foreword

Dear clients and friends

In recent times, companies have increasinglybeen disclosing non-GAAP measures in their investor communication and capital markets related offering documents. The rationale for use of such non-GAAP measures is that they assist management to provide the users of financial information with an understanding of the key business drivers of the company and enable management to present a perspective to users, which might not be possible only through GAAP measures.

Considering the increasing use of non-GAAP measures by companies, the regulators have continued to focus on the same as a part of their supervisory agenda. For example, the Securities Exchange Commission (SEC) in the United States of America, vigilantly monitors the non-GAAP measures and metrics being published by companies. In India, the Securities and Exchange Board of India (SEBI), had in November 2022 approved certain rules to be followed by companies who use Key Performance Indicators (KPIs) metrics in the offering documents.

In this publication, we have analysed the use of non-GAAP measures by companies and provided our perspective, which we hope you will find to be informative. We look forward to continuing to engage with you.

Thank you.

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Existing global and local practices on monitoring of non-GAAP measures

GAAP stands for Generally Accepted Accounting Principles, which may include Indian GAAP, Ind AS, IFRS, US GAAP or any other prescribed accounting framework. GAAP lays down a uniform set of rules and formats, along with guidelines for recognition, measurement, and disclosures, that companies need to adopt for accounting and reporting purposes. On the other hand, non-GAAP is a tailored and customized set of performance measures adopted by companies to report their own performance. Non-GAAP measures are not defined by accounting standards.

Global practice

Globally, regulators have prescribed requirements and prohibitions for use of non-GAAP measures. Some of the salient requirements of such regulators are as follows:

- Undue prominence should not be placed on non-GAAP measures;
- Purpose and use of the non-GAAP measure should be clearly disclosed i.e. the usefulness of the non-GAAP measure to investors and the additional purpose, if any, for which management uses the non-GAAP measure should be clearly disclosed;
- Non-GAAP measures and related adjustments should be clearly and transparently labelled as such;
- Non-GAAP measures should not be misleading. Some examples where non-GAAP measures could be misleading is if they exclude normal or recurring cash operating expenses necessary for business operations, inconsistent presentation of non-GAAP measures between periods, exclusion of certain non-recurring charges but not of non-recurring gains or are based on individually tailored accounting principles; and
- There should be appropriate disclosure controls and procedures related to disclosure of non-GAAP measures.

Hence, it is essential to have defined principles for frequently used non-GAAP measures which will not only bring parity/consistency amongst companies but will also enable the investors to compare, understand and interpret them meaningfully.

Indian scenario

In India, the SEBI has issued regulation on KPIs included in Offer Documents, in November 2022, which requires companies to provide information on non-GAAP measures and metrics. This has been followed up with the Institute of Chartered Accountants of India (ICAI) issuing a technical guide, in April 2023, on disclosure and reporting of KPIs in Offer Documents.

As per the technical guide, the Issuer company and the lead merchant bankers are primarily responsible to ensure disclosure of KPIs in Offer Documents is in accordance with SEBI regulations. Further, KPIs disclosed in the Offer Document need to be approved by the audit committee of the Issuer company. KPIs disclosed in the offer document are required to be certified by the statutory auditor(s) or chartered accountants or firm of chartered accountants.

Whilst this is a positive move which will significantly enhance transparency and aid investors in decision making in the Indian context, basis our assessment of the filings which have taken place from 21 November 2022 till 15 March 2023, we noted that there was mixed compliance with the SEBI requirements on KPIs *(see UNIQUS Corner – Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2022 issued by Uniqus on 3 April 2023)*.

Further, whilst the SEBI and ICAI guidance provide a framework to the Issuer's management, its Audit Committee and the statutory auditors / Chartered Accountants associated with the Issuer on KPI preparation, reporting and certification, one may need to assess the incentives required to ensure absolute compliance with the issued regulation.

Analysis of filings by Indian companies

We have analysed the non-GAAP disclosures of the top 100 NIFTY companies based on market capitalisation as of 14 February 2023, for the annual year ended 31 March 2022 and the quarters ended 30 June 2022, 30 September 2022 and 31 December 2022, in their investor communications.

Findings

Use of non-GAAP measures

We noted a widespread use ofnon-GAAP measures and that the same is across sectors. As the data below indicates, 94 of the 100 companies have used non-GAAP measures. More particularly, we note that companies in the start-up/IPO stage have utilized non-GAAP measures as a tool, a lot more than traditional companies, in communicating their business performance to investors.

For the 100 companies analysed, the number of non-GAAP measures used by such companies is as follows:

Number of non-GAAP measures reported	Number of companies
3 or more	20
Less than 3	74
None	6

Nature of non-GAAP measures used by companies:

Frequently used non-GAAP measures are of the following nature:

Frequently used non-GAAP financial measures

- Earnings before interest, taxes, depreciation, and amortization (EBITDA)
- Adjusted EBITDA
- Adjusted EBITDA Margin
- Adjusted Revenue
- Funds from operations

Other non-GAAP financial measures

- Gross Margin
- Operating Profit/ Operating Income/ Operating
- Margin
- Adjusted Profit
- Contribution Margin
- Free Cash flows

Manner of determining non-GAAP measures

Within the non-GAAP measures, we noted that the manner of arriving at a non-GAAP measure differs by companies. For example, the adjustments made to GAAP measures, like profit before tax, to compute the non-GAAP measures varies across the companies, for instance, some companies have included other income as part of EBITDA while others have not. Further, companies have also adjusted GAAP measures to exclude, for example, non-operating gains and losses, restructuring charges, integration costs, stock compensation costs, impairment charges or gains and losses from asset dispositions in reporting financial results.

Reconciliation to GAAP measures

We also noted that majority of companies do not disclose reconciliation of non-GAAP measures to the nearest financial statement item, for example reconciliation between EBITDA and profit before tax, which would otherwise provide users with an understanding of how the non-GAAP measure is related to or reconciles to a GAAP measure.

Areas which could benefit from additional guidance / regulation / oversight of management

We note that the regulators and standard setters are making continual progress on requiring companies to explain the non-GAAP measures and metrics included in the financial statements / filings and capital market offering documents.

However, as a common practice, it is noted that non-GAAP measures and metrics are also widely used outside of the financial statements, for example, in investor presentations and analysts calls, an area which is currently not covered by the existing regulations. Considering that the use of non-GAAP measures and metrics is increasingly becoming an important mechanism for stakeholder engagement, there may be merit in the regulators and standard setters thinking about the potential framework to include such areas within its purview.

Also, from a company's perspective, there are specific aspects which they could consider. For example:

- does the company have a policy/ formal process of approving which non-GAAP measures will be used for engagement with external stakeholders;
- have those charged with governance at the company assessed and concluded that the proposed non-GAAP measure or metric is relevant in the context of the company's business;
- have those charged with governance at the company assessed and concluded that the proposed non-GAAP measure or metric is relevant in the context of the company's business;
- have those charged with governance at the company assessed whether the non-GAAP measure or metric being used by the company is consistent with the measures which competitor companies may be using i.e. the reporting company is not an outlier and in case it is an outlier, the reasons for the same are well deliberated;
- have those charged with governance at the company assessed and concluded that the proposed non-GAAP measure or metric is not misleading;
- have those charged with governance at the company ensured that the manner of determination of non-GAAP measure or metric is consistent on a period on period basis and that the same is not being frequently changed to meet short term business objectives;
- do those charged with governance understand and review how the non-GAAP measure reconciles to the nearest GAAP measure; and
- are internal controls implemented on quantifying the non-GAAP measure or metric.

Conclusion

Although GAAP measures are the prescribed standard to be followed in reporting to users, it may not be suitable for every company and its users. Hence, some adjustments may be required to be made to the GAAP measures to make it suitable to users, so as to enable the reporting company to effectively present its business results and performance.

From an investor perspective, prescribed standards and formats are required so as to rely on non-GAAP measure as part of reporting by any company. Until such measures are stringently applied in practice, companies should follow GAAP reporting in their accounting and reporting.

From managements perspective, a critical aspect for use of non-GAAP measures are the policies, processes and management controls over the disclosure of non-GAAP financial measures and operational metrices. Companies and audit committees need to consider designing control processes to ensure that procedures are in place regarding:

- compliance;
- consistency of preparation;
- data quality;
- accuracy of calculation;
- transparency of disclosure;
- review; and
- monitoring mechanism

These management controls may be included as part of risk control matrix considered for monitoring Internal Financial Control.

In conclusion, across all industries and sectors, it is true that effective use of non-GAAP measures requires careful, up-front, and thoughtful planning. This requires an investment to be made by the companies. However, that investment and compliance with the applicable rules and regulations, can allow management to effectively communicate their perspective on their company's financial position and/or performance and aid in meaningful stakeholder engagement.

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