



# Accounting Standard Transition Disclosures and Non-GAAP Measures

A Q&A With Mark Shannon of Crowe

With preparers counting down to the adoption dates of the new revenue recognition, leases, and credit loss standards, their attention is turning toward the expanded number of disclosures required by the standards, and toward transition-related disclosures mandated by SEC Staff Accounting Bulletin No. 74.

To learn more about how companies are preparing for these major accounting standard updates and about the SEC's emphasis on non-GAAP measures and operating metrics, Financial Executives International (FEI) spoke with Mark Shannon, a Crowe managing director.

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## FEI: How are companies approaching disclosures related to the new standards?

**MARK SHANNON:** In general, companies seem to be approaching the transition disclosures in a fairly systematic way. Many companies have involved stakeholders throughout their organizations, including from outside the financial reporting function. An important part of the adoption process is gathering the right data and designing the appropriate internal controls that will be needed to address their transition-related disclosures.

It's important to consider the three major standards together. I've heard the standards described as an avalanche or a tsunami of work that's coming down the road. As companies are thinking about these transition disclosures, they should be working on their adoption efforts concurrently; it's not a sequential effort where you can wait for revenue to be done, and then move on to leases, wait for that to be done, and then move on to credit losses.

Companies should be very focused on the three standards, where they're at in the process, and how they can draft their disclosures in a meaningful way to inform their investors about adoption status and how their financial statements might change upon adoption.

## FEI: How can people outside financial reporting support the adoption and disclosure efforts?

**MARK SHANNON:** Any time a company adopts an accounting standard, it should involve professionals outside the financial reporting function who will be doing the day-to-day work that is going to be accounted for under the new standard. The company will need a process to look at the new standard and to draft an accounting policy that is operable and understood by people outside the accounting function.

For example, if you think about revenue, it is difficult to come up with scenarios where the revenue standard is not going to affect an entity. Every entity has revenue. Granted, some entities might have revenue streams that are not within the scope of the new standard, but there's still work to be done with respect to determining the scope of the standard.

The breadth of the revenue standard goes throughout the organization. It starts at the sales function, and sales team members need to understand how the new revenue recognition standard is going to work and what they need to be doing to support complete and accurate financial reporting. Outside of the sales function, IT people will be involved. Perhaps systems changes will be needed to account for revenue under the new standard. And internal controls will be affected — any owner of a control within the revenue function needs to understand how the new revenue standard works.

And all of the relevant information these people outside of the financial reporting function have needs to be communicated to those in the financial reporting function who are in charge of drafting the transition disclosures, so the disclosures are accurate and complete, and represent information investors can use to understand the status of the entity's adoption efforts as well as the impact the standard will have on the entity's financial statements.

## FEI: As we get closer to revenue adoption, are we seeing more robust disclosures?

**MARK SHANNON:** Disclosures have evolved, in particular over the past year or so. Companies are finalizing their analyses with respect to each of their revenue streams. A certain revenue stream might be very easy to analyze under the new standard. Another stream might be more difficult, and more judgment might be required to analyze that standard. As preparers complete those analyses, their disclosures are evolving incrementally over time.

The SEC also has been quite active in the marketplace sharing messages about its expectations for disclosures. Companies have been modifying their disclosures to react to that messaging, and I think, both qualitatively and quantitatively, their disclosures have certainly become more robust over time.

## FEI: Is there any surprise about the number of companies saying the effects of the revenue standard won't be material?

**MARK SHANNON:** I've heard it suggested that somewhere in the range of two-thirds of registrants in the Standard & Poor's 500 index had said that the impact would be immaterial or was not yet known. That's a pretty big chunk of the registrant population. Given the revenue standard's wide-ranging breadth mentioned earlier, certainly, on its face, it feels surprising.

It's important to understand there's not going to be only quantitative impacts from the revenue standard. A number of new disclosures are going to affect the information that's presented to investors when they review financial statements. And if you think about its messaging, the SEC has noted this aspect as well.

In September 2016 at the Financial Accounting Standards Board's Emerging Issues Task Force (EITF) meeting, the SEC staff suggested new qualitative and quantitative disclosures they think are important with respect to all of the major standards. More recently, they've been observing in their speeches that many entities are expressing that the impacts of the new revenue standard are going to be immaterial, and they question whether or not those entities have thought about the standard's disclosure aspect.

Certain industries will face a larger quantitative impact than others, but all industries are going to have an impact from a disclosure perspective, so I think it is surprising that entities are stating that the disclosure aspect of adoption will be immaterial.

## FEI: If you look at leases, are there specific types of disclosures that companies should be making by now?

**MARK SHANNON:** As I mentioned, at the September EITF meeting, the SEC outlined some quantitative and qualitative disclosures that companies should be considering for all three of the major standards, so I think that's certainly a place to start. As registrants have focused on the new revenue recognition standard, some preparers may have given short shrift to the leasing standard and the credit loss standard.

For specific disclosures, the short answer is companies should disclose what they know about the standard, and they should disclose where they are in the process. A company that has very little in the way of leasing activities might be in a position now to make a statement that says, "We don't have a lot of leasing activities, and therefore we think the adoption will be immaterial."

Perhaps a different entity has completed its work with respect to gathering an inventory of its leasing contracts but hasn't worked through the inventory to quantify what the impact would be. That would be the type of qualitative information it would need to disclose.

Generally, the bottom line is that the disclosures should provide an accurate and complete picture to investors of where a company is at in the adoption process, what the quantitative impacts might be, and what the new disclosures are going to look like when the company actually adopts the standard.

## FEI: Changing to another topic, have we seen shifts in the use of non-GAAP measures over the past year?

**MARK SHANNON:** Definitely. We're slightly more than a year past the SEC's issuance of its Compliance & Disclosure Interpretations (C&DIs) that dealt with non-GAAP measures, and preparers have reacted to those.

Generally, preparers have thought more critically about the types and volume of measures they're using, and a significant concept within the C&DIs was prominence. And prominence is an area where there have been a lot of shifts over the past year since those interpretations were issued.

On the whole, preparers have looked at those interpretations and made some changes. Perhaps they've changed the way they've reconciled a specific non-GAAP measure, or perhaps they've discontinued the use of a measure.

I think the changes were driven not only by the C&DIs but also by an ongoing dialogue preparers have had with audit committees about why companies are using these measures. Why are the measures providing useful information to our investors? Are they in compliance with the new disclosure interpretations?

There has also been a dialogue between companies and auditors as well as an ongoing dialogue between preparers and regulators, primarily through the comment letter process. In general, a lot of communications are occurring in the marketplace.

**FEI:** Similarly, we're seeing more attention being paid to operating metrics. Could we define, within this context, what is an operating metric?

**MARK SHANNON:** Sometimes operating metrics are referred to as key performance indicators (KPIs), and people generally use those terms interchangeably. Either way, operating metrics are key pieces of operational data or ratios developed from key pieces of operational data. Many companies use these types of measures to enhance an investor's understanding of their results.

An example of an operating metric would be, in the retail industry, the number of stores that are open or sales per square foot. The number of stores is a piece of data that is not necessarily in the accounting records but is operational in nature. A same-store-sales metric takes a piece of GAAP – sales – and breaks that into operational buckets. What was the revenue for that same store? How did it grow? Similarly, sales per square foot would take the GAAP measure and apply a ratio to it that's based on a piece of operating data for a particular entity.

**FEI:** How would you compare a KPI or an operating metric to a non-GAAP measure?

**MARK SHANNON:** It is common to confuse the two, and it's probably easiest to start by defining a non-GAAP metric. Item 10 of Regulation S-K defines a non-GAAP measure as a measure that either includes or excludes an amount from a GAAP metric. Start with a GAAP metric and either add something to it or take something away from it that turns it into a measure that is not GAAP.

Operating metrics, on the other hand, don't have a definition within SEC rules or regulations, but using the earlier examples, nothing is included or excluded from number of stores. It's a number that comes from counting the number of stores. Similarly, in determining sales per square foot, sales are sales. Just taking sales and cutting the GAAP sales figure into different slices allows users to think about it in a way different from a total sales figure.

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## FEI: Has the SEC expressed any concerns about these operating metrics?

**MARK SHANNON:** In some respects, the SEC's messaging about operating metrics is fairly similar to some of its messaging about non-GAAP measures. In May, SEC Chief Accountant Wesley Bricker delivered a speech in which he made some remarks about operating metrics, and he pointed out that operating metrics include a risk of management bias, or have the potential to be misleading.

As already noted, for operating metrics there really is no definition, and one operating metric that a particular entity presents might be different from a similarly titled operating metric that another entity presents. No mechanism exists for standard-setting due diligence around these types of metrics. So Bricker pointed out that in thinking about operating metrics, there really should be some internal processes in place. People are needed in an oversight role, whether that's the audit committee or other functions within financial reporting, to help mitigate those risks.

Entities need to make sure they fully understand how their operating metric is defined and make sure that it's communicated clearly to investors. They need to think about not only transparency but also consistency over time, so the way an operating metric is calculated shouldn't be changing unless that change is clearly disclosed.

Companies also need to have appropriate disclosure controls and procedures for how they develop operating metrics and how those operating metrics are included in their disclosure documents. Bricker suggested that preparers think about getting input on operating metrics from those outside the financial reporting function.

## FEI: Is the audit committee playing a larger role in transition disclosures?

**MARK SHANNON:** An overarching principle through transition disclosures as well as non-GAAP and operating measures is the oversight function of the audit committee. The SEC's messaging about the role of the audit committee recently has emphasized the importance of making sure the audit committee is discharging its oversight role and not getting bogged down in things that perhaps are outside of its oversight mandate.

The audit committee needs to focus on executing its mandate of being the gatekeeper over the financial reporting function and ensuring that an entity's financial statements and disclosures are complete, accurate, and communicating appropriate information to investors in a meaningful way.



## Learn More

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