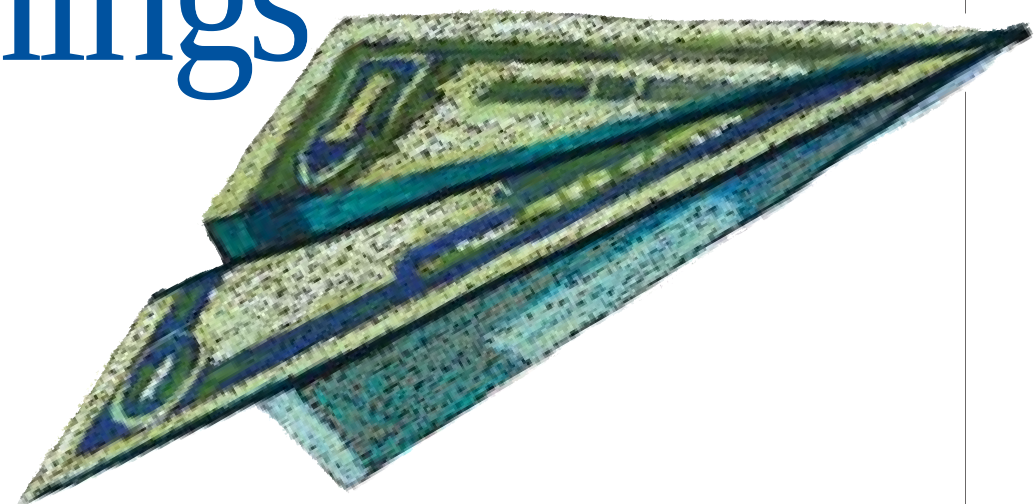
Goodbye "Pro Forma" Earnings



The SEC tightens non-GAAP financial reporting.

BY MARK P. HOLTZMAN, CPA; ROBERT FONFEDER, CMA, CPA; AND J. K. YUN, CPA

REMEMBER the euphemisms for incomparable, non-GAAP reporting of earnings before one-time charges? Operating income. Pro forma earnings. Income before one-time charges. Street earnings. Or, as Lynn E. Turner, former chief accountant of the Securities & Exchange Commission (SEC), called it, "everything but bad stuff." Even while the business press and regulators attacked this financial reporting as biased and misleading, more companies used it.

Computer Associates, for example, said in its 2001 earnings news release that "Operating earnings per share (diluted) increased 27% to $3.28 from last year's $2.59, excluding special charges and acquisition-related amortization costs." Toward the bottom of the earnings release, Diluted Earnings per Share is reported as only $2.74. But even this is "Earnings Before Special Charges" and excludes more than $800 million in charges related to acquisitions, mostly from in-process R&D. The bottom of the last table in the news release reveals that, according to GAAP, the company earned just $1.25 per share.

ILLUSTRATION: JONATHAN EVANS/ARTVILLE

With blaring headlines, the business media brought public—and regulators'—attention to these abuses that "pump earnings," "fool investors," "confuse," and even cause stock markets to fall. The charge? Pro forma earnings measures often omit expenses like depreciation, goodwill amortization, restructuring charges, unusual gains and losses, and stock option compensation-related expenses, which artificially inflates income and misleads investors.

Now, as mandated by the Sarbanes-Oxley Act of 2002, the SEC has introduced new rules designed to end abuses of non-GAAP earnings disclosures.

NEW RULE

The Sarbanes-Oxley Act of 2002 said the SEC:

> *shall issue final rules providing that pro forma financial information…shall be presented in a manner that (1) does not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the pro forma financial information…not misleading, and (2) reconciles it with the financial condition and results of operations…under GAAP.*

In January 2003, the SEC released its final rule, "Conditions for Use of Non-GAAP Financial Measures," which became effective March 28, 2003. The new rule created Regulation G, covering all public disclosures, defining non-GAAP financial measures, and creating standards for their disclosure. It added new requirements for earnings announcements and reporting non-GAAP measures in SEC filings. It also revised Regulation S-K to prohibit disclosing certain non-GAAP measures in filed documents. Furthermore, the rule requires earnings releases to be filed with the SEC on Form 8-K.

Regulation G defines the term "non-GAAP financial measure" as any numerical measure of historical or future financial performance, financial position, or cash flows that excludes amounts that would be included in analogous GAAP measures. Non-GAAP financial measures might also *include* amounts that would be *excluded* from analogous GAAP measures. For example, Westwood One, Inc. reported "operating cash flow" in the first quarter of 2001 as operating income plus depreciation and amortization. This "operating cash flow" would be considered a non-GAAP financial measure under Regulation G because it ignores the usual depreciation and amortization that would be subtracted in arriving at GAAP operating income. On the other hand, because commonly used metrics such as "backlog" have no analogous GAAP measures, they aren't classified as non-GAAP financial measures. Projections of future revenues and expenses, as long as they are computed using GAAP amounts and techniques, are also not considered to be non-GAAP financial measures.

REGULATION G REQUIREMENTS

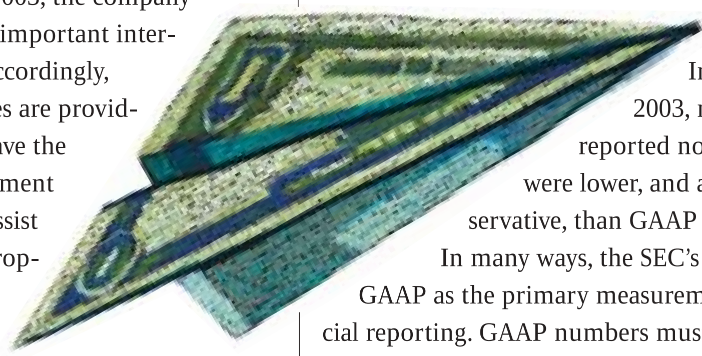
For any public disclosure of a non-GAAP financial measure, companies must present the most directly comparable GAAP-based measure along with a reconciliation between the two figures. Furthermore, disclosures of non-GAAP financial measures may not omit any material facts that would otherwise cause the disclosures to be misleading. For example, if calculation of the non-GAAP measure changed from prior years, investors should be informed of the changes. The previously issued SEC Regulation FD (Fair Disclosure) requires that any private disclosures be made public. Now, any resulting public disclosures that include non-GAAP measures must be accompanied by or provide the location of the related GAAP measures and reconciliations.

Under the new rule, earnings announcements need to be filed with the SEC as Item 12 of Form 8-K within five days of their public release, regardless of whether they contain non-GAAP financial measures. In addition to the requirements of Regulation G, earnings announcements now must explain why management believes that a disclosed non-GAAP financial measure provides useful information to investors. Such a justification should be substantive. It would be insufficient to make a boilerplate statement saying the measure provides useful information to investors. The earnings announcement must also disclose any additional ways in which management uses each non-GAAP financial measure.

Essentially, the SEC is increasing transparency of earnings announcements by requiring companies to explain how a non-GAAP measure is calculated and why it's useful. If a company can't demonstrate why the measure is useful and how and why management uses it, then they can't present it. For example, in its first-quarter earnings release for 2003, Eastman Kodak Company defines and reconciles non-GAAP measures such as "Income (loss) from continuing operations, excluding nonoperational items," "Operating cash flow," and "Free cash flow" (and certain calculations based on non-GAAP financial measures) to GAAP numbers.

SEC FILINGS

SEC filings such as Forms 10-K, 10-Q, and 8-K must meet all of the requirements of Regulation G and the additional requirements of earnings announcements. Companies must disclose analogous GAAP numbers, provide a reconciliation to the analogous GAAP numbers, and justify the use of non-GAAP measures, among other requirements. For example, in Kodak's Form 8-K, filed with the SEC on April 23, 2003, the company said: "These measures represent important internal measures of performance. Accordingly, where these non-GAAP measures are provided, it is done so that investors have the same financial data that management uses with the belief that it will assist the investment community in properly assessing the underlying performance of the company on a year-over-year and quarter-sequential basis." In further 8-K disclosures, Kodak describes the usefulness of each measure in detail.



In SEC filings, there are additional limitations on including non-GAAP financial measures. Non-GAAP financial measures may not:

◆ Be given prominence over GAAP numbers. For example, companies may not discuss non-GAAP results in great detail while offering only terse mention of GAAP figures.

◆ Exclude any charges or liabilities that would require cash settlement (except earnings before interest, taxes, depreciation, and amortization (EBITDA) and earnings before interest and taxes (EBIT)) from non-GAAP liquidity measures. For example, companies may not adjust non-GAAP earnings for severance costs because such costs would be settled in cash.

◆ Be adjusted to eliminate items deemed to be nonrecurring, infrequent, or unusual if either (1) there was a similar charge or gain within the prior two years, or (2) the charge or gain is reasonably likely to recur within two years for non-GAAP performance measures. For many companies, this requirement would eliminate restructuring costs as a reconciling item in arriving at a non-GAAP performance measure.

◆ Be inserted into GAAP financial statements or in the accompanying notes.

◆ Be inserted into any pro forma financial information required under Article 11 of Regulation S-X.

◆ Use titles the same as or similar to GAAP titles. For example, a non-GAAP financial measure called "operating earnings" may not be used because it is confusingly similar to "operating income." A preferable term would be "adjusted operating earnings."

A BRAVE NEW WORLD

In today's post-scandal environment, managers and regulators are working hard to restore and build public confidence in the quality of financial reporting. Some companies, such as Intel and Sun Microsystems, have discarded non-GAAP earnings altogether. In the first quarter of 2003, more companies reported non-GAAP results that were lower, and apparently more conservative, than GAAP net income.

In many ways, the SEC's new rule reaffirms GAAP as the primary measurement system for financial reporting. GAAP numbers must be emphasized over non-GAAP measures, and departures from GAAP must be clearly explained. But the rule continues to give corporate managers enough flexibility to design and provide useful, company-specific measures of performance in earnings releases.

Most important, the new rule is intended to provide investors with more meaningful and balanced disclosures when non-GAAP measures are used and help ensure that investors aren't misled. It will likely lead to stronger disclosures that are more carefully prepared and presented and help curb biased or misleading earnings releases. More public confidence in the quality of financial reporting should follow. ■

The authors thank Christine Q. Davine, national office partner with Deloitte & Touche, for her insight and assistance in preparing this article.

The authors are grateful for the financial support of a Summer Research Grant from the Frank G. Zarb School of Business at Hofstra University.

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