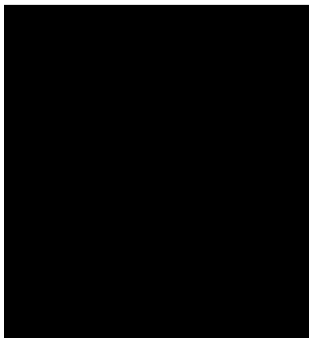


DO LARGE AUSTRALIAN COMPANIES EMPHASISE NON-GAAP FINANCIAL MEASURES OVER STATUTORY NET PROFIT (GAAP) IN ANNUAL REPORTS?

Large companies' frequent focus on non-GAAP financial measures ('pro forma' earnings), rather than statutory net profit or GAAP measures, raises concerns about the potential for misinformed financial decision-making. Despite recommendations by ASIC and Finsia, in Australia there is no consistency in the calculation of non-GAAP financial measures or in their reconciliation to statutory net profit. Our study of the disclosures and the reconciliation to GAAP earnings by the largest 50 Australian listed non-mining companies finds considerable variations in reporting practices from highly transparent reconciliations to what appears to be considerable secrecy.¹



ROBYN CAMERON is a Lecturer in the Department of Accounting, Finance and Economics Griffith Business School, Gold Coast campus, Griffith University. Email: r.cameron@griffith.edu.au

MAJELLA PERCY is an Associate Professor in the Department of Accounting, Finance and Economics, Griffith Business School, Nathan campus, Griffith University. Email: m.percy@griffith.edu.au

PETA STEVENSON-CLARKE is a Lecturer in the School of Accounting, City campus, RMIT University. Email: peta.stevenson-clarke@rmit.edu.au

In March 2009, Finsia and the Australian Institute of Company Directors issued a Policy Guidance Paper on disclosures about non-GAAP financial measures (AICD 2009). The stated intention was to 'encourage companies to provide, in a responsible and consistent manner, additional non-statutory information about underlying profit ... in a table that shows and explains adjustments made to the statutory profit'.

In the United States, concern about the potential for pro forma or non-GAAP financial measures to mislead investors (Jennings & Marques 2001, p. 2), resulted in the *Sarbanes-Oxley Act 2002* requiring that the Securities and Exchange Commission (SEC) issue regulation related to this issue. The SEC issued Regulation G (effective 28 March 2003), which prohibits disclosure of 'a non-GAAP financial measure and related disclosure that is misleading', and requires 'quantitative reconciliation of the non-GAAP measure to the most directly comparable GAAP measure' (Nichols, Gray & Street 2005, p. 30).

These examples indicate concern by regulators and the profession about the disclosure of non-GAAP financial measures. Although earlier research (Bradshaw & Sloan 2002; Bhattacharaya et al. 2003) provided evidence that non-GAAP financial measures are more value relevant than statutory net profit or GAAP earnings, recent research finds that investors can be misled by non-GAAP or pro forma financial measures. For example, Zhang and Zheng (2011) reported that prior to Regulation G, mispricing of pro forma earnings was limited to firms with low reconciliation quality, with no evidence of mispricing for firms with high reconciliation quality. After Regulation G, they found no evidence of mispricing at all, which would suggest that better reconciliations reduce the extent of mispricing.

Marques (2010) reported that managers strategically give more prominence to non-GAAP measures than to GAAP figures when the GAAP number falls short of a benchmark but the non-GAAP earnings number does not. According to Marques

(2010, p. 119): 'This disclosure strategy may influence the perception of the firm's financial results'. As well, Jennings and Marques (2011) provide evidence that prior to Regulation G, but not after it, investors were misled by disclosures on non-GAAP or pro forma financial earnings by firms with weaker corporate governance. Earlier, Lougee and Marquardt (2004) reported that the higher the pro forma earnings relative to GAAP earnings, the lower the future returns and Doyle, Lundholm and Soliman (2003) found that excluding certain transitory or non-recurring expenses (as deemed by the company) leads to predictably lower future cash flows and that investors do not fully assimilate the lower future cash flow implications.

Bowen, Davis and Matsumoto (2005, p. 1011) reported that a subset of firms reporting pro forma profits but GAAP losses placed more emphasis on pro forma earnings and less emphasis on GAAP earnings. Greater emphasis on pro forma earnings results in a stronger market reaction to the surprise in pro forma earnings reported in the press releases. The authors concluded that their results suggest that managers appear to be deliberate in the metrics they emphasise in their press releases.

Our results provide evidence that the provision of non-GAAP or pro forma financial earnings in the narrative sections of corporate annual reports is a common occurrence, with the emphasis being more frequently on pro forma earnings in preference to statutory net profit than vice versa.

Managers of firms provide non-GAAP or pro forma financial earnings for many reasons, for example, to report underlying earnings that are likely to recur, or to provide a more positive image of the company by removing expenses that they claim will be transitory. We address the following research questions in our study: (1) Which earnings metric(s) is emphasised by management in the annual report? (2) Where pro forma earnings are emphasised, is reconciliation to GAAP net profit provided within the annual report? (3) Where a pro forma earnings metric is emphasised, does it convey a different view of the firm's performance? Our research is partly motivated by Schrand and Walther (2000), who reported that managers disclose information in an attempt to influence stakeholders' perceptions of earnings, which suggests that managers may act opportunistically in choosing which earnings measures to disclose.

Pro forma earnings disclosures by US companies most frequently relate to either quarterly earnings announcements or the mandated Management Discussion

and Analysis (MD&A) section of company annual reports. However, in Australia, these disclosures typically appear in the largely unregulated narrative sections of the corporate annual report. Although unaudited, except to the extent that the auditor has to read for consistency with the financial statements,² such voluntary disclosures may draw credibility from their proximity to the auditor's report (Neu, Warsame & Pedwell 1998), enhancing their capacity to influence financial decision making.

A review conducted by the Australian Securities and Investments Commission (ASIC 2010) on the 30 June 2010 annual reports of 50 of the top 200 Australian listed entities observed that 61 per cent of sample entities made disclosures of alternative profit measures within the management commentary section of the annual report. Further, approximately two-thirds of these entities gave more prominence to the alternative profit figure than the statutory net profit, while approximately half failed to provide reconciliation between their alternative profit figure and statutory profit. This is consistent with our findings which cover the prior three-year period.

Our results provide evidence that the provision of non-GAAP or pro forma financial earnings in the narrative sections of corporate annual reports is a common occurrence, with the emphasis being more frequently on pro forma earnings in preference to statutory net profit than vice versa. We observe that considerable variation occurs in the ways that pro forma earnings are measured, and in the extent to which reconciliation to statutory net profit is available. More often than not, emphasised pro forma earnings exhibit a better year-on-year trend than statutory net profit, which could indicate management emphasises the earnings measure that presents the company's financial performance in the best light. These findings have implications with regard to the comparability of financial performance both across accounting periods and between companies.

Evidence to date

The empirical evidence to date is mixed in terms of the effectiveness of Regulation G in the United States in reducing the bias towards reporting higher pro forma earnings (relative to GAAP) and in terms of the potential for investors to be misled by such disclosures. While Nichols, Gray and Street (2005) found that pro forma earnings (for a sample covering 1999 to 2004) were significantly and materially higher than the comparative GAAP earnings, Johnson and Schwartz (2005) cast doubt on the notion that investors are, on average, misled by pro forma earnings disclosures.

Using an experimental approach (see, for example, Frederickson & Miller 2004), behavioural research has demonstrated that presenting pro forma earnings before GAAP earnings influences non-professional investors' judgements but not those of analysts. The earlier study by Moser (1989) found that when subjects were required to

make an assessment about whether the earnings of a company would increase, their assessments were influenced by the order of the information provided to them.

More recently, Elliott (2006) showed that the emphasis placed by management on pro forma earnings, rather than the mere disclosure of pro forma earnings, influences non-professional investors' judgements and decisions, although this is mitigated by the presence of a quantitative reconciliation. Analysts, however, tended to view pro-forma earnings as more reliable in the presence of a quantitative reconciliation.

In a study of media releases using a sample of the top 20 Australian listed companies, Ernst & Young (2008, p. 5) report that there are variations in the number of earnings figures reported, and also variations in the terminology used to describe the adjustments made by companies to earnings. While there was 'consistency in the types of adjustments made' (p. 5), with the most common form of adjustments pertaining to significant or one-off adjustments and IFRS related-matters, these findings related primarily to media releases rather than annual reports. In that respect, there has been little academic research conducted in Australia on these strategic disclosures, either in relation to their emphasis and the placement of the quantitative reconciliation within the annual report, or any associated behavioural implications.

Australian evidence

We investigate the prominence of pro forma earnings disclosures and the availability of their reconciliation to statutory net profit (GAAP earnings) for the years 2007, 2008 and 2009. Our sample included the Top 50 (by market capitalisation) Australian public non-mining companies as at 30 June 2009. From sample companies' annual reports we hand-collected data pertaining to statutory (GAAP-based) net profit and various pro forma earnings measures for the years 2006³ to 2009. Thus we established a dataset comprising 200 firm-years.

Analysis of this dataset was undertaken to classify firms on a year-by-year basis to address the following three research questions: (1) Which earnings metric(s) is emphasised by management in the annual report? (2) Where pro forma earnings are emphasised, is a reconciliation to GAAP net profit provided within the annual report? (3) Where a pro forma earnings metric is emphasised, does it convey a different (compared with GAAP net profit) view of the firm's performance?

Illustrative of pro forma earnings disclosures adopted by Australian companies, on page 1 of Rio Tinto's 2008 annual report the Highlights state, 'Record underlying EBITDA of US\$22,317 million, 60 per cent above 2007 ... Record underlying earnings of US\$10,303 million, 38 per cent above 2007 ... Net earnings were US\$3,676 million, 50 per cent below 2007'. However, the Group GAAP income statement reported a profit of US\$4,609 million, which was almost 60 per cent lower than the 2007 figure. It is not until page 23

of the annual report that 'Underlying earnings' is defined:

Underlying earnings is the key financial performance indicator used across the Group. It is a measure of earnings that provides insight into the underlying business performance of the Group's operations. Items excluded from net earnings to arrive at underlying earnings are explained in note 2 of the 2008 full financial statements.

Perusal of note 2 of the financial statements reveals that the difference between Rio Tinto's underlying earnings and statutory net profit was almost exclusively due to net impairment charges of US\$7,579 million being excluded from so-called underlying earnings.

Our first research question is: which earnings metric(s) is emphasised by management in the annual report? Table 1 shows the frequency of disclosure for various pro forma earnings measures.

While all of the 50 largest Australian non-mining companies in our sample disclosed pro forma earnings in the narrative sections of their 2008 and 2009 annual reports and 48 of the 50 in their 2007 annual reports, the degree of emphasis and actual computations varied widely. Table 1, column 1 shows that the most frequently disclosed metrics were variants of EBIT (Earnings Before Interest and Tax) or EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation) followed by variants of NPAT (Net Profit After Tax, column 2). But the adjustments to EBIT, EBITDA or NPAT vary from one company to another, and sometimes from one year to the next for the same company. The next most frequent performance measure was 'underlying earnings' followed by 'normalised' earnings. These measures were sometimes based on either EBIT/EBITDA or NPAT, although some were variants of pre-tax profits or (in one case) cash flows. Occasionally, 'underlying' or 'normalised' earnings were provided without any mention of how this measure had been calculated. The 'other' classifications referred to in Table 1 included firm-specific measures such as insurance profit and proportionate earnings where assets were not wholly owned.

The degree of emphasis on pro forma earnings, relative to GAAP net profit, was assessed by considering which measure was discussed first, together with the relative emphasis in the management discussion. As some degree

While all of the 50 largest Australian non-mining companies in our sample disclosed pro forma earnings in the narrative sections of their 2008 and 2009 annual reports and 48 of the 50 in their 2007 annual reports, the degree of emphasis and actual computations varied widely.

TABLE 1: Number of companies disclosing various measures of pro forma earnings*

Year	1 EBIT/EBITDA variations	2 NPAT excluding...	3 Underlying earnings	4 Normalised earnings	5 Other classification
2007	14	12	4	2	16
2008	16	9	6	4	17
2009	17	12	8	2	15

* The total number of disclosures exceeds the number of firms due to companies disclosing more than one measure of pro forma earnings.

TABLE 2: Number of companies emphasising pro forma earnings vs emphasis on GAAP NPAT

Year	1 Emphasis on Pro Forma Earnings	2 Emphasis on GAAP NPAT	3 Focus on non- earnings measures	4 Total
2007	31 (5 US-listed)	16 (1 US-listed)	3	50
2008	34 (5 US-listed)	14 (1 US-listed)	2	50
2009	35 (5 US-listed)	14 (1 US-listed)	1	50

TABLE 3: Number of companies reconciling emphasised pro forma earnings to NPAT (Column 1 of Table 2)

Year	1 Reconciliation to GAAP NPAT	2 No reconciliation to GAAP NPAT but trail provided	3 No reconciliation or trail provided to GAAP NPAT	4 Total
2007	22	7	2	31
2008	22	9	3	34
2009	24	7	4	35

of subjectivity was required in making this assessment, two researchers independently assessed each firm and in the few cases where there was initial disagreement, the cases were reconsidered and discussed until consensus was reached. Table 2 presents the results of this analysis, and suggests a slight shift in emphasis from GAAP net profit to pro forma earnings over the three-year period analysed. Table 2 shows that in 2007, 31 companies emphasised pro forma earnings as compared with 16 emphasising GAAP net profit. By 2009 the relative proportions had increased to 35 companies emphasising pro forma earnings and 14 emphasising GAAP net profit.

The second research question we address is: Where pro forma earnings are emphasised, is reconciliation to GAAP net profit provided within the annual report? Table 3 gives the number of sample companies: providing a reconciliation (Column 1); providing no reconciliation but providing a 'trail'⁴ enabling a reconciliation (Column 2);

and where no reconciliation or trail is provided (Column 3). This is of importance given prior (US) research findings (Elliott 2006) that the reporting of a quantitative reconciliation can mitigate the influence of pro forma earnings disclosures on non-professional investors' judgements and decisions.

We found that most companies provided either a full reconciliation or a sufficient 'trail' that such reconciliation could be determined by the reader. Nevertheless, there were a small number of cases in which the emphasised pro forma figure could not be reconciled to GAAP profit due to insufficient information on how the pro forma figure had been calculated.

Our third research question is: Where a pro forma earnings metric is emphasised, does it convey a different (compared with GAAP net profit) view of the firm's performance? We addressed this question in two

ways. First, we calculated the difference between the emphasised pro forma earnings measure and GAAP net profit and compared this difference with the absolute value of GAAP net profit (see Table 4). This provides a ‘feel’ for the magnitude of the difference between the two performance measures. Second, we calculated the annual change in both pro forma earnings and GAAP earnings to determine whether the trend in pro forma earnings reflected better financial performance than the trend in GAAP net profit.⁵ This was done to provide some insight into whether management might be choosing to emphasise the earnings measure that presents firm performance in the best light. Table 5 presents the results of this analysis.

With reference to the data presented in Table 4, we constructed (somewhat arbitrarily) seven categories representing varying magnitudes of the scaled (by absolute value of GAAP net profit) difference between emphasised pro forma earnings and GAAP net profit, and then determined the number of companies falling into each category. For the years 2008 and 2009 (after the global financial crisis), the number of companies making net positive adjustments to net profit, to derive a pro forma earnings measure that is emphasised, is considerably greater than the number of companies making net negative adjustments, particularly with respect to the larger impact adjustments. The magnitudes (not tabulated) of the net negative adjustments ranged from 1 per cent to 92 per cent of the absolute value of reported net profit. The magnitudes (not tabulated) of the net positive adjustments ranged from zero to more than 1000 per cent of the absolute value of reported net profit. The most common types of adjustments related to gains/losses on disposal of assets, business restructuring costs, depreciation/amortisation and impairment losses.

While the data presented in Table 4 provide an indication of the significance of the adjustments that may be made in deriving pro forma earnings, investors may also be influenced by comparisons with figures from the previous year. We therefore calculated the year-on-year trends for both statutory and pro forma earnings. Panel A of Table 5 reports the number of sample companies for which

emphasised pro forma earnings showed a better trend than GAAP net profit, while Panel B reports the number of sample companies for which emphasised pro forma earnings showed a worse trend than the reported GAAP net profit.

Panel A indicates that in both 2008 and 2009, in more than two-thirds of cases which emphasised pro forma earnings growth was better than that of statutory net profit. (In 2007, there was an equal split). While these figures provide limited evidence of selective reporting, we observed that in a number of cases where emphasised pro forma earnings exhibited a worse trend than net profit, the emphasised metric had shown a better trend (relative to net profit) in the previous year. For example, in 2008 there were eight companies that emphasised pro forma earnings that exhibited a worse trend than statutory net profit. However, in three of these cases the pro forma measure had shown a better trend than net profit in 2007 (suggesting that the emphasis on the pro forma measure was for the sake of consistency of reporting), leaving only five cases that could be construed as examples of genuinely informative reporting. In 2009, of the 11 companies emphasising pro forma earnings showing a worse trend than statutory net profit, seven had shown a better trend for pro forma earnings (relative to net profit) in either 2008 and/or 2007. We therefore conclude that it is probably only in a minority of cases that pro forma earnings are emphasised for genuinely informative reasons.

We also questioned whether companies were emphasising positive pro forma earnings in an attempt to focus attention away from negative statutory net profit figures. While we identified only one such case in 2007, in 2008 there were five cases, with the number of cases increasing to eight by 2009 (see Table 6). By contrast, there were no cases of the opposite situation occurring (that is, of companies emphasising negative pro forma earnings where statutory net profit was positive). These findings reinforce our belief that management may be seeking to engage in a form of ‘impression management’ by emphasising the earnings measure that presents the company’s financial performance in the best light.

TABLE 4: Magnitude of the difference between emphasised pro forma earnings (Column 1 of Table 2) and NPAT, as measured by (pro forma – NPAT) / NPAT

Number of companies	-100% to -50.1%	-50% to -10.1%	-10% to -0.1%	0 to 10%	10.1% to 50%	50.1% to 100%	>100%	Total
2007	2	10	3	4	6	2	4	31
2008	3	3	1	8	5	5	9	34
2009	2	1	2	5	6	10	9	35
Totals	7	14	6	17	17	17	22	100

TABLE 5: Number of companies emphasising pro forma earnings trending better than GAAP NPAT vs pro forma earnings trending worse than GAAP NPAT

Year	Panel A: Emphasised pro forma earnings shows better trend than GAAP NPAT	Panel B: Emphasised pro forma earnings shows worse trend than GAAP NPAT
2007	15	16
2008*	25	8 [†]
2009*	23	11 ^{††}

* For one company, emphasised pro forma earnings and NPAT showed identical trends.

† In three of these cases, emphasised pro forma earnings showed a better trend than NPAT in 2007.

†† In seven of these cases, emphasised pro forma earnings showed a better trend relative to GAAP NPAT in either 2008 and/or 2007.

TABLE 6: Number of companies emphasising positive pro forma earnings where GAAP NPAT negative vs number of companies emphasising negative pro forma earnings where GAAP NPAT positive

Year	Panel A: Emphasised pro forma earnings positive, GAAP NPAT negative	Panel B: Emphasised pro forma earnings negative, GAAP NPAT positive
2007	1	0
2008	5	0
2009	8	0

These findings reinforce our belief that management may be seeking to engage in a form of ‘impression management’ by emphasising the earnings measure that presents the company’s financial performance in the best light.

Conclusion

This study has highlighted that the provision of pro forma earnings in the narrative sections of the annual report is a common occurrence. The most frequent performance measures disclosed were modified EBIT, EBITDA or NPAT, with the types of modifications varying from one company to another and sometimes from one year to the next for the same company. More companies emphasised these pro forma earnings in preference to the statutory net profit than vice versa. In approximately 60 per cent of all firm-years, the emphasised pro forma earnings exhibited a better year-on-year trend than the statutory net profit, while in 14 per cent of firm-years the emphasised pro forma earnings figure was positive while statutory net profit was negative.

Overall, the results suggest that management may be attempting to engage in a form of ‘impression management’ by emphasising the earnings measure that presents the company’s financial performance in the best light. We conclude that it is only in a minority

of cases that pro forma earnings are emphasised for genuinely informative reasons. The findings of this study have implications for financial statement users as not only does this type of reporting make comparisons across reporting periods difficult, it also impedes comparisons with other companies, potentially leading to misinformed and inappropriate decisions on the part of investors. Using a larger sample, future research could further examine: whether pro forma earnings disclosures appear to be efficient (information-enhancing) versus opportunistic, perhaps adopting an experimental approach; and whether particular firm characteristics are associated with efficient versus opportunistic pro forma disclosures. ■

Notes

1. The authors appreciate the helpful comments of the referee and participants at the Accounting Standards Special Interest group at the 2010 AFAANZ Conference, Christchurch, New Zealand, particularly, Michael Bradbury, Bryan Howieson and Kevin Stephenson. Funding for data collection was provided by an AFAANZ 2009 Research Grant.
2. If the auditor does identify a material inconsistency in information reported in the narrative sections compared with the audited financial report, then the auditor shall determine whether the audited report or the narrative section needs to be revised (ASA 720).
3. The 2006 data is used to calculate the change in annual earnings from the previous year for 2007.
4. 'Trail' means sufficient information to allow the reader to do their own reconciliation.
5. We chose to look at the change in earnings metrics rather than the actual values of these metrics on the basis that financial decision-making is more likely to be based on performance trends than individual yearly performance figures.

References

- Australian Institute of Company Directors & Financial Services Institute of Australasia 2009, *Underlying profit: principles for reporting of non-statutory profit information*, Sydney.
- Australian Securities and Investment Commission 2010, *10-282AD ASIC's review of 30 June 2010 financial reports and focuses for 31 December 2010*, ASIC, Victoria.
- Bhattacharaya, N., Black, E.J., Christensen, T.E. & Larson, C.R. 2003, 'Assessing the relative informativeness and permanence of pro forma earnings and GAAP operating earnings,' *Journal of Accounting and Economics*, vol. 36, pp. 285-319.
- Bowen, R, A. Davies & Matsumoto, D. 2005, 'Do firms strategically emphasize performance metrics in their earnings press releases?', *The Accounting Review*, vol. 80, no. 4, pp. 1011-38.
- Bradshaw, M. & Sloan, R.G. 2002, 'GAAP versus The Street: an empirical assessment of two alternative definitions of earnings', *Journal of Accounting Research*, vol. 40, no. 1, pp. 41-66.
- Doyle, J.T., Lundholm, R.J. & Soliman, M.T. 2003, 'The predictive value of expenses excluded from pro forma earnings,' *Review of Accounting Studies*, vol. 8, pp. 145-74.
- Elliott, W.B. 2006, 'Are investors influenced by pro forma emphasis and reconciliations in earnings announcements?', *The Accounting Review*, vol. 81, no. 1, pp. 113-33.
- Ernst & Young 2008, *Reporting earnings, Trends, analysis and predictions*, Ernest & Young Australia.
- Frederickson, J. & Miller, J. 2004, 'The effects of pro forma earnings disclosures on analysts' and nonprofessional investors' equity valuation judgements', *The Accounting Review*, vol. 79, no. 3, pp. 667-86.
- Jennings, R. & Marques, A. 2011, 'The joint effects of corporate governance and regulation on the disclosure of manager-adjusted non-GAAP earnings in the US,' *Journal of Business Finance and Accounting*, vol. 38, nos. 3 and 4, pp. 364-94.
- Johnson, W.B. & Schwartz, W.C. 2005, 'Are investors misled by 'pro forma' earnings?', *Contemporary Accounting Research*, vol. 22, no. 4, pp. 915-63.
- Lougee, B. & Marquardt, C. 2004, 'Earnings informativeness and strategic disclosure: an empirical examination of 'pro forma' earnings', *The Accounting Review*, vol. 79, no. 3, pp. 769-96.
- Marques, A. 2010, 'Disclosure strategies among S&P 500 firms: evidence on the disclosure of non-GAAP financial measures and financial statements in earnings press releases', *British Accounting Review*, vol. 42, pp. 119-31.
- Moser, D. 1989, 'The effects of output interference, availability, and accounting information on investors' predictive judgements', *The Accounting Review*, vol. 64, no. 3, pp. 433-44.
- Neu, D., Warsame, H. & Pedwell, K. 1998, 'Managing public impressions: environmental disclosures in annual reports', *Accounting Organizations and Society*, vol. 23, no. 3, pp. 265-82.
- Nichols, N., Gray, S. & Street, D. 2005, 'Pro forma adjustments to GAAP earnings: bias, materiality and SEC action', *Research in Accounting Regulation*, vol. 18, pp. 29-52.
- Rio Tinto 2008, Annual report.
- Schrand, C. & Walther, B. 2000, 'Strategic benchmarks in earnings announcements: The selective disclosure of prior-period earnings components', *The Accounting Review*, vol. 75, no. 3, pp. 769-95.
- Zhang, H. & Zheng, L. 2011, 'The valuation impact of reconciling pro forma earnings to GAAP earnings', *Journal of Accounting and Economics*, vol. 51, pp. 186-202.