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UTS
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The rise and rise of non-GAAP reporting by Australian firms

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OVERVIEW OF PRESENTATION

1. Introduction
2. What is non-GAAP reporting?
3. An example of non-GAAP reporting: Qantas
4. Why is non-GAAP reporting an important issue?
5. A brief regulatory summary
6. Overseas practice and evidence
7. Australian non-GAAP reporting evidence
8. Conclusions

WHAT IS NON-GAAP REPORTING?

A Quick Quiz: Which of the following can you reliably “define” based on (Australian) regulations applicable to financial reporting (Accounting Standards, Corporations Act, ASX rules, etc.)

- Net profit – AASB 101
- Comprehensive income – AASB 101
- Earnings per Share – AASB 133
- Operating cash flow – AASB 107
- Cash profit/earnings - ? – is this a contradiction in terms?
- Underlying profit/EBITDA - ? – underlying what?
- Recurring earnings - ? – recurring when?
- Street earnings - ? - something analysts talk about?

WHAT IS NON-GAAP REPORTING?

- Non-GAAP reporting refers to the promotion/use of measures of financial performance (“income”) that do not (strictly) comply with GAAP.
- Sometimes called “Pro-forma” reporting, but this is not the same as reporting “what if” combinations or IPO effects.
- Not the same thing as promoting “non-financial” measures of performance
- Non-GAAP reporting doesn’t replace GAAP financial statements, but often appears to be (in other documents such as media releases etc) the “dominant” metric of discussion.

AN EXAMPLE: QANTAS FY2015

Reconciliation of Underlying to Statutory PBT		2015	2014	2013	2012
Underlying PBT	$M	**975**	**(646)**	**192**	**95**
Items not included in Underlying PBT					
- AASB 139 mark-to-market movements relating to other reporting periods	$M	(39)	72	32	(46)
Items not included in Underlying PBT					
- Impairment of Qantas International CGU	$M	-	(2560)	-	-
- Net impairment of property, plant and equipment	$M	-	-	(86)	(147)
- Redundancies and restructuring	$M	(80)	(428)	(118)	(203)
- Fleet restructuring	$M	(4)	(394)	-	-
- Net impairment of investments	$M	(19)	(50)	2	(19)
- Impairment of goodwill and other intangible assets	$M	(7)	(9)	(24)	(18)
- Write down of inventory	$M	-	-	(4)	(13)
- Net profit on disposal of investment	$M	11	62	30	-
- B787 introduction costs	$M	-	(14)	-	-
- Write off of Jetstar Hong Kong	$M	(21)	-	-	-
- Other	$M	(27)	(9)	(7)	2
Total items not included in Underlying PBT	**$M**	**147**	**(3402)**	**(175)**	**(444)**
Statutory PBT	**$M**	**789**	**(3976)**	**17**	**(349)**

Source: Qantas PFS ASX and Media Release2013, 2014 and 2015.

AN EXAMPLE: QANTAS FY2015

For the 2013/14 STIP, the Board set the following scorecard of performance conditions:

Strategic Objective	Performance Measures	Scorecard Weighting
1. Delivering sustainable returns to shareholders	» Underlying Profit Before Tax (50% weighting) » Operating cash flow to net debt (10% weighting)	60%

Source: Qantas annual report 2014, p.52

WHY IS NON-GAAP REPORTING AN IMPORTANT ISSUE?

- The reporting (emphasis) of non-GAAP metrics has grown substantially
  - ➢ Lots of anecdotal evidence (just read the newspapers and press releases!)
  - ➢ Surveys produced by accounting firms
  - ➢ “quasi-guidance” from interest groups such as AICD
  - ➢ History of regulatory action overseas and in Australia
- Note that AASB 101 does not require a specific “format” for the Statement of Financial Performance, but does require line items within the Statement of Financial Performance when appropriate (see Para. 85 requirements)
- Also note AASB 101 (para. 87) PROHIBITS identification of “Extraordinary Items”. The IASB concluded that this “distracts users” (?)
- Fundamental issue is that self-defined performance metrics represent a challenge to the conventional models of accounting and reporting regulation. They also raise an obvious question about bias.

WHY IS NON-GAAP REPORTING AN IMPORTANT ISSUE

- Most fundamentally, because we don't know why do firms do this!
  - "Better information" for investors (but what does "better" mean – more accurate earnings forecasts, more accurate valuations?)
  - Problems created by switch to IFRS in 2005 (but this behaviour was also evident in US during late 90s tech boom)
  - More easily managed to ensure benchmarks (e.g. analysts' forecasts) are beaten – not clear if there are penalties for this)
  - Self-serving behaviour by management – for example use of non-GAAP metrics in bonus plans (recall about 70% are higher than the GAAP equivalent)
  - Creates link between internal end external performance measurement
  - Interesting research has "tension" – definitely the case here!

- The answer has important implications!

WHY IS NON-GAAP REPORTING AN IMPORTANT ISSUE?

- **Accounting standard setters**
  - ❖ should income be defined differently?
  - ❖ Should we encourage disaggregation?
  - ❖ Are preparers and standard setters heading in opposite directions?
  - ❖ Is the move to comprehensive income an “issue” here?
  - ❖ Free market versus standards?
  - ❖ The role of accounting standards – comparability?
  - ❖ Lessons for the Conceptual Framework?
- **Corporate governance**
  - ❖ What is the most appropriate performance metric for compensation?
  - ❖ Broad issues of remuneration design and links to accounting performance
  - ❖ Relationship between internal and external demand for reporting

WHY IS NON-GAAP REPORTING AN IMPORTANT ISSUE?

- **Market regulators**
  - ❖ Are investors being misled?
  - ❖ Does regulatory intervention produce better information?
- **Investors**
  - ❖ Are non-GAAP metrics a better predictor of future returns?
  - ❖ Is non-GAAP "news" more important to stock markets?
  - ❖ Are non-GAAP metrics higher quality?
  - ❖ Do analysts "use" these metrics?
  - ❖ Do analysts have a role in shaping non-GAAP definitions?
  - ❖ What differences between GAAP and non-GAAP "matter" to investors?

WHY IS NON-GAAP REPORTING AN IMPORTANT ISSUE?

- **Researchers**
  - ❖ Improved understanding of causes and consequences of financial disclosures more generally
  - ❖ Better understanding of the governance/compensation/performance linkages
  - ❖ Opportunity to test alternative “disaggregation's” of summary metrics
  - ❖ Opportunity to observe reporting decisions in a relatively unregulated environment.

A BRIEF REGULATORY SUMMARY

- AAS 1 (1974): distinction between operating, abnormal and extraordinary items
- AASB 1018 (1989): Increased restrictiveness of abnormal and extraordinary definitions
- AASB 1018 (1999): Abnormal items not permitted on face of income statement. Significant items segregated to notes to accounts.
- AASB 1018 (2002): defined an extraordinary item as "extremely rare"
- AASB 101 (2005): No extraordinary items anywhere (not on face of statement or in notes). Flexibility in creating line items in income statement.
- ASIC Consultation Paper 69: What should be reported and how.
- AICD/Finsia (2009): Underlying profit – transparency and consistency
- ASIC RG 230 (2011): Reconciliation a key requirement

OVERSEAS PRACTICE AND EVIDENCE

- Extensive US evidence of rapid growth in non-GAAP reporting around dot.com boom 1998-2002
- Rapid decline in this reporting once Reg. G was introduced
- Some evidence that this type of reporting has begun to increase again (albeit Reg. G compliant).
- SEC recognized (2010) that Reg G may have dysfunctional effects – not wanting to "encourage or discourage" non-GAAP.
- Academic research is almost totally US-based, and is only sometimes based on actual non-GAAP disclosures as compared to outcomes recorded in analyst surveys (e.g. IBES "actual").

OVERSEAS PRACTICE AND EVIDENCE

- Research findings (and implications) appear to depend on the method used:
  - Studies looking at earnings management/benchmark beating find non-GAAP is used to achieve this
  - Studies looking at persistence of exclusions find they predict earnings (so they are not as transient as exclusion from GAAP implies)
  - Studies looking at correlation with prices/returns generally suggest non-GAAP is informative (but also evidence that investors are misled in pricing earnings)
  - Studies examining compensation effects suggest this encourages aggressive non-GAAP disclosures
  - Studies which look at regulatory intervention generally show better quality disclosure (but possibly at the expense of corporate governance disciplinary effects)
  - Overall academic research is a “mixed bag”

AUSTRALIAN EVIDENCE

- Build a database that enables an informed view of what firms do – avoid small sample approaches.
- Understanding “why” firms report the way they do starts from knowing “what” firms report (and where).
- Start by using text interrogation methods to review all relevant documents – earnings media releases, PFS, investor presentations, annual report, etc.
- Financial support from CIFR, with technical support from SIRCA
- Examine ASX All-Ords from 2000-2014 with forward/backwards inclusion to maximize sampling – coverage exceeds 98% of market capitalization
- Sample size of just over 10,000 firm years.

AUSTRALIAN EVIDENCE

- Our focus is on post-tax figures unless a pre-tax non-GAAP number is the “obviously” pre-eminent number (researcher judgement)
- We identify the following in addition to non-GAAP disclosure:
  - Equivalent GAAP result
  - Terminology used for non-GAAP
  - Source of primary disclosure
  - Fundamental data such as date/time of announcement
  - Existence of reconciliation between GAAP and non-GAAP

FIGURE 1: FREQUENCY OF ASX ALL ORDS FIRMS REPORTING NON-GAAP EARNINGS

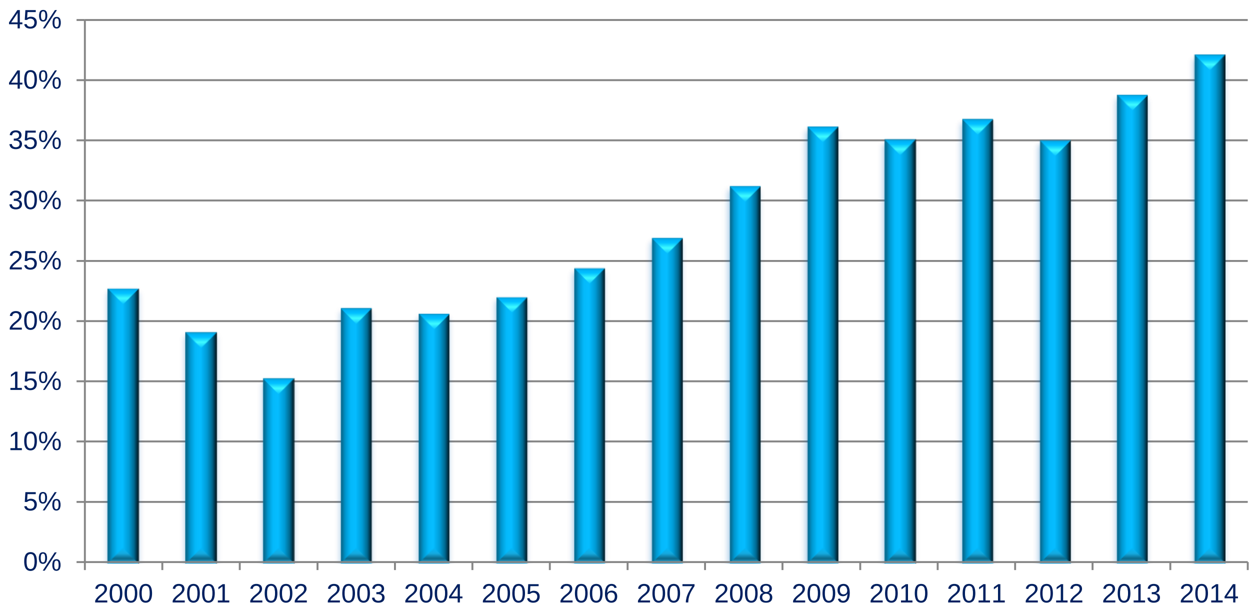


FIGURE 2: THE PERCENTAGE OF NON-GAAP EARNINGS ANNOUNCEMENTS WITH RECONCILIATION

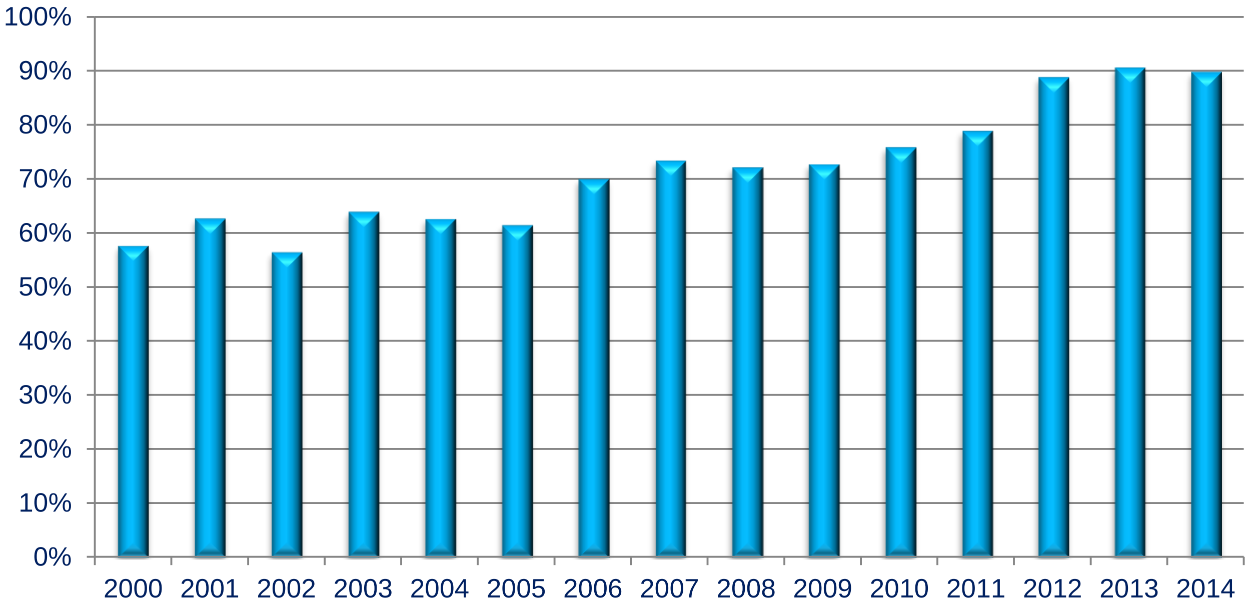


FIGURE 3: THE PERCENTAGE OF ALL ORDS FIRMS DISCLOSING NON-GAAP EARNINGS EXCEEDING THE CORRESPONDING GAAP EARNINGS

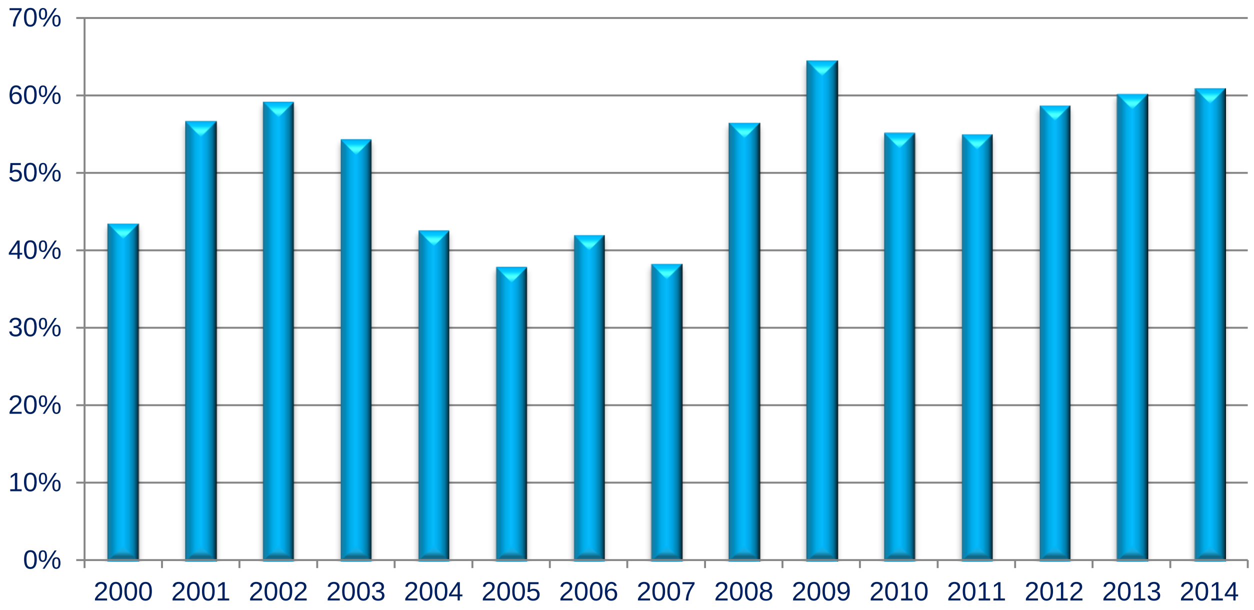


FIGURE 4A: ANNUAL MEAN OF THE AGGREGATE VALUE OF EXCLUSIONS ($MILLIONS)

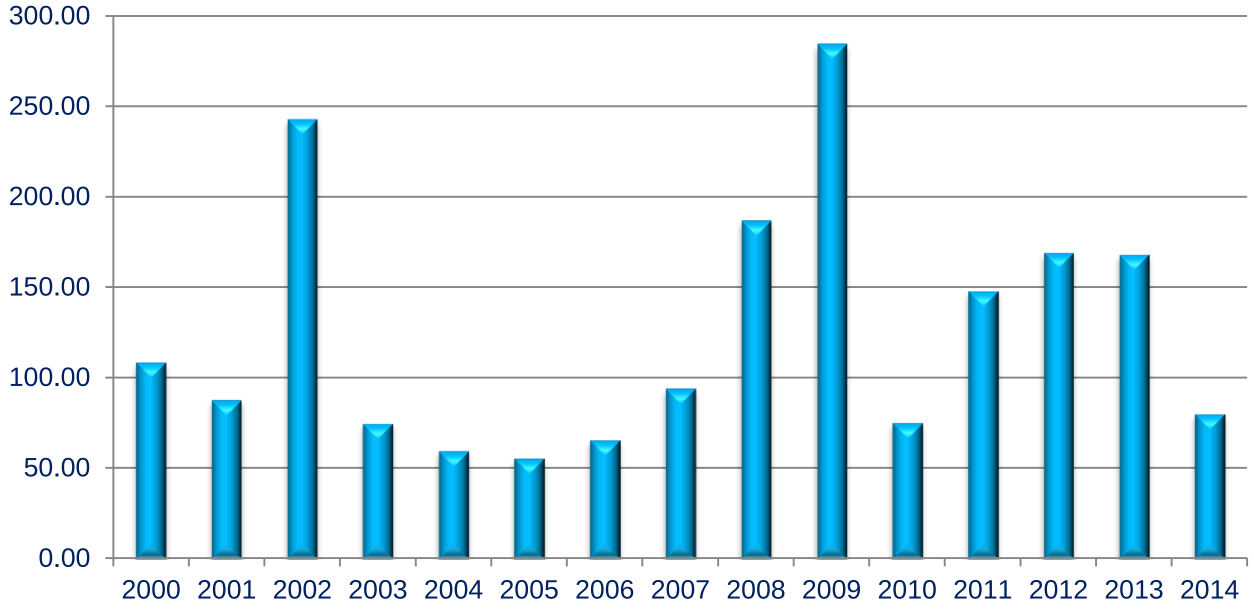


FIGURE 4B: ANNUAL MEDIAN OF THE AGGREGATE VALUE OF EXCLUSIONS ($MILLIONS)

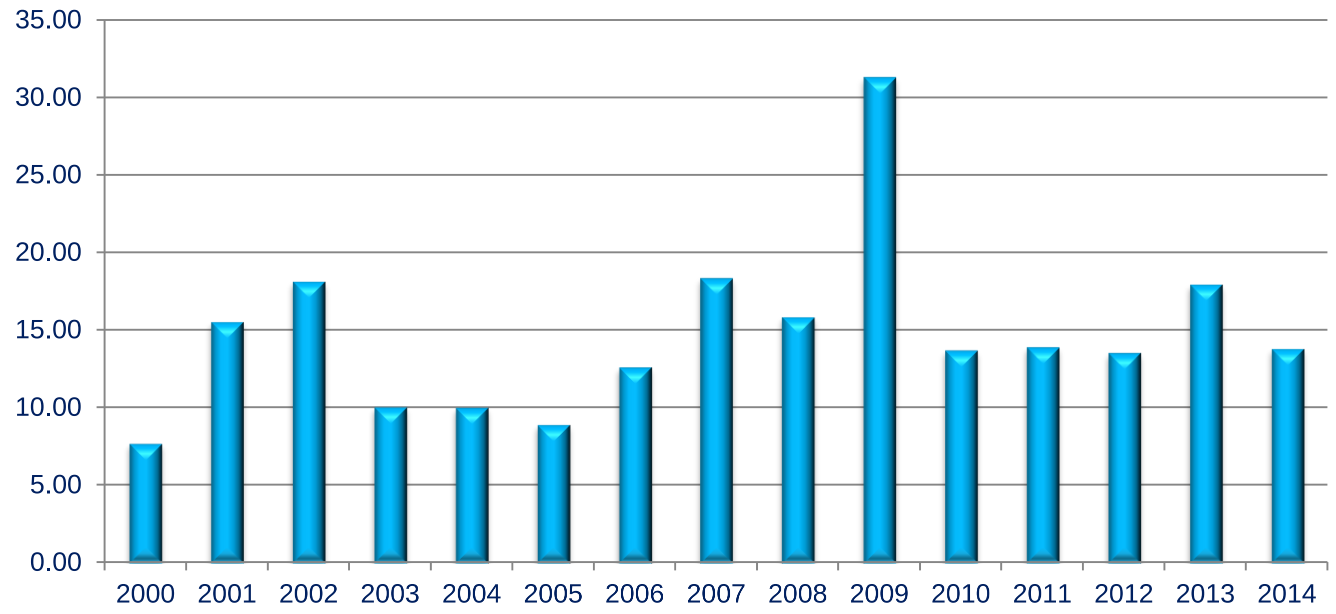


FIGURE 5: ANNUAL MEDIAN PERCENTAGE OF THE ABSOLUTE VALUE OF EXCLUSIONS IN RELATION TO THE CORRESPONDING GAAP EARNINGS

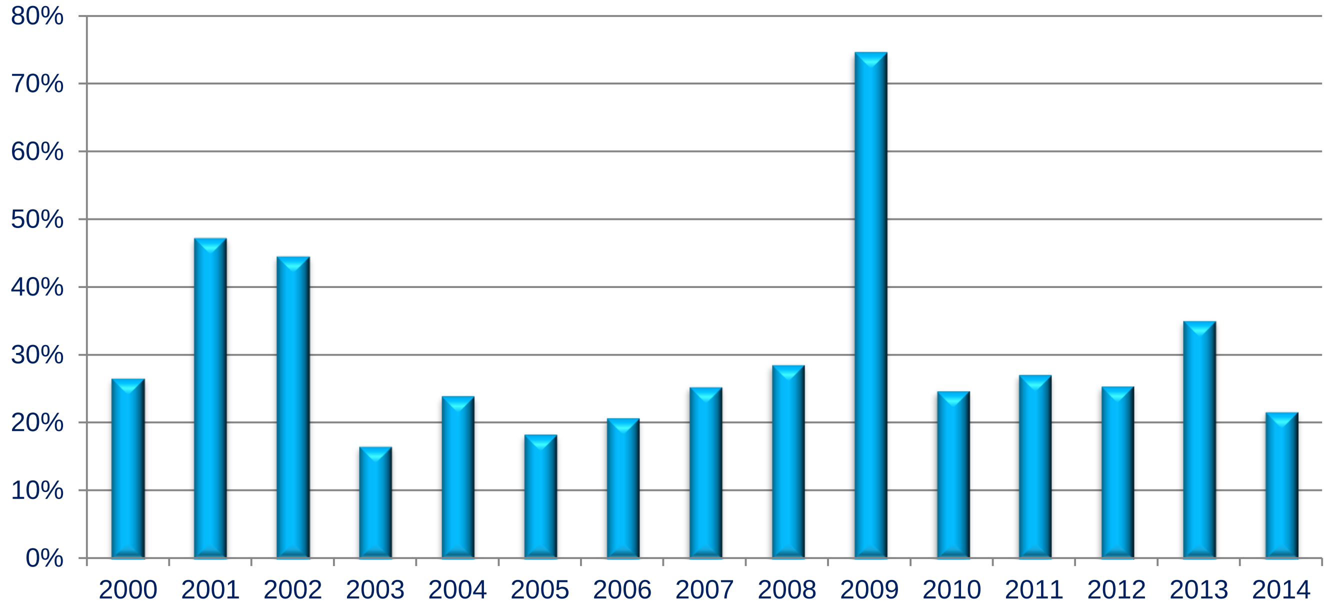


FIGURE 6A: ANNUAL PERCENTAGE OF NON-GAAP REPORTERS THAT DISCLOSE A NON-GAAP PROFIT BUT A GAAP LOSS.

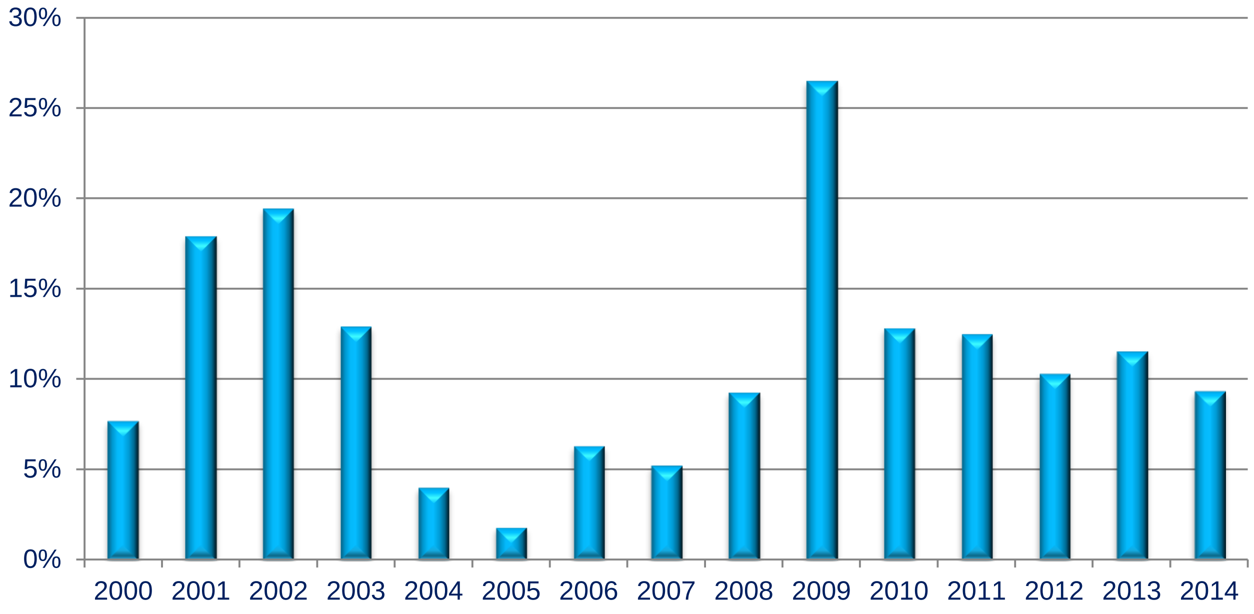


FIGURE 6B: ANNUAL PERCENTAGE OF NON-GAAP REPORTERS THAT REPORT A NON-GAAP LOSS BUT A GAAP PROFIT.

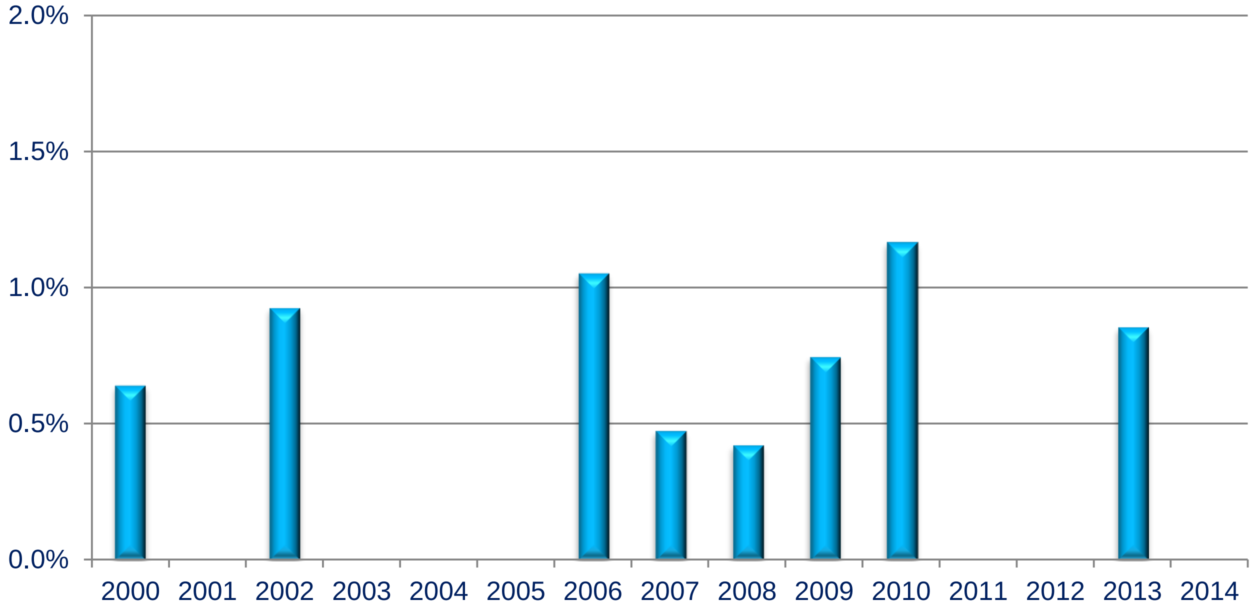


FIGURE 7: TERMINOLOGY USED BY NON-GAAP REPORTERS

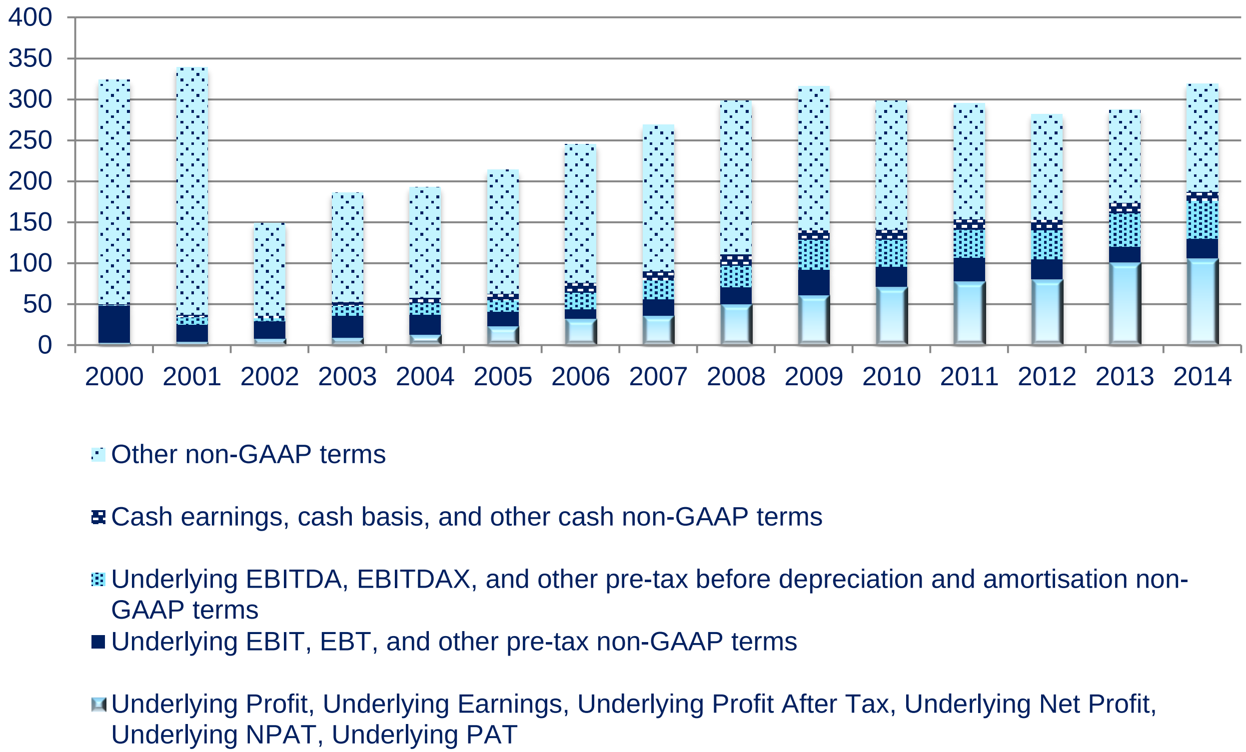
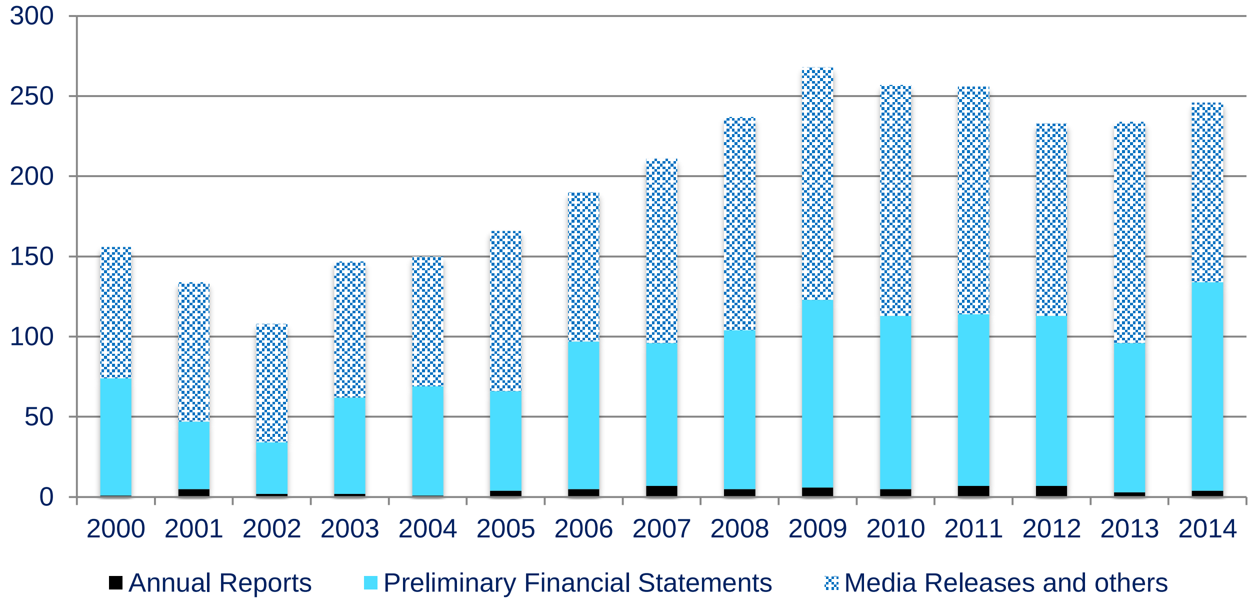


FIGURE 8: SOURCE DOCUMENTS WHERE NON-GAAP EARNINGS ARE IDENTIFIED



AUSTRALIAN EVIDENCE: SOME INITIAL OBSERVATIONS

- Frequency of non-GAAP disclosures has shown significant increase over 2000-2015
- Percentage of non-GAAP disclosures with reconciliation to GAAP has increased significantly over 2000-2014
- The percentage of non-GAAP disclosures where the non-GAAP result exceeds the GAAP results has shown a marginally significant increase over 2000-2014
- We observe no statistically significant pattern over the magnitude of exclusions from GAAP
- We observe no statistically significant pattern on the tendency to move a GAAP loss to a non-GAAP profit
- The use of the term “underlying earnings” has risen dramatically over the period 2000-2014

CURRENT RESEARCH

- Compare the quality of non-GAAP earnings vs. GAAP earnings for Australian ASX500 firms over 2000-2014
- We assess important attributes of earnings: **persistence, smoothness, timeliness, conservatism**, predictability, and value relevance
- Are there trade-offs?
- Consider whether differences between these attributes are influenced by firm size, market-to-book, board independence and industry propensity to disclose non-GAAP
- Examine whether the difference in quality between non-GAAP and GAAP earnings has changed after the adoption of IFRS in 2005

CONCLUSIONS

- Non-GAAP reporting is now an integral part of the financial reporting landscape
- Regulation is currently based on ensuring no “misleading” information
- The level of visible engagement between the evolution of non-GAAP practices and the accounting standard setting community seems low – they seem headed in different directions.
- There is unlikely to be one “catch all” explanation for non-GAAP reporting. There are, no doubt, instances where it is self serving and others where it is genuinely “better information”. Can we distinguish these?
- Our evidence (work-in-progress) suggests non-GAAP earnings trade off certain attributes of earnings that are argued to be “desirable”.
- Is non-GAAP reporting a visible example of links between (unregulated) internal reporting and (regulated) external reporting?
- Role of auditors is quite unclear.