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

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

AN EXAMPLE: QANTAS FY2015

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

<table>
<thead>
<tr>
<th>Strategic Objective</th>
<th>Performance Measures</th>
<th>Scorecard Weighting</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Delivering sustainable returns to shareholders</td>
<td>» Underlying Profit Before Tax (50% weighting)</td>
<td>60%</td>
</tr>
<tr>
<td></td>
<td>» Operating cash flow to net debt (10% weighting)</td>
<td></td>
</tr>
</tbody>
</table>

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

- 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

- Other non-GAAP terms
- Cash earnings, cash basis, and other cash non-GAAP terms
- Underlying EBITDA, EBITDAX, and other pre-tax before depreciation and amortisation non-GAAP terms
- Underlying EBIT, EBT, and other pre-tax non-GAAP terms
- Underlying Profit, Underlying Earnings, Underlying Profit After Tax, Underlying Net Profit, Underlying NPAT, Underlying PAT
FIGURE 8: SOURCE DOCUMENTS WHERE NON-GAAP EARNINGS ARE IDENTIFIED

- Annual Reports
- Preliminary Financial Statements
- Media Releases and others
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.