# The Pros and Cons of Pro Forma Financial Reporting

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Pro forma (definition): A presentation of data, typically financial statements, where the data reflects the world on an "as if" basis; that is, as if the state of the world were different from that which is in fact the case.[1]

Pro forma data adds to or subtracts from information that is required by Generally Accepted Accounting Principles (GAAP) to provide users information that is supposedly more relevant, pertinent and reflective of an entity's ongoing core business activities. Pro-forma adjustments strip out such nonrecurring expenses as asset write downs or the effects of foreign-currency fluctuations that the companies' executives and many investors consider to be outside a company's core operations. Companies also often omit results from newly opened and recently closed units to better reflect expected ongoing operations.

## What's the Problem?

The central problem associated with presenting non-GAAP data as a yardstick for measurement for financial performance is that there is no standard accounting definition of such data, thus allowing each company to tailor its adjustments to its own circumstances. Some companies have become rather aggressive in making these discretionary adjustments, excluding charges that are often a part of doing business, such as legal costs, acquisition expenses and the cost of stock-based compensation. Thus, it is often harder to compare one company's results to another's or even one company's results to its own over time.

The incidence of usage of non-GAAP data is growing. In 2015, about 10 percent of the major securities filings in the United States used the term "adjusted EBITDA" (earnings before interest, taxes, depreciation and amortization) in these filings. This compares with only about 2.5 percent of the filings in 2005. Moreover, most of the adjustments to GAAP-based income were positive, painting a rosier picture than GAAP painted.

On a yearly basis, S&P 500 companies reported pro-forma earnings of about 0.4 percent more per share in 2015 than 2014. However, under GAAP, S&P 500 earnings actually fell by 12.7 percent, the sharpest decline since the financial crisis of 2008. In addition, GAAP earnings were 25 percent lower than pro forma figures – the widest gap since 2008 when public companies took a record amount of charges[2]. Tech, energy and health care companies have taken the lead, but the overall list of companies engaged in non-GAAP reporting is quite diverse.

## Enter the SEC

In 2003, immediately after the passage of the Sarbanes-Oxley Act, the Securities and Exchange Commission (SEC) issued Regulation G, which requires public companies that disclose or release non-GAAP financial measures to include, in the same disclosure or release, a presentation of the most directly comparable GAAP financial measure, as well as a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP measure. Over time, however, companies have become more aggressive in interpretation of these rules, often more prominently disclosing the (more favorable) non-GAAP measure than the GAAP measure. Therefore, the SEC has announced that it is stepping up its scrutiny of companies' usage of non-GAAP measures, targeting firms that inflate sales and that employ customized metrics that stray too far from GAAP[3]. It is hoped that this measure will help reign in companies that have employed more aggressive tactics in recent years.

### Questions to Ask When Using a Non-GAAP Measure

Following are some good questions to ask that serve as guidance going forward when a company considers the use of non-GAAP measures[4]:

1. Is the measure misleading or prohibited?
2. Is the measure presented with the most directly comparable GAAP and with no greater prominence?
3. Is the measure appropriately defined and described, and clearly labeled as non-GAAP?
4. Does the reconciliation between the GAAP and non-GAAP measure clearly label and describe the nature of each adjustment, and is each adjustment appropriate?
5. Is there transparent and company-specific disclosure of the substantive reason(s) why management believes that the measure is useful for investors and the purpose for which management uses the measure?
6. Is the measure consistently prepared from period to period and is it comparable to that of the company's peers?
7. Is the measure balanced with respect to treatment of nonrecurring gains, as well as nonrecurring losses?
8. Does the measure appropriately focus on material adjustments and not include immaterial adjustments that would not seem to be a focus of management?
9. Do the disclosure controls and procedures address non-GAAP measures?
10. Is the audit committee involved in the oversight of the preparation and use of non-GAAP measures? ■

## Footnotes

1. Economics.about.com
2. Justin Lahart, "S&P 500 Earnings: Far Worse than Advertised," *The Wall Street Journal*, Feb. 24, 2016.
3. Dave Michaels, "SEC Cracks Down on Novel Earnings Measures that Boost Profits," *The Wall Street* Journal, April 28, 2016.
4. Lisa Mitrovich and Christine Davie, "Questions to Ask When Using a Non-GAAP Measure." *CFO Journal*, April 22, 2016

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