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Maybe Pro-Forma Earnings Aren't So Evil After All

By **BILL ALPERT**

Read the financial pages and you'd think investors have been pervasively bilked by tech companies reporting "pro-forma earnings" -- you know, those degenerate earnings reports that leave out merger costs, restructuring charges and maybe even research and development expenses. Abetting this purported scam have been the brokerage firm analysts and the services that collect consensus forecasts, such as First Call and Zacks.

"O Tempora! O Mores!" the writers wailed. "O Amazon! O Yahoo!" In earnings announcements, companies have trumpeted pro-forma earnings, while burying the poor results shown under Generally Accepted Accounting Principles. "Where's the outrage?" cried a recent editorial in Business Week. "Now nearly all companies stretch GAAP standards to make up their own."

Regulators share similar qualms. Instead of EPS, quipped Lynn Turner, chief accountant at the Securities and Exchange Commission, company earnings releases were reporting "EBS" or "Everything but Bad Stuff."

The savvy investor only needed to remember: "GAAP, good! Pro forma, bad!"

Well, darn it all, now some pesky professors have gone and studied pro-forma earnings. And their findings (all still in unpublished manuscripts) raise doubts about the dastardly nature of pro-forma reporting. The studies confirm that investors pay more heed to pro-forma numbers than to GAAP numbers. But hyperinflated pro-forma numbers prove less common than headlines suggest. More startlingly, tests show that pro-forma numbers are a better guide to stock value than are GAAP-style earnings. Management's pro-forma numbers, conclude Georgia State accounting professors Lawrence D. Brown and Kumar Sivakumar, are of

better quality than the numbers found in a 10-Q or 10-K filing at the SEC.

Everyone complains that firms are increasingly reporting pro-forma earnings. Well, now it's scientific fact. Press releases were sampled from 1987 and from 1999, by another pair of accounting professors, Mark T. Bradshaw, of the Harvard B-school, and Richard G. Sloan, of the University of Michigan. Only 18% of earnings announcements from the earlier period mentioned any form of non-GAAP earnings. Come the latter period, 71% of releases mentioned non-GAAP numbers. The pro-forma number appeared more frequently in the lead paragraphs, typically a couple of paragraphs before the GAAP number. Over the last decade, the researchers recount, management has persuaded analysts and forecast data collectors that pro-forma numbers give a better picture of a company's operations, by excluding items that are arguably non-recurring, non-cash or somehow non-core.

"I was of a cynical bent when I first wrote this paper," says Harvard's Bradshaw. "I thought that managers were taking advantage of investors. A reader pointed out that I didn't have that evidence, so I now see the validity of an alternative explanation: Management is just cleaning up the numbers for us."

Extreme cases of pro-forma hijinks have naturally captured the attention of regulators and journalists. But only some 10% of companies reported pro-forma earnings that exceeded their GAAP results by more than a fraction of a cent (on average), in a study of 90,000 earnings reports by professors Jeffery Abarbanell and Reuven **Lehavy**, of the University of North Carolina, in Chapel Hill, and the University of California, at Berkeley, respectively. And about half those reports, from the 13 years ended 1998, showed no difference.

In speeches, SEC accountant Lynn Turner has counselled investors to study the "more balanced" GAAP numbers, in addition to the pro-forma version. But each of the research groups showed that pro-forma numbers impact stock prices more than the GAAP results. A jump in pro-forma numbers moved stocks more strongly than a jump in GAAP numbers, when measuring stock moves in the days and months after earnings announcements.

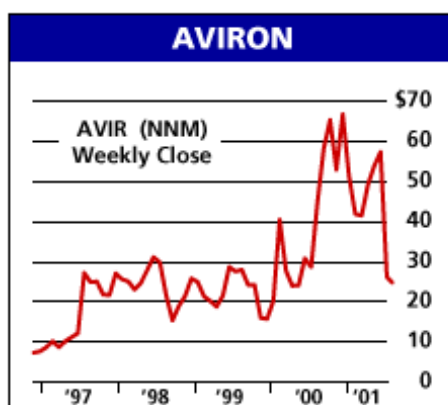
In his study of 25,000 earnings reports through 1997, Georgia State's Lawrence Brown makes the strong claim that management's pro-forma numbers are better guides than any GAAP numbers he found. Unlike the other researchers, Brown didn't just compare pro-forma numbers with the net income numbers at GAAP's "bottom line." He made a more interesting comparison of pro-forma earnings (which Thomson Financial's I/B/E/S service got from company announcements) and operating income numbers (which S&P's Compustat extracted from SEC filings). Brown expected the operating income numbers to be worthier rivals for the pro-forma numbers, in terms of moving stocks, because

operating results lack the non-recurring and non-operating items found in net income.

The operating income numbers indeed had greater impact on stock movements than did net income. But pro-forma numbers had a still greater impact. Because the GAAP operating numbers are often unavailable for weeks after the pro-forma earnings release, Brown checked to see if stocks made compensatory moves when SEC filings finally appeared with the operating income figures: He found nothing of significance. The pro-forma earnings were also more consistent than operating earnings, changing less in year-over-year comparisons.

None of the studies, Brown cautions, disprove that companies can manipulate pro-forma numbers to manufacture earnings surprises or forestall disasters. But Brown concludes that pro-forma numbers are better, on average, for figuring a stock's value. He assumes that stock markets efficiently reflect all public information. Under that assumption, the higher impact of pro-forma numbers on stock prices suggests that the GAAP numbers are poorer guides for investors -- particularly momentum-oriented investors who care about earnings surprises. "The regulators will look at our studies," Brown predicts, "and just say the people are being fooled."

Earnings surprises drive stocks, and the definition of an earnings surprise these days is an announced EPS number that differs from the consensus of brokerage analyst forecasts at a reporting service like First Call. But when accounting profs like UNC's Jeffrey Abarbanell checked the internal procedures at services like First Call and Zacks, the professors found that the services computed the average EPS estimate -- that is, the consensus -- in ways politely described as "idiosyncratic." An analyst whose EPS estimate falls at the high or low edge of the pack, for example, might find her number dropped from the consensus calculation at First Call, reports Abarbanell. Details of the consensus calculations matter, because consensus earnings are basic numbers throughout the world of finance: in examinations of how companies manage earnings expectations; in quantitative trading strategies; in CNBC reports that a company beat the estimates.



So I'll detail another challenge to consensus calculations -- some research firms withhold their earnings forecasts from the reporting services. One such firm is Avalon Research Group, of Boca Raton, Florida. Head honcho Michael Margolies says that his firm's short-sale recommendations often forecast earnings numbers far more

pessimistic than the typical Wall Street forecast. Consensus numbers would come down, if Avalon's forecast got averaged in. And that would shrink the distinction between Avalon and the mainstream, and shrink the "surprise" that Avalon's customers seek.

Last week, Margolies pointed out a surprise that he helped clients avoid. On July 27, a Food and Drug Administration advisory panel recommended against approval of an application by [Aviron](#), a biotech firm in Mountain View, California, to sell a flu vaccine patients spray in their noses. Doctors on the panel said Aviron and its partner [American Home Products](#) had failed to supply complete data showing the safety of the vaccine, which uses a live virus. The shares dropped 37% to 26, on news of the rejection, then ended last week above 25. Avalon analyst David Hines dourly notes that the February prospectus for Aviron's \$50-a-share secondary stock offering downplayed the incompleteness of Aviron's safety tests. In a conference call Friday morning, the biotech firm said it expected FDA feedback by the end of August.

Add Mary Meeker's name to the list of Internet analysts-cum-defendants in investor securities complaints. In suits filed in Manhattan's federal court, investors claimed to have been duped by the Morgan Stanley analyst's bullish recommendations of [Amazon.com](#) and [eBay](#). Last month, Merrill Lynch settled an arbitration case by a client complaining he'd been misled by that firm's Internet bull Henry Blodget.

One of the suits against Meeker makes the horrifying allegation that Morgan Stanley paid her bodacious sums, because she helped to land underwriting deals. By itself, such an arrangement would make Meeker no different from analysts at every other investment-banking firm. Most analysts have to work banking deals just to keep the lights turned on. One such analyst recently told me that his firm expects him to cover \$1.5 million in expenses each year. The analyst can cover that nut by hustling up thousands of commission generating trades, or else by helping with a couple of banking deals.

Another seeming outrage that has produced much howling in the press has sprung from the fact that Credit Suisse First Boston rewarded its best clients with shares of hot stock offerings amid the Internet frenzy. But this offense -- like that of rewarding analysts for assisting in investment-banking deals -- is employed by bankers everywhere.

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