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Scratch Below the Surface

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The headline earnings numbers reported in the media are not always the most reliable indicator of how a company performed in a given period or how a company might perform in the future. As an example, in the most recent fiscal year, Facebook reported earnings per share of $0.53 on an adjusted basis, while GAAP earnings were only a penny. So what is the difference?

Companies are required to report earnings under Generally Accepted Accounting Principles (GAAP). These standards are designed to allow financial statement users to make comparisons between companies, while minimizing the opportunity for businesses to provide misleading information. In addition to GAAP earnings, companies are allowed to report adjusted non-GAAP measures of earnings, as long as they also provide a reconciliation to the most comparable GAAP number, and can explain the rationale for showing such an adjusted number. Typical reasons given for excluding an item from adjusted earnings are that it is non-recurring, non-operating, or non-cash. Some examples of adjustments include restructuring charges, acquisition related expenses, asset impairment charges, and share-based compensation expense.

In presenting an adjusted measure of earnings, management contends that the adjusted number more accurately reflects the company's financial performance and future growth prospects, and presumably gives investors a better way to evaluate a company versus its peers. Of course, while the majority of managers are honest, they have a bias to present the company's results in the best light possible. These adjusted earnings are the measure that is more frequently cited by media outlets rather than GAAP earnings.

Yet there are several problems with adjusted earnings: 1) comparability of one company to the next is difficult, because unlike GAAP there are no strict rules on what may or may not be included in adjusted earnings; 2) not all companies report adjusted earnings; and 3) items labeled as "unusual" or "special" may not be so unusual or special.

The SEC has weighed in over the years on the use of non-GAAP measures, and the subject remains a prevalent topic in its comment letters to registrants. For example, the SEC had Groupon remove a non-GAAP measure from its offering document coined "adjusted consolidated segment operating income". The adjustments included marketing expenses, acquisition related expenses, and stock-based compensation expenses.

Exhibit #1 below illustrates the difference between GAAP earnings and 'adjusted' earnings over the last decade for S&P 500 companies in aggregate. The difference between the two measures can vary greatly, but not surprisingly, the adjusted number is always higher. The higher (adjusted) earnings numbers make stocks look cheaper and increases the likelihood of unfair valuation comparisons with companies that don't report adjusted earnings. Adjusted earnings for the twelve months ended in the latter part of 2008 through early 2010 are skewed by massive write-offs. The spread post-recession has been around 9-12%, which is a more normal range.

Because of these persistent and fluctuating differences, it is important to look beyond the reported earnings numbers, as well as GAAP earnings for that matter, when evaluating the health and earnings power of a company. Many investors take them at face value. At the Smith Group, earnings quality is a key input to our process. An analysis of cash flow and the discretion management applies to reported earnings provides crucial insight into the quality and sustainability of those earnings. This provides a more complete picture of a company's future growth prospects and its ability to grow faster than expectations.

Exhibit #1: GAAP earnings vs. Adjusted earnings
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