How Many Ways Are There To Say The Word Earnings?: Beware Of 'Pro Forma'

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If you haven't read a financial statement since before 1990, you're in for a rude surprise. They're often written in a new language these days.

With companies constantly coming up with new and convoluted ways to measure their performance in the most positive light possible, it's little wonder investors are confused about what's what.

Here are a few key definitions you'll need when you dig beneath the surface of financial statements and dive headlong into the footnotes.

GAAP: An acronym for generally accepted accounting principles. Companies must report their earnings in compliance with GAAP, but they are free to include other "pro forma" measures that are not endorsed by GAAP.

Firms that choose to emphasize "pro forma" results will often refer to results that comply with GAAP as their "reported" earnings.

PRO FORMA: From the Latin meaning "as a matter of form," pro forma accounting was originally intended to allow investors to evaluate a company's results from year to year on a comparable basis. It refers broadly to any accounting method in which certain amounts are hypothetical.

For instance, after a series of acquisitions, year-earlier results can be restated on a pro-forma basis as if the newly acquired businesses had been part of the firm's results in the previous year.

The meaning and purpose of "pro forma" accounting has since expanded to include a wide variety of reporting methods that exclude various parts of a company's operations. These accounting methods are identified in quarterly reports in various ways, such as "cash" earnings, "adjusted" earnings, or earnings from "core operations."

NET INCOME (OR LOSS): This is the bottom-line result according to generally accepted accounting principles, including all cash and non-cash expenses.

OPERATING INCOME: This is a GAAP-recognized operating measure, meaning net sales (revenue from ongoing business, excluding special gains from investments, etc.) minus cost of raw materials and salaries, all selling, general and administrative costs, depreciation and amortization.

This is frequently confused with non-GAAP measures, sometimes referred to as operating earnings, or profit from operations. These metrics are not covered by GAAP and usually exclude certain operating costs, such as depreciation.

EBITDA: An acronym for earnings before interest, taxes, depreciation and amortization.

The measure gained prominence in the late 1990s as technology and telecom companies took on large amounts of debt and spent heavily to build manufacturing facilities, expand communication networks and acquire rivals.

The resulting interest expenses, depreciation and amortization of certain acquisition costs severely curtailed bottom-line profits. EBITDA excluded those items and was supposed to provide a measure of growth potential.

When technology markets cooled and those acquisition costs and capital expenses failed to pay off, EBITDA was derided by many as a misleading statistic when taken in isolation.

LONG-TERM RECEIVABLES: This is a measure that shows up as an asset on a company's balance sheet. These are debts owed by customers that are not expected to be collected within the usual time frame of customer credit and therefore are not included in normal accounts receivable.

Investors can compare the increase in this number over time, compared to revenue, to see the extent to which the company is financing its own sales growth.

DILUTED EARNINGS PER SHARE: This number is the amount of profit or loss divided by the number of outstanding common shares, after dividends to preferred shareholders.

Basic earnings per share is simply net income or loss divided by the total number of shares outstanding.

SPECIAL CHARGES: These expenses, sometimes referred to as unusual items, can be cash costs such as severance payments, or non-cash accounting adjustments, such as writedowns for impaired investments.

These special charges are typically excluded from companies' pro-forma results on the grounds that they are non-recurring and not part of ongoing operations. Special charges can, however, have a significant impact on cash balances and key ratios used by credit-rating agencies.

WRITEDOWN: Taking a write down means reducing the stated value of an asset and must be taken as a special charge against earnings.

Companies typically dismiss these charges as immaterial to their core results, but writedowns often represent an admission that management has invested poorly, either in the market or joint ventures or equipment, burning through shareholder equity in the process.