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CFO JOURNAL

Companies' Non-GAAP Adjustments to Net Income Have Soared

Reliance on adjusted earnings has made it harder for investors to forecast performance, study says

Adjusted earnings figures have proliferated among technology companies, including Uber Technologies. PHOTO: BRENDAN MCDERMID/REUTERS

By Mark Maurer

Oct. 18, 2019 4:07 pm ET

Companies' reliance on disclosing adjusted earnings or other figures not consistent with generally accepted accounting principles has made it more difficult for investors to forecast performance, putting them at greater risk than they may realize, new academic research shows.

Companies say that such tailor-made metrics are a way for investors to better understand their business. As a result, the rise of earnings adjustments over the past 20 years has been dramatic.

Non-GAAP adjustments related to net income increased 33% from 1998 to 2017, according to the research, which was conducted by accounting professors from the Harvard Business School and the Massachusetts Institute of Technology's Sloan School of Management.

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The researchers analyzed two decades of operating earnings from Russell 3000 companies. Based on the data, compiled by financial technology firm New Constructs LLC, they concluded that company managers are not calculating non-GAAP earnings correctly and are embedding their own biases.

"Companies will tell you this is the way investors want to see it, but it's not necessarily what investors are asking them for," said Sandy Peters, head of financial reporting policy for the CFA Institute, which represents chartered financial analysts, in an interview.

Research firm Audit Analytics found that 97% of S&P 500 companies used non-GAAP figures in 2017, up from 59% in 1996.

The recent proliferation of non-GAAP usage among technology companies has created greater discrepancies between the valuations of publicly traded companies. Sector participants are highly unlikely to have positive net income according to normal accounting rules. For example, Uber Technologies Inc. uses non-GAAP "core platform adjusted net revenue," which attempts to strip out recurring costs it incurs to grow in competitive markets.

The Harvard and MIT researchers found that companies averaged eight total adjustments to their income statements in 2017, up from six in 1998. The average adjustment per company added 26 cents per share, which equates to about 15% of average GAAP earnings per share.

A significant portion of GAAP earnings consists of non-operating earnings, which companies frequently hide in the management discussion and analysis section or in the footnotes of their annual reports. Companies make non-GAAP adjustments by taking some subset of non-operating earnings and adding it back to net income.

"These non-operating earnings can substantially complicate the forecasting of companies' future performance for analysts and investors," Charles Wang, an associate professor at Harvard and one of the authors of the study, said in an interview.

For a younger generation of analysts, adjusted earnings comprise most of what they've seen, Ms. Peters said. Some portfolio managers have said those analysts are not as skeptical of the numbers as they should be, she added.

The average number of hidden adjustments rose 13%, to 3.78 from 3.35, over 20 years, the researchers found. The per-share value of hidden total adjustments increased by more than seven times to $0.127 in 2018 from $0.015 in 1998.

Write to Mark Maurer at mark.maurer@wsj.com