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Apples to Apples: A Template for Reporting Quarterly Earnings



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Its sponsoring organization, CFA Institute, is the 89,000-member, not-for-profit organization that awards the Chartered Financial Analyst® designation worldwide. CFA Institute was known as the Association for Investment Management and Research (AIMR) from 1990 through early 2004 and before that was two separate organizations with roots going back to 1947. More information can be found at www.cfainstitute.org.

The Business Roundtable Institute for Corporate Ethics is an independent entity established in partnership with Business Roundtable—an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees and \$4.5 trillion in annual revenues—and leading academics from America's best business schools. The Institute, which is housed at the University of Virginia's Darden Graduate School of Business Administration, brings together leaders from business and academia to fulfill its mission to renew and enhance the link between ethical behavior and business practice through executive education programs, practitioner-focused research, and outreach. More information on the Institute can be found at www.corporate-ethics.org.

Apples to Apples

A Template for Reporting Quarterly Earnings

March 2007

INTRODUCTION AND CALL TO ACTION

In July 2006, the CFA Institute Centre for Financial Market Integrity (the Centre) and the Business Roundtable Institute for Corporate Ethics (the Institute) issued a report, “Breaking the Short-Term Cycle,” which for the first time addressed the issue of “short-termism”—corporate and investment decision making based on short-term earnings expectations versus long-term value creation for all stakeholders—from a unique cross-group perspective.¹

The report drew on insights from thought leaders of the corporate issuer, analyst, asset and hedge fund manager, institutional investor, and individual investor communities to confirm what the academic research suggests: namely, that the obsession with short-term results by investors, asset management firms, and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance.

SUMMARY OF RECOMMENDATIONS from “Breaking the Short-Term Cycle”

Corporate leaders, asset managers, investors, and analysts should:

1. **Reform earnings guidance practices:** All groups should reconsider the benefits and consequences of providing and relying upon focused, quarterly earnings guidance and each group’s involvement in the “earnings guidance game.”
2. **Develop long-term incentives across the board:** Compensation for corporate executives and asset managers should be structured to achieve long-term strategic and value-creation goals.
3. **Demonstrate leadership in shifting the focus to long-term value creation.**
4. **Improve communications and transparency:** More meaningful, and potentially more frequent, communications about company strategy and long-term value drivers can lessen the financial community’s dependence on earnings guidance.
5. **Promote broad education of all market participants about the benefits of long-term thinking and the costs of short-term investing.**

This report, “Apples to Apples: A Template for Reporting Quarterly Earnings,” seeks to advance the specific principles and recommendations from the initial work in confronting short-termism. Specifically, the report analyzes the role and impact of quarterly earnings releases in light of two of our key principles related to combating short-termism: 1) reforming earnings guidance practices and 2) improving communications and transparency.

¹“Breaking the Short-Term Cycle” is available online at: www.cfapubs.org/loi/ccb.

Apples to Apples

A Template for Reporting Quarterly Earnings

There has been much discussion about the challenge investors face trying to comprehend quarterly earnings announcements. Effective March 2003, the SEC adopted Regulation G (Reg. G) to implement provisions of the Sarbanes-Oxley Act of 2002.² Reg. G directs companies using non-GAAP financial measures in their furnished information (e.g., quarterly earnings announcements) to reconcile such information to the most directly comparable GAAP measure. Reg. G was issued in response to the growing concern that quarterly earnings releases were becoming increasingly misleading and opaque in terms of actual GAAP earnings information and is intended “to provide investors with balanced financial disclosure when non-GAAP financial measures are presented.”³

While companies must now follow Reg. G requirements when disclosing or releasing material information that includes a non-GAAP financial measure, many observers continue to suggest that these requirements only partially address SEC concerns for having transparent and fair disclosures. These concerns become more apparent when one considers that companies provide their earnings releases some weeks before the formal 10-Q or 10-K filing. As part of our continuing efforts regarding short-termism, we are recommending specific refinements to the content and organization of quarterly earnings releases to improve transparency.

²Securities and Exchange Commission. “Conditions for Use of Non-GAAP Financial Measures.” Rel. No. 33-8176; 34-47226; FR-65; File No. S7-43-02 (22 January 2003).

³Ibid.

RECOMMENDATIONS

To better enable all financial statement users to make consistent, apples-to-apples comparisons among quarterly financial reports, we recommend that all public companies voluntarily adopt a consistent template for quarterly earnings releases. The template would provide management with a user-friendly format in which to highlight issues of importance in an informative and concise manner. These recommendations are based on a comprehensive review of quarterly earnings announcements from a number of companies and discussions with financial experts and users of financial statements.

In order to improve the quality of communications between companies and investors, we strongly urge companies to issue quarterly earnings reports that:

- **End quarterly earnings guidance:** The current practice of focused quarterly earnings guidance inadequately accounts for the complex dynamics of companies and their long-term value drivers. The costs and negative consequences of the current focused, quarterly earnings guidance practices are significant, including:
 1. unproductive efforts by corporations in preparing such guidance,
 2. neglect of long-term business growth in order to meet short-term expectations,
 3. a “quarterly results” financial culture characterized by disproportionate reactions among internal and external groups to the downside and upside of earnings surprises, and
 4. macro-incentives for companies to avoid earnings guidance pressure altogether by moving to the private markets.⁴
- **Include a GAAP income statement that starts at the revenue line and proceeds to net income:** Although the information necessary to reconcile the text of the earnings release and the GAAP financial income statement data is often contained in the release, it is too often unnecessarily cumbersome and challenging to find and piece together. Current reconciliation tables to GAAP data are too often confusing and obscured within the earnings announcement. The GAAP statement—which could use either gross or net measures, depending on how the company normally reports—ought to 1) provide sufficient line-item information for the investor to follow the calculation from revenue to net income and 2) display shares outstanding, making it easy for investors to calculate per share figures and the per share earnings for the quarter. While companies can focus their quarterly earnings reports on any number of items, we find the primary common theme to be management discussion of adjustments to GAAP earnings.⁵ We assume management believes these adjustments provide a more useful picture of the company or they would not provide a discussion of them. We recommend a common format for such tables in order to improve the clarity of reconciliation between GAAP and text of the release, thereby improving communication between investor and company. The table would show the adjustments to the relevant numbers at both the company level and per share level, with pre- and after-tax information as necessary.
- **Position GAAP reconciliation tables in immediate proximity to the non-GAAP financial measures they are meant to illuminate:** A concise GAAP reconciliation table should be positioned immediately after (or next to) non-GAAP earnings or income highlighted in the release. The table should clearly present the management adjustments from GAAP net income to the particular metric management has defined as most useful for understanding the financial status of the firm.

⁴Further justification can be found in “Breaking the Short-Term Cycle.”

⁵Often referred to by management as the non-GAAP term “special items.”

- **Include a balance sheet and statement of cash flows:** A balance sheet and statement of cash flows, along with any relevant reconciliation tables, should be included in the release. In addition, we encourage expanded discussion of balance sheet and cash flow items as appropriate. The balance sheet and cash flow information should be sufficiently representative so that it is possible to reconcile income statement items that have a direct cause or effect on the balance sheet or cash flow statement. For example, changes in interest expense on the income statement cannot be fully reconciled without the information on the balance sheet about the level of debt. Full display of financial information, including GAAP reconciliations, will support efforts to improve communication.

SEC statements have indicated an increased scrutiny of “non GAAP financial measures that eliminate the effect of recurring items by describing them as non-recurring . . . Merely labeling an item as non-recurring does not make it so.”⁶

- **Place information consistently:** While we acknowledge the need for flexibility and the variety of considerations related to the release of corporate information, we encourage the consistent placement of all tables and reconciling information within the release. Specifically, we recommend placement of such information at the front or the end of all future quarterly releases.

⁶See “Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures,” prepared by staff members in the Division of Corporation Finance, U.S. Securities and Exchange Commission, Washington, D.C., Question 9.

TEMPLATE FOR REPORTING QUARTERLY EARNINGS

The following example provides a version of the template described earlier in the form of a third quarter earnings announcement for a fictitious firm, XYZ Company. In this announcement, the company has certain earnings and income that management has highlighted. We include the opening paragraphs from XYZ Company's announcement. We do not include the full GAAP financial statements for the quarter or year to date because these would not change from what is currently reported in the typical earnings announcement.

XYZ COMPANY REPORTS THIRD QUARTER EARNINGS FROM CONTINUING OPERATIONS OF \$0.97 PER SHARE

- *Revenue Grew by 3.3% to \$10.8 Billion from the Quarter Ended 30-Sep-05 to the Quarter Ended 30-Sep-06.*
- *GAAP Earnings from Continuing Operations Improved by \$0.06 Per Share from the Quarter Ended 30-Sep-05 to the Quarter Ended 30-Sep-06.*
- *Results Were Positively Impacted by Net Adjustments to GAAP Earnings of \$0.03 Per Share for Special Items.*
- *Discontinued Operations Contributed \$0.05 Per Share to Overall Earnings.*

New York – Dec. 15, 2006 – XYZ Company (NYSE: XYZ) today reported diluted GAAP earnings per share from continuing operations (EPS) of \$0.97 for the third fiscal quarter of 2006, compared with \$0.91 in the third fiscal quarter of 2005. Last year's results included net charges of \$0.15 per share related to charges from Hurricane Katrina, as well as early retirement of debt, restructuring, and divestiture charges. Revenue in the third quarter totaled \$10.8 billion, with organic revenue growth of 2 percent. Cash flow from operating activities was \$2.0 billion, and the company generated free cash flow of \$1.5 billion in the quarter.⁷ During the fourth quarter, the company entered an agreement to sell the Widget Division. The division has been classified as a discontinued operation for the quarter, and results are reported accordingly. Widget revenue was \$625 million, and operating income was \$103 million for the quarter. The comparable adjustments for the previous quarter ending 30-Sep-05 would have been \$552 million in revenue and \$94 million in operating income. The company determined to divest the division due to underperformance related to other company divisions and because it no longer fit the overall business strategy.

In the current quarter, EPS from continuing operations included net charges of \$0.15 per share. During the quarter, the company sold some plant assets no longer required for operations and resolved certain legacy legal matters that resulted in \$0.07 per share of income. Included in this income were asset sales of \$0.05 per share and a court award from a legal matter of \$0.02 per share. Both adjustments to charges and income are reflected in the following adjustments to GAAP net income table.

For the year to date, the company had revenue of \$xxx billion, with net income of \$xxx. etc.

Financial tables follow.

⁷Cash flow from operations would be displayed in the cash flow statement, and a reconciliation table to free cash flow would also be provided. While we recommend that the free cash flow reconciliation table be provided near the discussion of such items, because it is not directly related to a discussion of GAAP earnings, it could also be placed with all other financial tables.

XYZ Company Condensed Statements of Income
(\$ in millions)

	Quarter ended	
	30-Sep-06	30-Sep-05
Net revenue	10,826	10,476
Operating expenses (COS, SG&A, D&A, other)	7,685	7,406
Operating income	3,141	3,070
Interest income	4	36
Interest expense	(224)	(257)
Other income	18	(97)
Pre-tax income	2,939	2,752
Income taxes	882	798
Minority interest	5	5
Net income from continuing operations	2,052	1,949
Income from discontinued operations (after tax)	110	94
Net income	2,162	2,043
Effective tax rate	30.0%	29.0%
Diluted shares outstanding	2,125	2,150
EPS from continuing operations – diluted	0.97	0.91
EPS from discontinued operations – diluted	0.05	0.04
EPS – diluted	1.02	0.95

XYZ Company Management Adjustments to GAAP Net Income
(\$ millions)

Management adjustments to GAAP net income	For quarter ended 30-Sep-06			
	Pre-tax adjustment	Taxes	After-tax adjustment	Per share adjustment
GAAP net income			2,162	1.02
Adjustments to expenses				
Disaster recovery	279	84	195	0.09
Early retirement of debt	114	34	80	0.04
Restructuring	54	16	38	0.02
Charge for divestitures	14	4	10	0.00
Subtotal	461	138	323	0.15
Adjustments from income				
Asset sales	153	46	107	0.05
Court award from legal case	67	20	47	0.02
Subtotal	220	66	154	0.07
Total adjustments to earnings, continuing operations	241	72	169	0.08
Income from discontinued operations	85	(25)	110	0.05
Management adjustments to GAAP net income	156	97	59	0.03
Adjusted Non-GAAP net income			2,221	1.05

XYZ Company Balance Sheets

XYZ Company Statements of Cash Flows

XYZ Company Segmental or Other Financial Statement Information