

## Case 10-5

## Management Earnings Disclosures and Pro Forma Reporting\*

In September 1999, a lessee (Official All-Star Café) vacated its space at the Trump Taj Mahal Casino in Atlantic City, which was owned by Trump Hotels and Casino Inc. (DJT). According to the lease termination contract, the casino was given some of the restaurant's fixtures and memorabilia. DJT valued those assets at \$17.2 million, resulting in a one-time gain included in the company's quarterly earnings. Management reported third-quarter results on October 25, 1999, and highlighted that earnings of \$0.63 per share not only beat analysts' estimates of \$0.54 per share, but also were more than double the reported earnings per share from the year-earlier quarter. The earnings reported by DJT were referred to as "pro forma earnings" and the press release noted that the "pro forma" numbers *excluded* a one-time charge of \$81.4 million. However, the press release did not mention that the results *included* the effects of the one-time gain of \$17.2 million.<sup>1</sup>

Subsequently, the Securities and Exchange Commission (SEC) charged that DJT had recklessly misled shareholders, and stated that DJT executives knew better than to allow the double standard of reporting an earnings number that excluded a one-time loss but not a one-time gain. DJT agreed to settle the charges and consented to the SEC's cease-and-desist order, acknowledging the federal agency's findings without admitting or denying them.<sup>2</sup> DJT also agreed to be subject to stiff sanctions if it committed similar violations again.<sup>3</sup>

**MANAGEMENT EARNINGS DISCLOSURES**

One of the most closely watched rituals on Wall Street is the announcement of quarterly earnings by managers of publicly traded companies. Shortly af-

ter each fiscal quarter, managers formally announce the results of operations, distributing the announcements through news wire services such as PR Newswire and Business Wire. These announcements are picked up by national and regional newspapers and periodicals, and also tracked by numerous investment-related firms. Prior to such earnings announcements, investors have expectations about what earnings figure managers will report. These expectations are generally summarized by a "consensus" earnings forecast, which is simply the average of all the forecasts of earnings per share released by equity analysts employed at the large Wall Street brokerage houses.

If a company announces earnings that exceed the consensus expectation, investors generally interpret this as good news. However, if the earnings fall below the consensus expectation, investors react negatively, frequently sending the stock down significantly. For example, on January 7, 1998, Rainforest Café announced that earnings would be 22 cents per share. Even though this was an increase over the 15 cents per share reported in the same quarter of the prior year, the consensus expectation had been 24 cents per share. In response to the announcement, investors pummeled Rainforest's stock and the stock price fell 40% on a single day.<sup>4</sup>

**PRO FORMA EARNINGS**

Managers have gradually supplemented quarterly earnings announcements with earnings preannouncements and conference calls. In addition, managers of corporations have been increasingly reporting earnings that are modifications of generally accepted accounting principles (GAAP). The term "pro forma" earnings has become the general term describing this type of reporting, although other terms are also frequently used, including "recurring," "operating," "core," "normalized," "adjusted," or "cash" earnings.

The primary characteristic of pro forma earnings is that they exclude certain items required to be included

\* Copyright © by the President and Fellows of Harvard College. Harvard Business School case 103-005.

<sup>1</sup> Judith Burns, "SEC Settles With Trump Hotels Casino Over Pro Forma Case," *Dow Jones News Service*, January 16, 2002.

<sup>2</sup> "SEC Brings First Pro Forma Financial Reporting Case Trump Hotels Charged With Issuing Misleading Earnings Release," *Securities and Exchange Commission*, January 16, 2002.

<sup>3</sup> Paul Haavardsrud, "Trump first to feel SEC crackdown: Pro forma earnings," *National Post*, January 17, 2002.

<sup>4</sup> Richard G. Sloan and Douglas J. Skinner, "Earnings Surprises, Growth Expectations, and Stock Returns." Working paper, University of Michigan Business School.

in the calculation of GAAP earnings that are filed with the SEC. Pro forma earnings, for which there are no explicit regulations, are typically disclosed through company press releases discussing quarterly performance results. They are not included in the company's audited financial statements and related notes.

The historical understanding of pro forma earnings was that they were an "as if" set of accounting statements, most frequently used to show how historical performance might have been had two merging (or divesting) companies been merged (or divested) in prior years. The disclosure of this type of pro forma earnings figure has been required by the SEC in Regulation S-X, which sets forth the form and content of financial statements and all related schedules required to be filed with the SEC. According to Article 11 of Regulation S-X,

Pro forma financial information should provide investors with information about the continuing impact of a particular transaction by showing how it might have affected historical financial statements if the transaction had been consummated at an earlier time. Such statements should assist investors in analyzing the future prospects of the registrant because they illustrate the possible scope of the change in the registrant's historical financial position and the results of operations caused by the transaction.<sup>5</sup>

Thus, the essence of pro forma earnings reporting initially envisioned by the SEC, was that it be a means of increasing the comparability of earnings between different reporting periods.

Rather than using pro forma to describe "what if" results in connection with a merger or divestiture, corporate managers began reporting pro forma earnings that might be described as "what if" certain income statement items were excluded from the calculation of earnings. Items commonly excluded from pro forma earnings include restructuring charges, asset write-downs, depreciation and amortization expense, impairment charges for goodwill and other intangible assets, stock-related compensation expenses, research and development charges, and numerous miscellaneous items. By far, the most frequently excluded items are write-offs and restructuring charges. See Exhibit 1 and Exhibit 2 for examples of earnings an-

<sup>5</sup> Regulation S-X, Securities and Exchange Commission, July 1982.

nouncements in which Proxim, Inc., and Cisco Systems, Inc., exclude a number of these charges in their calculation of pro forma earnings.

One study examined earnings announcements, finding changes over time in the composition of earnings announcements, indicating that managers are not only reporting non-GAAP earnings figures with increasing frequency now, but also that such managers emphasize the non-GAAP earnings figures much earlier than the actual GAAP earnings in the press release.<sup>6</sup> Sometimes GAAP figures are not discussed in the press release at all, but are included in tables attached to the end of the press release. Furthermore, the study showed that stock prices are better explained by the non-GAAP earnings than by GAAP earnings.

### REGULATORY RESPONSE TO PRO FORMA REPORTING

The reporting of pro forma and other forms of non-GAAP earnings has become a major issue for many organizations with an interest in corporate financial reporting, including the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), the SEC, the National Investor Relations Institute (NIRI), Financial Executives International (FEI), brokerage houses employing analysts who forecast earnings, financial forecast data providers such as First Call, rating agencies such as Standard & Poor's (S&P), and the House of Representatives Subcommittee on Commerce, Trade and Consumer Protection.

The FASB said it would consider launching a new project exploring ways to better standardize companies' financial statements. However, most of the controversy about pro forma earnings centered on companies' press releases, not their official financial statements. "We have no authority or responsibility for press releases or information that's provided to analysts other than through the presentation of full financial statements," said FASB's former Chairman Edmund Jenkins.<sup>7</sup>

As noted above, the SEC charged that Trump Hotels and Casino Inc. had abused pro forma reporting.

<sup>6</sup> Mark T. Bradshaw and Richard G. Sloan, "GAAP Versus The Street: An Empirical Assessment of Two Alternative Definitions of Earnings," *Journal of Accounting Research*, Vol. 40, No. 1, March, 41-66.

<sup>7</sup> Jonathan Weil, "Accounting Board Responds to Use Of Earnings on Pro-Forma Basis," *The Wall Street Journal*, August 22, 2001.

**EXHIBIT 1 Proxim Earnings Announcement****Proxim, Inc., Reports Q4 and Year-End 2001 Financial Results**

01/22/2002

Business Wire

(Copyright ©2002, Business Wire)

SUNNYVALE, Calif.—(BUSINESS WIRE)—Jan. 22, 2002—Proxim, Inc. (Nasdaq:PROX) announced today financial results for the fourth quarter and fiscal year ended December 31, 2001. Revenue for the fourth quarter of 2001 was \$16,701,000, compared to revenue of \$33,627,000 for the fourth quarter of 2000. Revenue for the year ended December 31, 2001, was \$85,536,000, compared to revenue of \$107,498,000 for the year ended December 31, 2000.

Excluding the provisions and charges discussed below, and the amortization of intangible assets and goodwill in the respective periods, the pro forma loss for the fourth quarter of 2001 was \$(1,093,000), or \$(0.04) per share, compared to pro forma net income of \$4,943,000, or \$0.17 per share (diluted) for the fourth quarter of 2000, and pro forma net income for the year ended December 31, 2001 was \$1,808,000, or \$0.06 per share (diluted), compared to pro forma net income of \$14,631,000, or \$0.51 per share (diluted) for the year ended December 31, 2000.

Including the provisions and charges discussed below, and the amortization of intangible assets and goodwill in the respective periods, the loss for the fourth quarter of 2001 was \$(16,002,000), or \$(0.53) per share, compared to net income of \$1,970,000, or \$0.07 per share (diluted) for the fourth quarter of 2000, and the loss for the year ended December 31, 2001 was \$(107,799,000), or \$(3.87) per share, compared to net income of \$2,149,000, or \$0.07 per share (diluted) for the year ended December 31, 2000.

During the fourth quarter of 2001, the Company recorded a restructuring charge of \$12,635,000 related to a reduction in workforce and closing certain facilities. The fourth quarter 2001 restructuring charge includes \$1,400,000 related to severance payments and closed facilities lease costs during the quarter, and \$11,235,000 related to closed facilities lease commitments, net of estimated future sublease receipts for the closed facilities.

During the fiscal year ended December 31, 2001, the Company recorded the following charges and provisions: restructuring charges of \$550,000 in the second quarter, \$400,000 in the third quarter, and \$12,635,000 in the fourth quarter; provisions for excess and obsolete inventory and purchase commitments totaling \$44,000,000 in the second quarter and \$6,000,000 in the third quarter; increases in the allowance for doubtful accounts of \$2,000,000 in the second quarter and \$2,500,000 in the third quarter; a charge for purchased in-process research and development related to the acquisition of Card Access, Inc. of \$1,373,000 in the third quarter; a charge for the impairment of goodwill and purchased intangible assets of \$10,372,000 in the second quarter; a charge for expenses related to a terminated merger of \$2,950,000 in the first quarter; a charge for expenses related to patent litigation of \$2,600,000 in the first quarter; charges for the impairment of equity investments in five companies of \$5,694,000 in the first quarter, \$1,000,000 in the second quarter, and \$5,380,000 in the third quarter; and a provision for deferred tax assets net of deferred tax liabilities of \$5,043,000 in the second quarter.

**Conference Call Information**

Investors and analysts are invited to dial 212/547-0138 at least five minutes before 2:00 P.M. PST (5:00 P.M. EST) today for a conference call. The pass code for the call is PROXIM and the moderator is Keith Glover. A replay of this call will be available at 402/220-9775 until January 26, 2002.

**About Proxim**

Proxim, Inc., a leader in wireless networking, delivers a complete range of flexible, multi-standard wireless networking solutions for enterprises, service providers, small businesses and homes. With more than 15 years at the forefront of wireless networking innovation and product development, Proxim has solutions that meet the unique needs of every market. Proxim is a member of the Wireless Ethernet Compatibility Alliance and a Promoter of the Home Radio Frequency Working Group. The company is headquartered in Sunnyvale, California, with offices globally. Visit [www.proxim.com](http://www.proxim.com) for more information.

**EXHIBIT 1 (continued)** Proxim, Inc., Statement of Operations for the Year Ended December 31, 2001  
(in thousands, except per share data)

|  | GAAP        | Pro Forma |
|--|-------------|-----------|
| Revenue  | \$ 85,536   | \$85,536  |
| Cost of revenue excluding amortization and provision | 49,367      | 49,367    |
| Amortization of intangible assets                    | 2,832       | —         |
| Provision for excess and obsolete inventory          | 50,000      | —         |
| Gross profit (loss)                                  | (16,663)    | 36,169    |
| Research and development                             | 13,235      | 13,235    |
| Purchased in-process research and development        | 1,373       | —         |
| Selling, general and administrative                  | 22,057      | 22,057    |
| Provision for doubtful accounts                      | 4,500       | —         |
| Restructuring charges                                | 13,585      | —         |
| Impairment of goodwill and intangible assets         | 10,372      | —         |
| Terminated merger costs                              | 2,950       | —         |
| Patent litigation costs                              | 2,600       | —         |
| Amortization of goodwill                             | 5,252       | —         |
| Income (loss) from operations                        | (92,587)    | 877       |
| Interest income, net                                 | 1,905       | 1,905     |
| Impairment gain (losses) on investments              | (12,074)    | —         |
| Income (loss) before taxes                           | (102,756)   | 2,782     |
| Provision for income taxes                           | 5,043       | 974       |
| Net income (loss)                                    | (\$107,799) | \$1,808   |
| Basic net income (loss) per share                    | (\$3.87)    | \$0.06    |
| Diluted net income (loss) per share                  | (\$3.87)    | \$0.06    |

Source: Proxim Inc., 2001 form 10-K filing with the SEC.

"This is the first Commission enforcement action addressing the abuse of pro forma earnings figures," said Stephen M. Cutler, Director of the Commission's Division of Enforcement.<sup>8</sup> "In this case, the method of presenting the pro forma numbers and the positive spin the Company put on them were materially misleading. The case starkly illustrates how pro forma numbers can be used deceptively and the mischief that they can cause."<sup>9</sup>

As a result of the controversy, S&P initiated a broad effort within the investment community to generate discussion and recommendations on how corporate earnings should be reported and examined. S&P wanted to develop a standard definition of "operating earnings." David M. Blitzer, managing director and chief investment strategist at Standard & Poor's said, "Our intention is to generate dis-

ussion on earnings measures that will lead to agreement on how these measures should be defined. Once agreement is reached, these definitions will be used for the earnings data."<sup>10</sup>

On May 14, 2002, S&P introduced its new definition for the term "operating earnings."<sup>11</sup> S&P recommended that companies *include* in operating earnings certain expense items many had been routinely excluding, such as restructuring charges, write-downs of assets used in continuing operations, stock option expenses, and write-offs of research and development purchased from other companies. Items that S&P suggested companies *exclude* from operating earnings fell into four broad categories: (1) goodwill write-downs; (2) charges from litigation settlements; (3) gains and losses on

<sup>8</sup> "SEC Brings First Pro Forma Financial Reporting Case Trump Hotels Charged With Issuing Misleading Earnings Release," Securities and Exchange Commission, January 16, 2002.

<sup>9</sup> Ibid.

<sup>10</sup> "IOMA Supports S&P and SEC Ideas on Pro Forma Reporting," *Institute of Management & Administration (IOMA)*, December 1, 2001.

<sup>11</sup> Henry Sender and Michael Rapoport, "S&P Introduces New Definition for Term 'Operating Earnings,'" *The Wall Street Journal*, May 15, 2002.

## **EXHIBIT 2 Excerpt from Cisco Systems, Inc. 2001 Earnings Announcement**

### **Cisco Systems Reports Fiscal Year 2001 and Fourth Quarter Earnings**

08/07/2001

Business Wire (Copyright ©2001, Business Wire)

SAN JOSE, California—August 7, 2001—Cisco Systems, Inc., the worldwide leader in networking for the Internet, today reported its fiscal year 2001 and fourth quarter results for the period ending July 28, 2001.

Net sales for fiscal 2001 were \$22.29 billion, compared with \$18.93 billion for fiscal 2000, an increase of 18%. Pro forma net income, which excludes the effects of acquisition charges, payroll tax on stock option exercises, restructuring costs and other special charges, excess inventory charge (benefit), and net gains realized on minority investments, was \$3.09 billion or \$0.41 per share for fiscal 2001, compared with pro forma net income of \$3.91 billion or \$0.53 per share for fiscal 2000, decreases of 21% and 23%, respectively.

Actual net loss for fiscal 2001 was \$1.01 billion or \$0.14 per share, compared with actual net income of \$2.67 billion or \$0.36 per share for fiscal 2000.

Net sales for the fourth quarter of fiscal 2001 were \$4.30 billion, compared with \$5.72 billion for the same period last year, a decrease of 25%. Pro forma net income was \$163 million or \$0.02 per share for the fourth quarter of fiscal 2001, compared with pro forma net income of \$1.20 billion or \$0.16 per share for the fourth quarter of fiscal 2000, decreases of 86% and 87%, respectively.

Actual net income for the fourth quarter of fiscal 2001 was \$7 million or \$0.00 per share, compared with actual net income of \$796 million or \$0.11 per share for the same period last year.

"In many ways, fiscal 2001 was like two different years, starting out even more positive than we anticipated through December with year-over-year growth in the 60%+ range and then turning into an extremely challenging second half of the year," said John Chambers, CEO of Cisco Systems. "In a consolidating market, our competitive advantages continue to play to what our customers value. Cisco is starting to develop early business momentum in key markets and we believe we are very well positioned from a financial and market share perspective to lead as our customers standardize on a few strategic partners as the market recovers."

Cisco will discuss its year-end and fourth quarter results for fiscal 2001 on a conference call today, beginning at 1:45 P.M. PST. A Webcast of the conference call will be available to all interested parties on the Cisco Web site at [www.cisco.com](http://www.cisco.com) under the "Investor Relations" section.

#### **About Cisco Systems**

Cisco Systems, Inc., (NASDAQ: CSCO) is the worldwide leader in networking for the Internet. News and information are available at [www.cisco.com](http://www.cisco.com).

This release contains projections and other forward-looking statements regarding future events and the future financial performance of Cisco that involve risks and uncertainties. Readers are cautioned that these forward-looking statements are only predictions and may differ materially from actual future events or results. Readers are referred to the documents filed by Cisco with the SEC, specifically the most recent reports on Form 10-K, 8-K, and 10-Q, each as it may be amended from time to time, which identify important risk factors that could cause actual results to differ from those contained in the forward-looking statements, including risks associated with business and economic conditions and growth in the networking industry in various geographic regions; global economic conditions; overall information technology spending, especially service provider capital spending in the data or IP segments; variations in customer demand for products and services; the ability to successfully restructure existing businesses; the timing of orders and manufacturing lead times; changes in customer order patterns; insufficient, excess or obsolete inventory; variations in sales channels, product costs, or mix of products sold; the ability to successfully reduce overhead and manage expenses; the ability to successfully integrate and operate acquired businesses and technologies; increased competition in the networking industry; dependence on the introduction and market acceptance of new product offerings and standards; rapid technological and market change; the trend towards sales of integrated network solutions; manufacturing and sourcing risks; Internet infrastructure and regulation; international operations, the timing and amount of employer payroll tax to be paid on employees' gains on stock options exercised; litigation involving patents, intellectual property, antitrust and other matters; stock price volatility; financial risk management; and potential volatility in operating results, among others. The financial information contained in this release should be read in conjunction with the consolidated financial statements and notes thereto included in Cisco's most recent reports on Form 10-K and Form 10-Q each as it may be amended from time to time. Cisco's results of operations for the three and twelve months ended July 28, 2001, are not necessarily indicative of Cisco's operating results for future periods.

Aironet, Catalyst, Cisco, Cisco AVVID, Cisco Systems, and the Cisco Systems logo are registered trademarks of Cisco Systems, Inc., or its affiliates in the U.S. and certain other countries. All other brands, names, or trademarks mentioned in this document or Web site are the property of their respective owners.

**EXHIBIT 2 (continued)** Cisco Systems, Inc., Income Statement for Fiscal Year Ended July 28, 2001  
(in millions, except per-share amounts)

|  | GAAP       | Pro Forma |
|--|------------|-----------|
| Net Sales  | \$22,293   | \$22,293  |
| Cost of Sales  | 11,221     | 9,159     |
| Gross Margin   | 11,072     | 13,134    |
| Research and Development                                       | 3,778      | 3,778     |
| Sales and Marketing  | 5,240      | 5,240     |
| General and Administrative                                     | 768        | 768       |
| Restructuring Costs and Other Special Charges                  | 1,170      | —         |
| Payroll Tax on Stock Option Exercise                           | 55         | —         |
| Amortization of Goodwill and Other Acquisition Related Charges | 1,210      | —         |
| In-Process Research and Development                            | 855        | —         |
| Total Operating Expenses                                       | 13,076     | 9,786     |
| Operating Income (Loss)  | (2,004)    | 3,348     |
| Net Gains Realized on Minority Investments                     | 190        | —         |
| Interest and Other Income, Net                                 | 940        | 940       |
| Pretax Income (Loss)   | (874)      | 4,288     |
| Taxes—Provision (Benefit)                                      | 140        | 1,202     |
| Net Income (Loss)  | \$ (1,014) | \$ 3,086  |
| Net Income (Loss) Per Share—Basic                              | \$ (0.14)  | \$ 0.43   |
| Net Income (Loss) Per Share—Diluted                            | \$ (0.14)  | \$ 0.41   |
| <b>Pro Forma Adjustments:</b>                                  |            |           |
| In-process research and development                            |            | \$ 855    |
| Payroll tax on stock option exercise                           |            | 55        |
| Amortization of goodwill and special charges                   |            | 1,210     |
| Net gains realized on minority investments                     |            | (190)     |
| Restructuring costs and other special charges                  |            | 1,170     |
| Excess inventory charge  |            | 2,062     |
| Income tax effect  |            | (1,062)   |
| Net effect of pro forma adjustments                            |            | \$ 4,100  |

Source: Cisco Systems, Inc., 2001 form 10-K filing with the SEC.

asset sales; and (4) expenses related to mergers and acquisitions.<sup>12</sup>

### INTERNATIONAL PRO FORMA REPORTING

At a time when U.S. regulators were increasingly occupied with whether to intervene in the use of pro forma accounting, some European companies enthusiastically began exploring its possibilities. Nokia Corp., in response to requests from shareholders and securities analysts, began reporting pro

forma results in 2001 and exclude amortization of goodwill and nonrecurring items. Nokia Corp. reported third-quarter pretax profit of nearly 1.1 billion euros on a pro forma basis compared with an actual pretax profit, based on International Accounting Standards, of 281 million euros.<sup>13</sup>

A study of pro forma accounting in the U.K. by Company Reporting Ltd., an Edinburgh, Scotland, independent financial research company, showed that not only was the practice growing, but the bigger the company, the more likely it was to produce

<sup>12</sup> Steve Leisman and Jonathan Weil, "S&P to Wade Into Pro-Forma Earnings Mess," *The Wall Street Journal*, November 7, 2001.

<sup>13</sup> Gren Manuel, "European Interest Grows In Pro Forma Accounting," *The Wall Street Journal*, January 8, 2002.

pro forma accounts. Among the 78 blue-chip companies analyzed between 1999 and 2001, 22 of them, or 28%, produced pro forma figures.<sup>14</sup> Similarly, in Germany the practice, although rare on the primary Frankfurt Stock Exchange, has been enthusiastically adopted by companies listing on the Neuer Market.<sup>15</sup>

In testimony before the House Energy and Commerce Subcommittee on Commerce, Trade and Consumer Protection, James Leisenring, a member of the International Accounting Standards Board and former FASB member, said pro forma accounting was starting to take root around the world: "Pro forma accounting seems to be something Americans can export, and it's probably going to cause the same confusion you're describing here."<sup>16</sup>

<sup>14</sup> Ibid.

<sup>15</sup> The Neuer Market is a German stock exchange that resembles the listing composition of the NASDAQ in the United States, consisting primarily of young but high growth high tech firms.

<sup>16</sup> "Unusual Expenses Trip Up Waste Management's Pro Forma Reporting," *The Institute of Management & Administration (IOMA)*, October 1, 2001.

## Questions

1. What is pro forma reporting according to regulation SX of the SEC? How has pro forma reporting been used by corporations over the years? Summarize the arguments for and against this type of reporting.
2. Exhibits 1 and 2 provide sample earnings announcements and pro forma information released by Proxim and Cisco Systems, respectively. Do you believe these disclosures are consistent with the spirit of the SEC regulation or are they corporate abuses of financial disclosure? As a CFO of these companies, what would you have reported in your earnings announcement for the respective period?
3. Do you believe the SEC should permit the type of disclosure shown in Exhibits 1 and 2?
4. What is the usefulness of the pro forma versus GAAP earnings disclosure found in Exhibits 1 and 2 with regards to evaluating:
  - a. Recent financial performance;
  - b. Expectations of future earnings;
  - c. Credibility of management;
  - d. Quality of earnings; and
  - e. Equity valuation.