POLICY PAPER

Accounting Measures of Financial Performance

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Net income is no longer the only measure of performance: other measures have been developed either by standard setters (*Comprehensive income*), or through practice (adjusted earnings, operating income or *Non-GAAP earnings*). With regard to the latter, a distinction is made between earnings adjusted by management (*Pro forma earnings*) and those adjusted by financial analysts (*Street earnings*). Note that the term "pro forma" is used with a broader meaning in this context than in standard setting[1].

Market participants are not always aware of the composition and relevance of these alternative indicators. The purpose of this paper is to provide standard setters with useful inputs based on a review of academic research on the accounting measures of financial performance. The scope of our review is defined by the purpose of this paper: it is limited to accounting measures of financial performance. Therefore stock exchange indicators (such as TSR: *Total Shareholder Return*) have not been considered in this paper. In the same way, the scope of this policy paper is limited to financial performance: non-financial performance indicators are excluded (social, societal environmental performance) as is integrated reporting.

After a presentation of the issues related to the measurement of performance, the main research results published on this subject will be examined. Lastly, three proposals will be presented as inputs to accounting standard setters.

1. Issues related to the measurement of financial performance

1.1 The objectives of performance measures

Measuring financial performance is complex and may serve two purposes at once. It is both useful for exercising control over management and for taking investment decisions (Lambert, 2004). To exercise control over management, financial reporting must provide a full account of the transactions for the previous period: this is a reference to the *Stewardship role of Accounting*. The other purpose is to assist shareholders in taking investment decisions; decisions to buy, sell or hold shares. This requires cash flow forecasts including an assessment of the related risks. These decisions rely on the predictive ability of the accounts, which is closely related to the concept of core earnings. These two purposes are associated with very different conceptions of the users of financial reporting. The stewardship concept is compatible with a large range of users (potential, current or future investors, financial analysts, employees or government) whereas the future cash flow forecast approach implies that investors are the primary users of financial reporting.

Moreover, the measures of performance associated with these two user purposes are incompatible because they have a different conceptual basis (Gjesdal, 1981). For instance, performance from the stewardship perspective is a comprehensive measure of past transactions. Conversely, a predictive measure of performance will exclude non-recurrent

[1] From a standard setting perspective, changes in scope, accounting policy and/or accounting framework and error correction give rise to pro forma information or to retrospective restatement of past data depending on their nature and the applicable accounting framework.

transactions which do not form part of sustainable future cash flows: under this prospective approach only the relevant transactions are selected.

Finally, although the international standard setter had a clear preference for the predictive function of accounting, a change now seems possible. Indeed, in the Exposure Draft (ED) *Conceptual Framework for Financial Reporting*, the IASB expresses its intention to reinstate the *stewardship role of accounting*.

1.2 Accounting indicators of performance in literature

The methodological approach adopted (see methodological appendix) focuses on two types of accounting indicators of performance: one which excludes certain transactions included in net income from the performance calculation, corresponding to adjusted earnings, and another which includes additional transactions not in net income in determining comprehensive income[2]. In addition there is another type of accounting indicator of an entity's performance presented before net income (intermediate operating indicators such turnover, added value EBITDA, EBIT, *etc.*). Our methodological approach introduces a bias in favour of Anglo-Saxon reviews which do not deal with this type of indicator[3].

A better representation of financial performance may be obtained by excluding non-relevant transactions in order to portray core earnings. In particular, transitory items (for example: exceptional restructuring costs) may be excluded. Adjusted earnings, which are sometimes audited (such as in the USA), are deemed to provide a better measure of performance and provide more useful information to market participants than accounting income which includes non-recurrent or non-relevant items (Johnson et Schwartz, 2005). Barth *et al.* (2012) distinguish two types of adjustments: those made by management and those made by financial analysts. Earnings adjusted by the entity's management are called *Pro forma earnings* (PF hereafter) in academic articles[4], whereas earnings adjusted by analysts are described as *street earnings* (SE hereafter)[5]. This approach to income is an attempt to determine recurrent operating income according to the perception of management or outside parties: financial analysts.

Conversely, it is possible to add changes in equity (other than transactions with shareholders) to net income, including realised or unrealised capital gains or losses arising from the revaluation of certain assets and liabilities. According to this view there are two opposing accounting concepts: the "*clean surplus*" and the "*dirty surplus*" (Ramond *et al.*, 2007). In "*clean surplus*" accounting, changes in equity (other than transactions with shareholders) are included directly in income for the period, whereas in "*dirty surplus*" accounting, some of these changes do not go through the income statement. Academics call items added to net income

[2] EVA or residual income related indicators which are more business valuation models than performance measurement models have been omitted.

[3] Moreover we were unable to identify works published in French on this subject (other than the reviews we pre-selected).

[4] This term is ambiguous and does not refer to Prospectus Directive terminology.

[5] N.B: the distinction between *street earnings* and *pro forma earnings* appears at a late stage in academic research. Indeed articles published before 2005 often use these two terms indiscriminately.

"*dirty surplus items*" or "*other comprehensive income*" (OCI). The latter include mainly revaluation surpluses (deficits), actuarial gains or losses, exchange or translation differences, unrealised gains on available-for-sale financial assets, changes in the value of derivatives used as cash flow hedges or certain additional provisions for post-employment benefits.

The issue of whether all OCI items must one day be recycled through net income is explicitly raised in the IASB's ED. The total of net income (NI) and OCI called *comprehensive income* (hereafter CI), is defined as follows by the FASB: *comprehensive income is the change in equity [net assets] of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners*. Those in favour of *all-inclusive performance measurement* believe that an indicator representing all sources of value creation is useful to investors in assessing an entity's financial performance.

The following table summarises these indicators and their relation to net income.

Inclusion of transactions not in net income	Net income (GAAP Earnings)	
	+ OCI	
	= Comprehensive Income	
Exclusion of transactions included in net income	Net income (GAAP Earnings)	
	- analysts adjustments	- management adjustments
	SE	Pro forma

These performance indicators reflect the choices made by different stakeholders in the financial reporting process. Certain standard setters seek to extend the boundaries of net income to encompass comprehensive income; whereas certain managers and analysts seek to restrict the scope of net income by excluding certain transactions.

These two approaches differ in their interpretation of performance. An operating income approach (determined by a *business approach* or by financial analysts) is intended to assist the users of financial statements in identifying the recurrent elements and discarding the non-recurrent elements of performance. By selecting the relevant information, management implicitly seeks to assist users in understanding the business. Conversely, the comprehensive income approach is based on the assumption that the user is capable of analysing and interpreting transactions in order to identify those that are relevant. Therefore income is the result of the changes in value of assets and liabilities (excluding equity contributions). This approach has the advantage of disclosing all value changes to investors; its disadvantage is that all investors are perhaps not capable of benefiting from this informational transparency to take their own investment decisions.

1.3 Issues related to reporting financial performance

The calculation and presentation of accounting indicators of performance other than net income raise a certain number of issues. Which transactions should be excluded in determining PF and SE? On what basis should these adjustments be made? Should an entity's press release give prominence to net income or to PF earnings? Is a comprehensive income statement relevant for investors? Do these indicators ultimately improve the representation of performance and/or the control of management?

These issues reflect academic and professional debate on performance reporting. There are two rival theories. The first assumes that the implicit or explicit choices made by management, analysts and standard setters are mainly intended to provide the other stakeholders with a more favourable view of the entity's performance. According to this approach, the choices made are essentially opportunistic. An alternative theory asserts that adjusted indicators avoid distortions in reported income by providing a better basis for assessing future cash flows. They supposedly reflect the objective shared by the entity, analysts and standard setters of providing more transparent information to investors. Opportunism and the improvement of predictive ability are not always opposing theories and may in some circumstances be complementary in explaining the choice of accounting treatment.

2. Summary of research

2.1. Literature review on adjusted earnings (PF and SE)

The results of research carried out by Bradshaw and Sloan (2002), Brown and Sivakumar (2003), Battacharya *et al.* (2003) and more recently by Cormier *et al.* (2011)[6] indicate that SE and PF provide a more useful basis than net income for assessing an entity's performance and taking investment decisions.

However, Johnson and Schwartz (2005) qualify this assertion by showing that investors do not rely solely on adjusted earnings published in a press release, but refer to a more complete set of data when assessing an entity's performance and share price. In addition, according to Lougee and Marquardt (2004), the informational content of PF depends on the circumstances in which they are published by management. The authors distinguish two situations, PF are published either to inform investors (where net income informativeness is low) or to deceive the very same investors (*strategic considerations*[7]). Therefore, PF are useful when (1) net income usefulness is low and/or (2) their publication is not motivated by strategic considerations. Christensen *et al.* (2014) find that PF disclosures attract *short sellers*. This conclusion implies that the adjustments may be of an opportunistic nature since sophisticated

[6] Cormier *et al.* (2011) use an alternative measure of SE: *distributable cash*.

[7] Firms which do not achieve GAAP profit benchmarks are more inclined to publish pro forma earnings in their press releases.

investors[8] (short *sellers*) are able to take advantage of the specific information drawn from exclusions made by management to make a profit.

Even if the superiority of the informational value of adjusted earnings over net income seems on the whole to be confirmed, it is appropriate (1) to examine closely the transactions considered to be non-relevant by management and (2) to make a distinction according to the type of market participant. To start with, Doyle *et al.* (2003), consider that investors might be misled by PF because the expenses excluded by management may be highly material and/or be recurrent. It follows that the systematic exclusion of these expenses from adjusted earnings might not necessarily provide a better measure of performance. The conclusions of Landsman *et al.* (2007) are similar: it is useful for investors to examine closely the items excluded from PF.

In addition, the relevance of PF is dependent on investor profile. Indeed, non-sophisticated individual investors are the most likely to use PF (Frederickson and Miller, 2004; Elliott, 2006; Allee *et al.*, 2007; Bhattacharya *et al.*, 2007). Research carried out by Frederickson and Miller (2004), Elliott (2006) as well as Allee *et al.* (2007) underlines the impact on non-sophisticated investors' judgment not only of the inclusion of PF in press releases but also of their relative prominence (PF presented before *GAAP earnings*). Dilla *et al.* (2013) have similar findings: The judgment of non-professional investors, unlike professional investors (financial analysts) is influenced by the graphical presentation of PF releases. According to Battacharya *et al.* (2003), financial analysts (and not other investors) tend to be sceptical about PF which transform losses into profit[9].

Considerable research has been devoted to the reasons why management excludes or does not exclude certain items from net income in order to adjust earnings. There are six particularly important causes of exclusion. Firstly, *investor sentiment* plays an important part. Brown *et al.* (2012) show that when investors have a good opinion of the entity, the management (1) tend to exclude items (including recurrent ones) in order to make the PF higher than net income; and (2) give more prominence to PF earnings than net income in press releases. A second factor is the management's propensity to achieve earnings benchmarks. Bhattacharya *et al.* (2004), Black and Christensen (2009) as well as Jennings and Marques (2011) show that management exclude items to achieve strategically important earnings benchmarks (nil earnings, last year's earnings or the analysts' consensus). A third factor behind adjustments is the management's intention to influence adjustments made by analysts. Christensen *et al.* (2011) show that if the management excludes certain items (recurrent or non-recurrent) then analysts tend to do the same, especially when the entity has few non-recurrent items. Considerations related to management compensation also seem to play a part. It appears that management decide to exclude certain items in order to maximise their compensation. Thus, Kuo *et al.* (2013) show that the introduction of stricter regulation of PF earnings in Taiwan coincides with a significant decrease in the management's bonus which is subsequently more

[8] According to Bushee (1998), institutional investors are described as sophisticated in the sense that they exercise active control over management. Their capital holdings in the investee entities and managerial knowledge enable them to exercise this control.

[9] According to Battacharya *et al.* (2003), about 66 % of published PF are profits as against 52 % of accounting profits. In addition, 80 % of published PF are equal to or above analysts' forecasts whereas only 39 % of accounting income is equal to or above these forecasts.

closely correlated to the entity's stock market performance. This suggests that in the absence of regulation, management manipulates published PF earnings to maximise its compensation. Barth *et al.* (2012) obtain similar results in the USA. Their research shows that management adjusts PF earnings by the amount of stock option related compensation (SFAS 123R) in an opportunistic manner (to increase or smooth earnings or to achieve an earnings benchmark) but not to improve their predictive ability. On the other hand, analysts only adjust earnings for compensation expense when it improves their predictive ability. Regulation has an influence on management practices. Thus, Entwistle *et al.* (2006a et 2006b) show that after the introduction of the Sarbanes-Oxley Act (and especially Regulation G which requires the publication of a reconciliation between PF and NI), that the absolute value of adjustments decreased so that the PF earnings increased less as compared to net income. The findings of Black *et al.* (2012) Kolev *et al.* (2008) and Zhang and Zheng (2011) are in the same vein: Regulation G enables investors to achieve a better understanding of management adjustments. The last factor which has an important influence on management adjustments is the entity's governance. Thus Frankel *et al.* (2011) and Isidro and Marques (2013) suggest that good quality governance encourages more transparent adjustments. More precisely, Frankel *et al.* (2011) find that when the proportion of independent directors decreases, the quality of adjustments (i.e. the differences between net income and PF) also goes down, in the sense that they have an adverse effect on the predictability of future cash flows. Isidro and Marques (2013) obtain similar results based on an expanded set of governance variables (independence of the board, practices for renewing board membership, functioning of the audit committee).

2.2. Literature review on comprehensive income (CI and OCI)

Several studies compare the ability of aggregate income indicators (CI and NI) to explain share prices and predict future cash-flows (Dhaliwal *et al.*, 1999; O'Hanlon and Pope, 1999; Wang *et al.*, 2006; Ramond *et al.*, 2007; Barton *et al.,* 2010; Goncharov and Hodgson, 2011). They either show there is no major difference between the two indicators or that NI is more relevant than CI. In other words, CI as an aggregate income indicator is not particularly useful to investors.

In the same way, the aggregation of the different components of OCI has no information content (Wang *et al.*, 2006).However, each individual component of OCI may possess specific information content on an entity's performance (Rees and Shane, 2012). According to Chambers *et al.* (2007), the adoption of SFAS 130 in the United States has indeed significantly reinforced the relevance of certain items in OCI, particularly those relating to investment portfolios measured at fair value. More specifically, unrealized gains and losses on available-for-sale financial assets have information content in the banking sector (Dong *et al.* 2014) as do gains and losses on cash flow hedges (Kanagaretnam *et al.* 2009; Campbell, 2015; Campbell *et al.*, 2015).

Even so, OCI is difficult for investors to understand (Campbell, 2015), including for sophisticated investors. The latter have difficulty in interpreting the components of OCI without the help of management (Wang *et al.*, 2006; Campbell *et al.*, 2015; Landsman *et al.*, 2011). Finally, the presentation model for OCI seems to be the most important issue. Hirst and Hopkins (1998) then Maines and Mac Daniels (2000) underline the importance of presenting changes in equity, other than transactions with shareholders, in a separate statement. Indeed, when they are published in a statement of changes in equity, their information content is very limited. Hunton *et al.* (2006) show that the propensity of management to manipulate earnings decreases when OCI is published in a separate statement. Lee *et al.* (2006) confirm this result on the basis of a sample of insurance companies. Bamber *et al.* (2010) show that, where managers have the choice, they prefer not to publish a total performance statement, especially when their compensation is closely linked to the entity's share price or they have a high risk of dismissal.

2.3. Main results

The four main conclusions to be drawn from this review of literature may be summarised as follows:

(1) Investors are interested in *pro forma* earnings releases although they are mainly used by non-sophisticated investors. Conversely, sophisticated investors are not influenced by PF which they tend to distrust.
(2) PF may mislead investors because they can be strategically manipulated by managers to modify stakeholders' perception of performance. However, corporate governance and regulation are effective means of limiting opportunistic adjustments.
(3) Whilst investors believe it is important to disclose the components of comprehensive income (OCI), the superiority of comprehensive income over net income cannot be demonstrated.
(4) The components of OCI are difficult to interpret even for sophisticated investors. They are useful when published in a separate statement (and not in the statement of changes in equity).

3. Outline proposals

Three outline proposals, based on literature review on the accounting measurement of financial performance, have been drawn up as inputs for standard setters.

- **Standard setters and preparers of financial statements need to make a considerable effort in explaining the relevance of OCI (Other Comprehensive Income).** Standard setters have devoted a considerable amount of effort to proposing, defining and circumscribing comprehensive income. The publication of a new financial statement (comprehensive performance statement) may be seen as the final stage in this process. Published research suggests that the publication of this separate statement is a necessary condition for establishing the relevance of the elements of OCI. However, the works reviewed in this paper establish that certain elements of OCI have information content but only the most sophisticated investors are aware of it. Further research is necessary to determine which components are really useful to preparers and the relevance (or not) of systematic recycling of items of OCI through net income as indicated in the IASB's ED.

- **Why not report business activity? Should the publication of operating income determined according to a "business approach" be systematically required**? If investors cannot see the use of comprehensive income; PF earnings, that is operating income published by management, appears useful to market participants in spite of it being subject to manipulation. It could also be useful to consult financial analysts as SE seems particularly relevant. The publication of adjusted earnings is not risk free because of the discretionary nature of the adjustments, but the information benefit is superior to that of net income or comprehensive income. Therefore the IASB's proposal in its ED to adopt a *business approach* in determining income seems to be a step in the right direction. It is also a means of restoring the internal value of the accounts as part of a strategic vision for value creation. This internal function of accounting seems to be compatible with both stewardship and valuation functions because it is effectively the underlying business activities which are concerned. From a managerial viewpoint, the measurement of performance must be consistent with an entity's business models and report on its activity (moreover the IASB uses the term *business activities*).
- **Accounting and governance regulators should work more closely together.** Indeed, corporate governance is an important factor in guaranteeing the information content of accounting information. One of the ways of improving the quality of financial reporting would probably be to better integrate the general principles of corporate governance into accounting regulations. The latter point is crucial if the IASB wishes to encourage a business approach in future standards. This is because academic research shows that management takes advantage of any leeway as soon as it is granted. The publication of an alternative measure of performance provides management with an opportunity to exert a significant influence on investors' perception especially that of the less sophisticated. Good governance practices would significantly reduce the risk of manipulation.

Methodological Appendix

The selection of articles examined in this paper is based on the following criteria:

- Articles published in **French** or in **English** in the three reference data bases :
  - Business source premier / ProQuest
  - Science direct
  - Springer Link.
- Articles published in **academic journals ranked 1, 2 and 3** in the fields of "Accounting" and "Finance and Insurance" on the CNRS list.
- Articles published **between 1995** and **2015**.

On this basis, the search for articles was conducted using the following keywords: "Financial performance measures" / "Financial performance measurement" / "Comprehensive income" / "Street earnings" / "Pro forma earnings".

An initial selection of 77 articles was made. This was reduced to the 50 articles which, after reading and analysis, were actually included in this paper.

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