

Measures of Corporate Earnings

Over the last decade, intensifying pressure to meet Wall Street earnings expectations led more and more companies to introduce new and different earnings measures and reporting approaches. At the same time, many members of the investment community have expressed concern that earnings reports are becoming harder to understand, more difficult to compare across companies and less useful to analysts and investors. Many observers agree that some organization should act as a forum for discussions of how earnings should be defined and measured. In the last few years a number of Wall Street firms have encouraged Standard & Poor's to take on this role. As the publisher of the leading database of corporate financial data (COMPUSTAT) and the provider of the S&P 500, the principal index and performance benchmark for US equities, Standard & Poor's is well positioned for this role. This note is a response to these suggestions and is aimed at beginning a discussion to achieve a consensus that will bring more uniformity and clarity to earnings analyses and forecasts. Everyone will still be able to take their own analytical course, but will know where they started from.

Several months ago Standard & Poor's equity investment analysis group began looking at how companies and analysts define various earnings measures with the goal of finding some common definitions that would support investment analysis. Our review identified three broad measures: as reported earnings, operating earnings and *pro forma* earnings. While all three measures have uses in the appropriate settings, the most popular – operating earnings – suffers because there is no agreement on how it is defined or what items should be included or excluded. This note provides a definition for operating earnings and comments on the way all three measures can be used.

Standard & Poor's intention is to generate discussion on earnings measures that will lead to agreement on how these measures should be defined. Once there are generally accepted definitions, it will be much easier for analysts and investors to evaluate varying investment opinions and recommendations and form their own views of which companies are most attractive. Standard & Poor's will collect and circulate comments about these definitions. Second, Standard & Poor's currently publishes data on As Reported and Operating Earnings for the S&P 500. Once agreement is reached, these definitions will be used for the earnings data. In addition, the tables included in this note provide the codes needed to review these earnings measures for companies by using the COMPUSTAT database. Recently there has been some discussion that the Financial Accounting Standards Board

(FASB) may publish its own definition of Operating Earnings. If FASB provides an official definition, Standard & Poor's will follow it.

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Earnings Measures

These measures are summarized here, more details are given below:

- **As Reported Earnings:** Earnings including all charges except for discontinued operations and extraordinary items, as defined by GAAP. This is the broadest measure of corporate performance of the three considered here. It is also the traditional measure with a long history. It has been used for the S&P 500 and for company analyses for decades.
- **Operating Earnings:** This measure focuses on the earnings from a company's operations. It is usually defined by As Reported Earnings with certain charges reversed to exclude certain corporate or one-time expenses. The major drawback is the lack of a generally accepted definition. The use of Operating Earnings seems to come from internal management controls used when a business unit manager is not responsible for managing corporate-level costs.
- **Pro forma Earnings:** Originally the use of the term *pro forma* meant a special analysis of a major change, such as a merger, where adjustments were made for an "as if" review. In this case, these measures are very useful. However, the specific items being considered in an as if review must be clear. In some recent cases, as if has come to mean "as if the company didn't have to cover proper expenses." In the most extreme cases, *pro forma* is nick named EBBS or "earnings before bad stuff."

In examining different earnings measures, a number of criteria were considered. The earnings measure should reflect the relevant revenues and expenses. Further, there should be a generally understood definition which can be applied consistently across companies in an industry and across the market at large. Third, access to historical data is important. Finally, the definition should be one that analysts and investors have found useful.

Standard & Poor's conclusions were two fold: First, the choice of earnings measure often depends on the specific circumstances. *Pro Forma* Earnings are useful in special as-if studies. As Reported Earnings are essential if long periods of historical data are important. Operating earnings have become the choice for forward looking analyses and forecasts. Second, a definition of operating earnings

is essential unless everyone agrees to return to As Reported Earnings based on GAAP.

Standard & Poor's welcomes comments from the investment community.

As Reported Earnings Defined

The table provides a sample income statement to show how As Reported Earnings are defined.

Table 1 – Summary Income Statement
Operating Revenues
(Cost of Goods Sold)
(Selling, General & Administrative Expenses)
(Depreciation Expense)
(Functional expenses ongoing businesses)
Earnings before Interest and Taxes (EBIT)
Interest income (expense)
(Amortization Expense)
Dividend Income
Royalty Income
Pension Income (expense)
Income Before Taxes
Taxes
Reported Net Income [As Reported S&P 500 EPS measure]
Discontinued Operations
Extraordinary items
Net Income

Operating Earnings Defined

The widespread and growing use of Operating Earnings requires a definition. Based on Standard & Poor's review, the idea behind operating earnings is to exclude various one time or special charges that are not expected to recur and which do not reflect the on-going business. The definition uses the COMPUSTAT database to assure that operating earnings can be calculated.

Standard & Poor's COMPUSTAT database specifically identifies and tracks seven items commonly included in “Special Charges” and also provides a single overall Special Charges entry that covers these seven plus additional items as a group. The Special Charges COMPUSTAT tracks individually are Gain/Loss on Sale of Assets, Purchased Research & Development, Restructuring Charges Including Severance, Acquisition/Merger Related Expense, Impairment of Goodwill, Litigation Settlements and Write Downs. The total Special Charges also encompasses other items including stock option costs, moving and relocation

costs, natural disasters and relief, prior period adjustments and gain/loss of debt obligations.

Table 2 shows which items Standard & Poor's believes should be excluded from Operating Earnings and which items are included in (or charged against) Operating Earnings.

In deciding what should be excluded from or included in operating earnings, Standard & Poor's sought to include in operating earnings those items which are normally part of a company's operations. Three special items should be included in operating earnings: Write Downs, Purchased R&D and all compensation related expenses including pension, option and severance costs related to restructuring. Write Downs refers to changes in the value of assets directly involved in operations (Discontinued operations as defined by GAAP are excluded from both As Reported and Operating Earnings.) When a write down results from a change in the nature of the operations, it should be part of the results of the operations, not some exception to be ignored. When a business performs its own research and development the R&D costs are included in operating earnings. Therefore, consistency requires that purchased R&D should also be charged to operating earnings.

All costs of wages, salaries and benefits for people involved in a business' operations should be charged to the business. Two specific compensation costs seem to raise issues – severance and stock options. Both are part of compensation and should be included in Operating Earnings just as wages and salaries are. Restructuring costs, including severance, are tracked by COMPUSTAT. Stock option related expenses are currently included in the overall Special Charges item, but not recorded separately. (Upcoming revisions will make it possible to identify option costs separately. Once these revisions are completed, Standard & Poor's will include option related expenses in its calculation of Operating Earnings for its indices.) Pension gains or losses are normally included in Operating Earnings. These are another component of compensation and should continue to be included in Operating Earnings.

Table 2:	
Adjustments to As Reported Earnings to Calculate Operating Earnings	
Included in Operating Earnings	Excluded from Operating Earnings
Purchased Research & Development	Acquisition/Merger related expenses
Restructuring including severance related to restructuring	Impairment of Goodwill
Write Downs from ongoing operations	Litigation Settlement
Stock Option expenses	Gain/Loss on Sale of Assets

Pro Forma Earnings Defined

Standard & Poor's is not providing a specific definition for *pro forma* earnings because this concept should be used only in special cases where the impact of a possible change, such as merger, is being considered. A working definition of *pro forma* earnings would be to define it as operating earnings should a particular event occur.

Standard & Poor's Plan:

Standard & Poor's will calculate As Reported and Operating Earnings for companies in its US indices according to these definitions. The data will also be available through the COMPUSTAT database. These earnings figures will be used to calculate earnings per share data for the S&P 500 and Standard & Poor's other US indices, including the GICS sectors. These data will provide a benchmark for comparing companies to the market based on a consistent definition of Operating Earnings.

Further, by publishing these guidelines and accepting comments on the guidelines, Standard & Poor's hopes to begin the process of developing a generally accepted definition of Operating Earnings to reduce some of the confusion surrounding recent earnings announcements.

Benefits to the Investment Community:

The investment community benefits when it can provide clear and consistent information, analyses and investment advice to the investing public and professional investors. Consistent earnings definitions that build on accepted accounting standards and procedures rather than trying to explain away bad results are much more helpful to investors.

An important component of investment analysis is accurate earnings forecasts. When a company introduces various special adjustments to calculate *pro forma* earnings, it is making adjustments that no securities analyst can be expected to anticipate. In contrast, As Reported and Operating Earnings are figures that a securities analyst can forecast and comment on.

In the current weak market and economic slowdown, a consistent definition for earnings is doubly important – it can help provide credibility to investment analyses and recommendations. By supporting this definition with data on its indices and through the COMPUSTAT database, Standard & Poor's believes all members of the investment community can contribute to more reliable investment information and advice.

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Data:

To support this effort, the following table gives the COMPUSTAT codes for relevant income statement items:

	Table 3 – Income Statement	
Income Statement Item	COMPUSTAT Mnemonic (Annual/Quarterly)	COMPUSTAT Data Item Number (Annual/Quarterly)
Sales - Net	SALE/SALEQ	A12/Q2
Cost of Goods Sold	COGS/GOGSQ	A41/Q30
Selling, General & Administrative Expense	XSGA/XSGAQ	A189/Q1
Operating Income Before Depreciation	OIBDP/OIBDPQ	A13/Q21
Depreciation & Amortization	DP/DPQ	A14/Q5
Operating Income After Depreciation	OIADP/OIADPQ	A178/Q21-Q5
Interest Expense	XINT/XINTQ	A15/Q22
Non operating Income (Expense)	NOPI/NOPIQ	A61/Q31
Special Items	SPI/SPIQ	A17/Q32
Pretax Income	PI/PIQ	A170/Q23
Income Taxes – Total	TXT/TXTQ	A16/Q23
Minority Interest	MII/MIIQ	A49/Q3
Income Before Extraordinary Items	IB/IBQ	A18/Q8
Preferred Dividends	DVP/DVPQ	A19/Q24
Income Before Extraordinary Items – Available for Common	IBCOM/IBCOMQ	A237/Q25
Common Stock Equivalents – Dollar Savings		A191/Q120
Income Before Extraordinary Items – Adj for Common Stk Equivalents	IBADJ/IBADJQ	A20/Q10
Extraordinary Items and Discontinued Operations	CSTKE/CSTKEQ	A48/Q26
Basic EPS – Excluding Extraordinary Items & Discontinued Operations	EPSPX/EPSPXQ	A58/Q19
Basic EPS – Including Extraordinary Items & Discontinued Operations	EPSPI/EPSPIQ	A53/Q11
Diluted EPS – Excluding Extraordinary Items & Discontinued Operations	EPSFX/EPSFXQ	A57/Q9
Diluted EPS – Including Extraordinary Items & Discontinued Operations	EPSFI/EPSFIQ	A169/Q7
Basic EPS from Operations	OPEPS/OPEPSQ	A233/Q177
Diluted EPS from Operations	OPEPSX/OEPSXQ	A323/Q181