

**Honest EPS: a measure of GAAP earnings relative to proforma earnings  
(International Journal of Managerial Finance 2005)**

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## **Northfield's 18<sup>th</sup> Annual Research Conference in Montebello Honest EPS**

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# Quantitatively Profits are Profits Right?

## Profits according to GAAP

- S.E.C requires 10K (Annual Report) and 10Q (Quarterly Reports) to be filed in accordance with Generally Accepted Accounting Principles (GAAP)
- EPS according to GAAP is **Net income before extraordinary expenses**. Income of company after all expenses, including special items, income taxes and minority interest-but before dividends.

Nearly all charges treated as ordinary expenses

## Profits according to Pro Forma

- I/B/E/S and FirstCall record Wall Street Analyst forecasts for company EPS and allow ProForma (majority rule) – Company supplies earnings in press release.
- Press releases by company stating profits -- not regulated. Lawsuit pending against SEC saying “free speech”. Companies free to provide EPS on “Pro Forma basis” also know as “earnings before the bad stuff” also as “Operating Earnings”.
- Pro Forma adds back expenses to profits referred to as restructuring charges, write downs, special charge. Tend to readily exclude “one-time” losses but less readily exclude “one-time” gains
- Adhere to no particular standard. Reg G / Sarbanes Oxley impact?

## Losses become Gains using Pro Forma, Dis-Honest?

### GAAP Quarterly Earnings

- Company A in June 2001 reports **loss** of \$342 million according to GAAP standards.
- July 2001 (WSJ) “Big companies have announced whopping writeoffs and charges to earnings. They have slashed the value on their books...”.
- 1<sup>st</sup> Qtr 2001, Corporate profits drop -43%.
- Today, has it stopped? (WSJ) June 22, 2005 (member DJIA). Company B slashes earnings outlook further on worse than expected sales slump.

### Pro Forma Quarterly Earnings

- Company A in June 2001 reports **gain** of \$323 million under its Pro Forma “preferred method”. Stock down -39% next quarter
- July 2001 (IBES) Pro Forma earnings All companies mentioned reported positive Pro Forma earnings. Since bear market stocks mentioned drop as much as -95%.
- Pro Forma profits 1<sup>st</sup> Qtr 2001, favored by Wall Street analysts, fell -6.5%.
- WSJ June 22, Company B expected to earn \$2.2 billion excluding “special items”...raised 2<sup>nd</sup> quarter earnings excluding special items.

# 2001 Profits Recession - Casualty is Honest



## Headlines prompt research and results in Factor: Honest EPS

- "...Use of Pro Forma Results Offers a Glossier Present and Much Cloudier Past"
- "...Terms Like 'Operating', 'Core', 'Pro Forma' Catch Fire Leave Investors Muddled... 'Earnings Before the Bad Stuff' "
- "Unusual Expenses' Raise Concerns"
- "Usually, companies' pro-forma-or "as if"-earnings are higher than their actual earnings because companies are making their own accounting rules
- "Missed Signals: Stock Gurus Write Off Most Big Writeoffs but they Shouldn't..."

# Academic Articles on GAAP vs Pro Forma



## Reference

- Bradshaw, Moberg, Sloan (2000) "GAAP versus the street: an empirical assessment of two alternative definitions of earnings", working paper, Harvard University
- Frederickson, Miller (2002) "Pro Forma earnings disclosures: do analysts and nonprofessional investors react differently?", working paper, University of Notre Dame
- Ciccone (2002) "Pro forma earnings look higher and smoother", working paper, University of New Hampshire

## Brief Statement on Paper

- Street definition of EPS has been accompanied by a dramatic increase in the proportion of corporate expenses that are classified as excluded items. 4Qtr Worst.
- argue that pro forma earnings disclosures affect less sophisticated and more sophisticated investors differently. Nonprofessional investors who see an earnings announcement that contains both pro forma and GAAP disclosures assess a higher stock price than when they see an earnings announcement that contains only GAAP disclosure
- there is strong trend that the difference between GAAP and street earnings has become progressively larger during recent years.

# Honest EPS Factor

# Factor Construction: Honest EPS



## (GAAP EPS – Pro Forma EPS) / Price

**GAAP EPS** “4 Qtr lagged Compustat Qtr EPS Primary excl extra items (as reported)”

**Pro Forma** “4 Qtr lagged I/B/E/S Qtr EPS Actual 0”

**Price** “Spread normalized by Price at end of month when portfolios formed”

**Universe** “Top 1000 market cap stocks xREITs, xMF, xLP, xADR, xforeign

**Data** “Monthly 1987-2001”

**Special1** “Compustat figure codes for mergers, acquisitions, restatements used”

**Special2** “CharterOak Lag concept used to correctly match fiscal to calendar qtr”

### **Best Honest EPS (Top decile on factor)**

True Corporate profits likely stronger, positive Honest EPS, GAAP > Pro Forma : BUY

### **Worst Honest EPS (Bottom decile on factor)**

“True Corporate profits likely weaker, negative Honest EPS, GAAP < Pro Forma : Sell

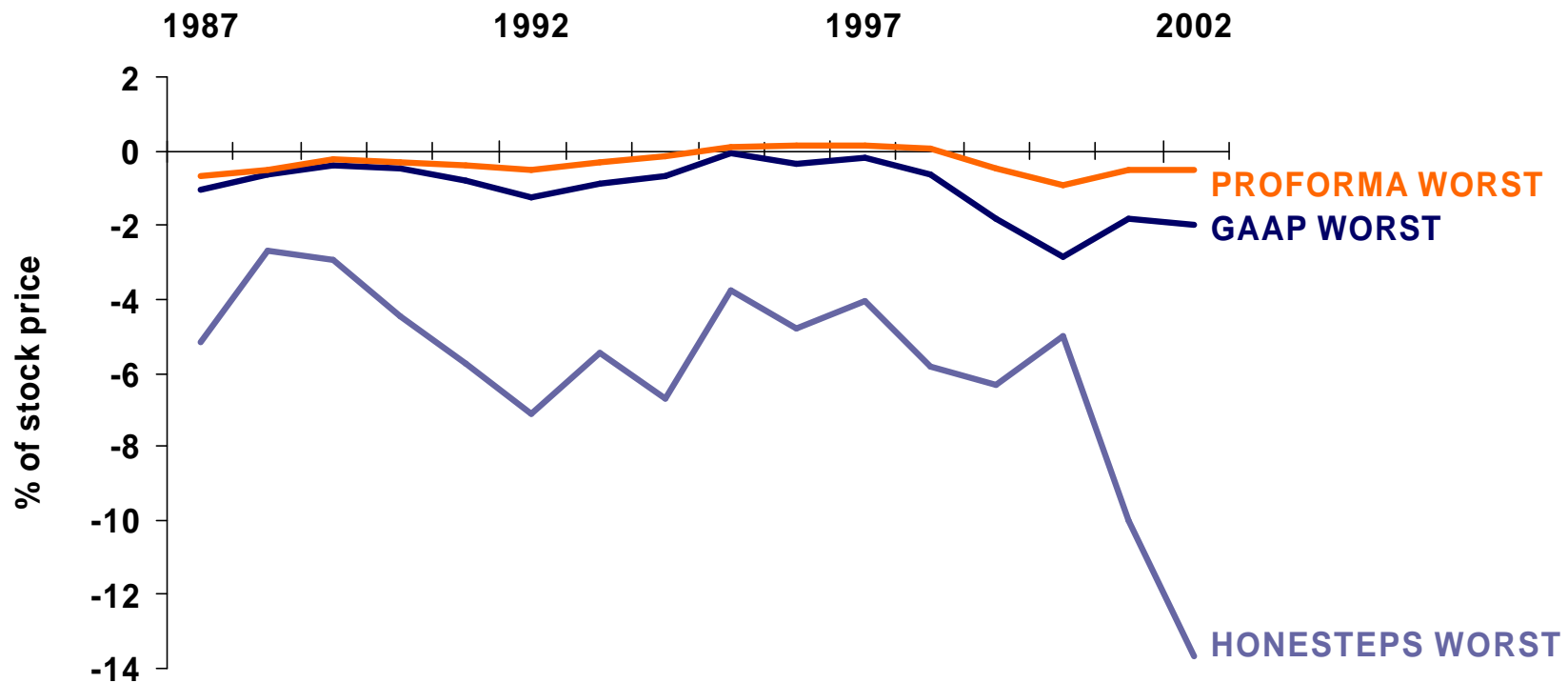
# Honest EPS

## Statistics and Backtest Results



# Honest EPS History of Worst Violators

## Bottom Decile of Honest EPS, GAAP EPS, Pro Forma EPS

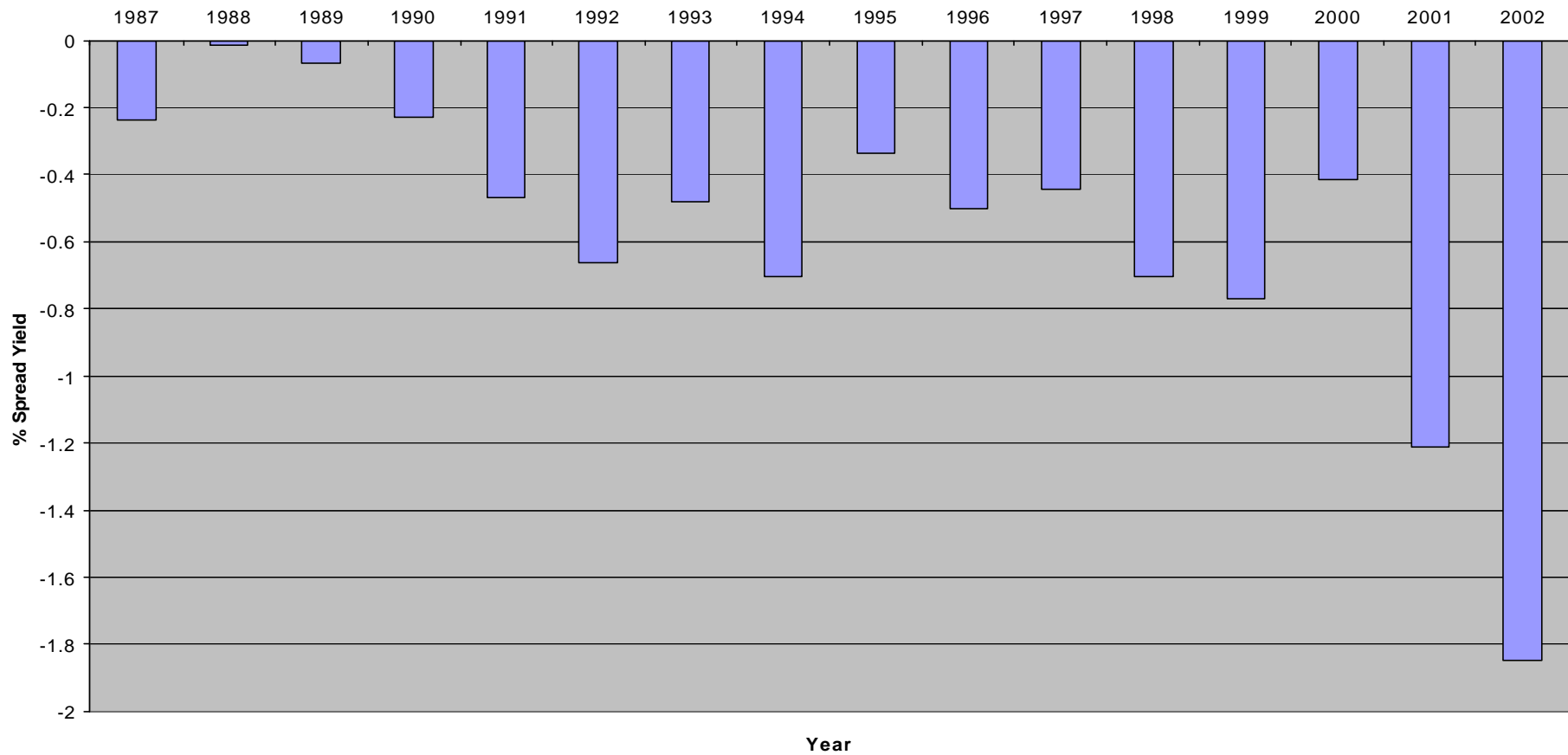


# Figure 1. Honest EPS by Year Top 1000



## Honest EPS (GAAP – Pro Forma/ Price) 1987-2002

Honest EPS by Year (Figure 1 page 29)



## Table I Summary Statistics

### Summary Statistics – Monthly ( 1987 – 2002) CharterOak

| <u>Variable</u>                | <u>Mean</u> | <u>Standard Deviation</u> | <u>Maximum</u> | <u>Minimum</u> |
|--------------------------------|-------------|---------------------------|----------------|----------------|
| <i>Panel A Top 1000 stocks</i> |             |                           |                |                |
| <b>GAAP</b>                    | 1.28        | 1.51                      | 33.60          | -28.80         |
| <b>Pro Forma</b>               | 1.44        | 1.26                      | 12.88          | -8.48          |
| <b>HONEST EPS</b>              | -0.56       | 2.63                      | 15.03          | -117.14        |

## Table IV Regression Results

### Pooled and Time series regression results

| Table IV            | pooled   |        |        | time series |        |        |
|---------------------|----------|--------|--------|-------------|--------|--------|
|                     | param    |        |        | param       |        |        |
| Top 1,000 stocks    | estimate | T-Test | P-test | estimate    | T-Test | P-test |
| 1 Month Fwd return  | 0.08     | 6.70   | 0.00   | 0.02        | 1.74   | 0.08   |
| 3 Month Fwd return  | 0.21     | 10.30  | 0.00   | 0.04        | 1.68   | 0.09   |
| 6 month Fwd return  | 0.42     | 13.40  | 0.00   | 0.07        | 1.89   | 0.06   |
| 12 month Fwd return | 0.52     | 9.31   | 0.00   | 0.05        | 0.91   | 0.36   |

## Table II Time Series Excess Returns

Time Series means of abnormal returns for each portfolio 1987-2002

| Honest EPS Decile                                       | One month<br>Fwd Return | Three month<br>Fwd Return | Six month<br>Fwd Return | Twelve<br>month<br>Fwd Return |
|---|-------------------------|---------------------------|-------------------------|-------------------------------|
| <i>Panel A top 1000 stocks by market capitalization</i> |                         |                           |                         |                               |
| <b>1 (Worst)</b>  | -0.03                   | -0.06                     | -0.50                   | -0.48                         |
| <b>2</b>  | -0.21                   | -0.44                     | -0.77                   | -0.66                         |
| <b>3</b>  | -0.18                   | -0.71                     | -0.61                   | -0.23                         |
| <b>4</b>  | 0.01                    | 0.25                      | 0.50                    | 2.26                          |
| <b>5</b>  | 0.18                    | 0.34                      | 1.03                    | 1.10                          |
| <b>6</b>  | 0.05                    | 0.20                      | 0.11                    | -0.94                         |
| <b>7</b>  | -0.13                   | -0.39                     | -0.26                   | -0.49                         |
| <b>8</b>  | 0.10                    | 0.43                      | 1.06                    | 2.12                          |
| <b>9</b>  | 0.16                    | 0.31                      | 1.15                    | 3.10                          |
| <b>10 (Best)</b>  | 0.19                    | 0.42                      | 0.68                    | 1.37                          |
| <b>D10-D1 (Best - Worst)</b>                            | 0.22                    | 0.48                      | 1.18                    | 1.85                          |
| <b>t - statistics</b>                                   | 1.07                    | 1.40                      | 2.64                    | 2.96                          |

# Figure 2. Annualized Strategy



## Honest EPS Hedge Return (D1-D10) 1987-2002

Top 1,000 Stocks Annual Returns of Honest EPS Strategy (1987-2002)

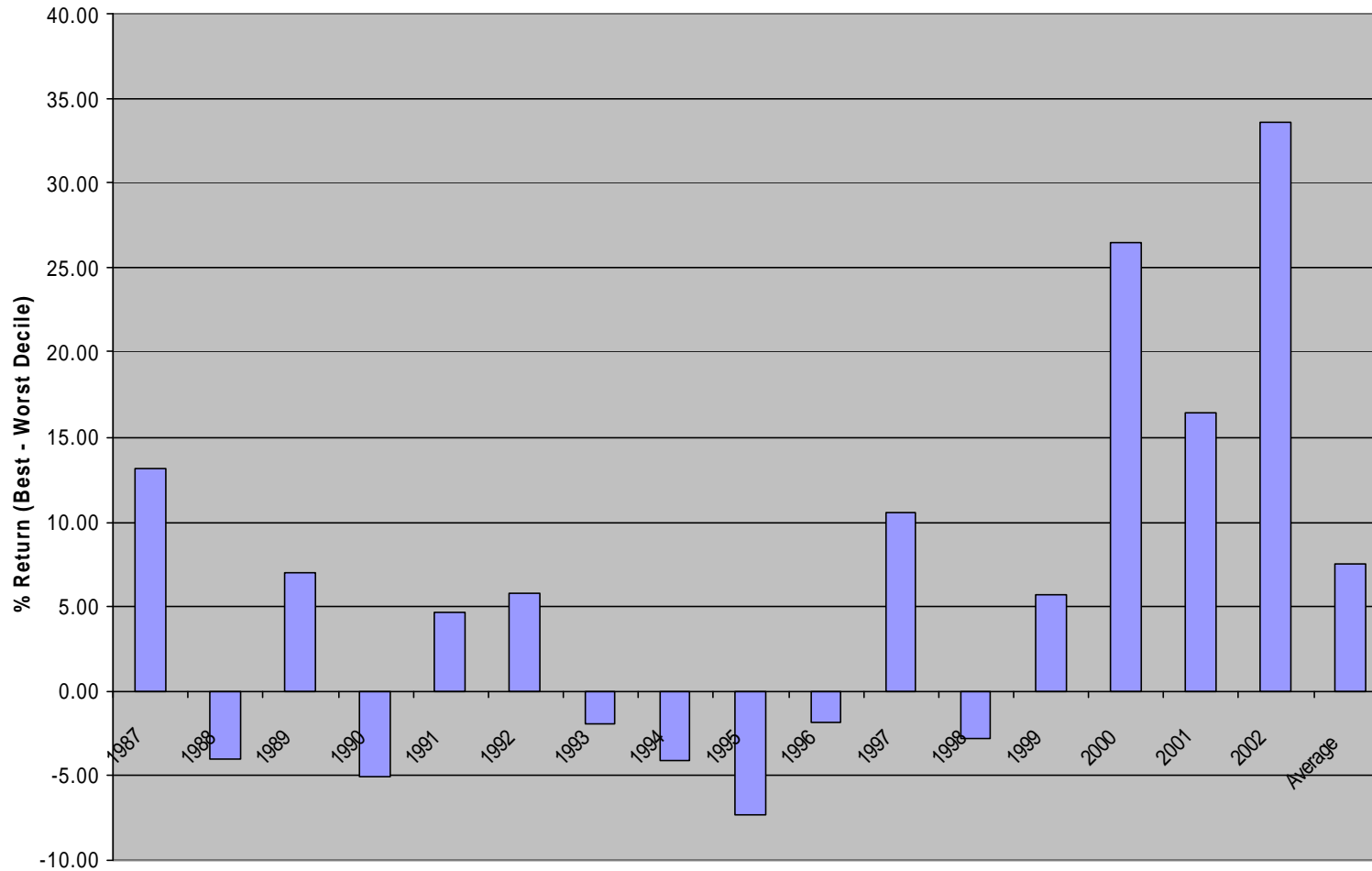


Figure 2 Page 32

Honest EPS Adds Value to Multi-Factor Model  
Low Correlation to Value, Momentum, Revision factors

| Other<br>Factor<br>Anomalies | Pearson<br>Correlation | <i>p</i> -value |
|------------------------------|------------------------|-----------------|
| Top 1000 stocks              |                        |                 |
| Analyst diffusion factor     | 0.020                  | 0.000           |
| Momentum                     | 0.039                  | 0.000           |
| Free Cash Flow               | 0.015                  | 0.000           |
| Dividend Yield               | -0.028                 | 0.000           |
| Capex/depreciation           | 0.007                  | 0.006           |
| Change in Accruals           | -0.015                 | 0.000           |

# Honest EPS Sample



Selected items from Income Statement 2002 Illustrating GAAP verses Pro Forma (outlier)

| <b>Company F</b>  | <b>12/2002</b>    |
|---|-------------------|
| Net Sales   | 40,961.0          |
| Cost of Goods Sold  | 25,047.0          |
| Operating Income after Depreciation                       | 5,998.0           |
| <b>Nonrecurring Pretax Income (Expense)</b>               | <b>(47,963.0)</b> |
| Impairments of Goodwill                                   | (45,538.0)        |
| Writedowns  | (2,214.0)         |
| Pretax Income   | (44,156.0)        |
| Net Income before Extraordinaries                         | (44,574.0)        |
| <b>Basic/Primary per share, excluding Extraordinaries</b> | <b>(10.01)</b>    |
| <b>Basic/Primary per share, including Extraordinaries</b> | <b>(22.15)</b>    |
| <b>I/BE/S Pro Forma ACTUAL</b>                            | <b>0.89</b>       |
| Net Inc before Extras Used to Calc Dil EPS                | (44,574.0)        |
| Extraordinaries & Discontinued Ops                        | (54,122.0)        |
| Extraordinary Items : Cum Effect Acctg Changes            | (54,235.0)        |
| Net Income after Extraordinaries                          | (98,696.0)        |

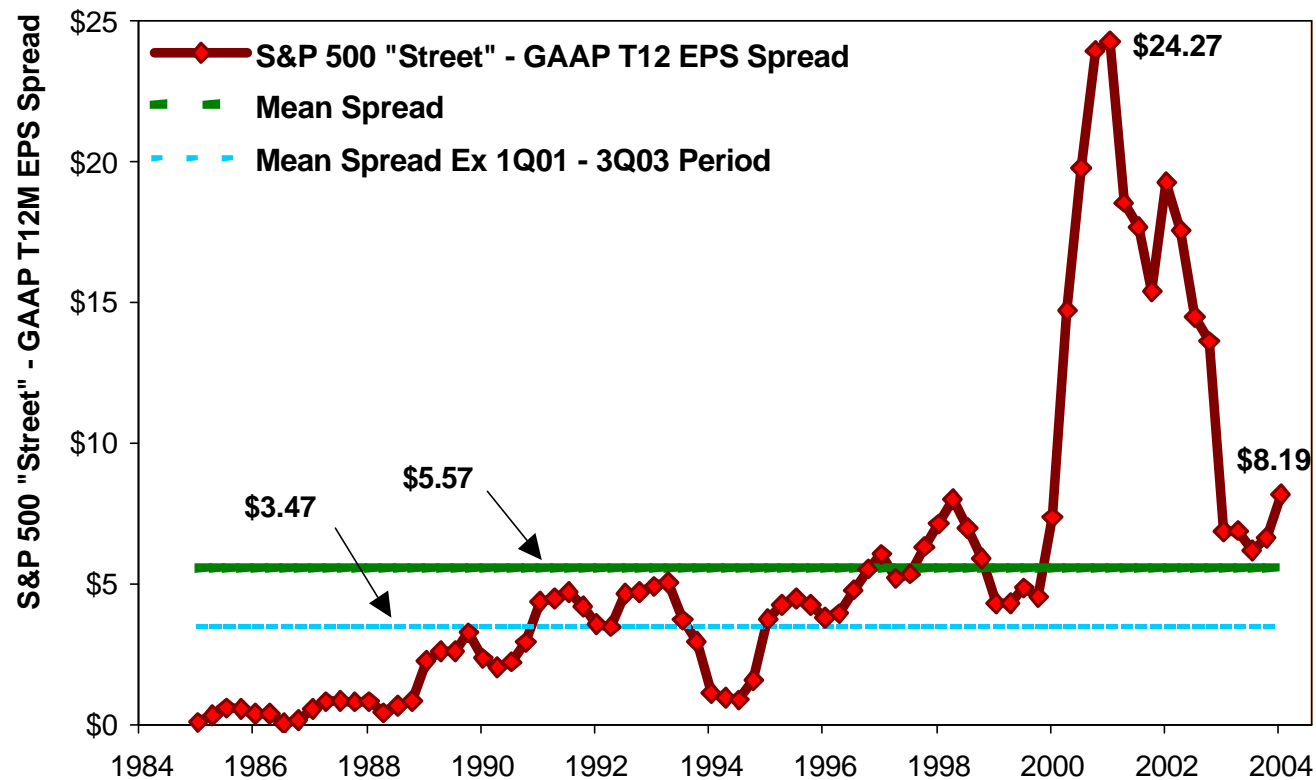
Honest EPS readily calculated in data providers such as Factset  
Source Factset I/B/E/S for Pro Forma and Factset Compustat for GAAP

| Company A<br>Fiscal<br>Quarter | Report<br>Date<br>Mean | Pro<br>Forma<br>Actual<br>EPS | %<br>Surp | Surp/Std<br>(SUE) | GAAP<br>Actual<br>EPS | Honest<br>Qtr EPS<br>Spread |
|--------------------------------|------------------------|-------------------------------|-----------|-------------------|-----------------------|-----------------------------|
| Mar-05                         | 0.38                   | <b>0.62</b>                   | 61.2      | 4.09              | <b>0.64</b>           | 3%                          |
| <b>Dec-04</b>                  | 0.27                   | <b>0.28</b>                   | 5.1       | 0.18              | <b>0.04</b>           | -86%                        |
| Sep-04                         | 0.14                   | <b>0.28</b>                   | 100.0     | 5.42              | <b>0.23</b>           | -18%                        |
| Jun-04                         | 0.49                   | <b>0.61</b>                   | 23.9      | 2.86              | <b>0.64</b>           | 5%                          |
| Mar-04                         | 0.44                   | <b>0.96</b>                   | 116.9     | 20.78             | <b>1.07</b>           | 11%                         |
| <b>Dec-03</b>                  | 0.27                   | <b>0.31</b>                   | 15.1      | 0.42              | <b>-0.36</b>          | -216%                       |
| Sep-03                         | -0.12                  | <b>0.15</b>                   |           | 4.24              | <b>0.13</b>           | -13%                        |
| Jun-03                         | 0.17                   | <b>0.22</b>                   | 26.6      | 0.66              | <b>0.24</b>           | 9%                          |
| Mar-03                         | 0.22                   | <b>0.45</b>                   | 109.0     | 6.99              | <b>0.49</b>           | 9%                          |
| <b>Dec-02</b>                  | 0.07                   | <b>0.08</b>                   | 11.3      | 0.18              | <b>-0.01</b>          | -112%                       |
|                                |                        | <b>4QSum</b>                  |           | <b>Price</b>      | <b>4QSum</b>          | <b>Honest EPS</b>           |
| June 29, 2005                  |                        | 1.79                          |           | 10.40             | 1.55                  | -2.31%                      |

# Wall Street Quants Catching On “Mind the Earnings GAAP”

Exhibit 2: S&P 500 Operating—As-Reported Earnings Gap Surges in Fourth Quarter 2004  
*bottom up; Street EPS is IBES actual operating EPS, GAAP EPS is earnings before extra. itms & disc. op*

Source: CSFB Quantitative Research, March 9, 2005, Mind the Earnings GAAP: Total Exclusions



# Conclusion: “Honesty is Best Policy”

# Honesty is the best policy is stock selection



- Honest EPS is easy to construct using publicly available information
- Not correlated with other Momentum, Value and Revision Factors
- Investors can profit by selling or shorting stocks low in Honest EPS
- Investors can profit by going long stocks high in Honest EPS
- Useful for “buy side” fundamental analysts to question “sell side”
- More companies are leaving it to analyst to come up with Pro Forma EPS by not explicitly stating it in their press release but still give all of the “special items”, “writeoffs” to come up with the Pro Forma number.
- Honest EPS will persist as a factor because attempts to rein in the abuse with Reg G requires reconciling to GAAP but still allows Pro Forma reporting.
- Northfield has the best quant conferences!