Research on Application of Non-GAAP Financial Measures to Overseas Listed Companies

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ABSTRACT

Listed companies publish financial reports in accordance with the general accounting standards quarterly or annually. Some companies, while disclosing their financial statements, will conduct non-GAAP financial measures, believing that non-GAAP measures can more accurately reflect the company's operating results and financial conditions to help investors to evaluate the company's performance. However, such measures may be used in adjusting profits to mislead the stakeholders. This paper aims to analyze non-GAAP financial measures, and illustrate the findings with the example of JD.com. The findings are that non-GAAP financial measures can reflect companies operating outcomes more accurately unless the regulators strengthen and standardize the disclosure and measurement of non-GAAP financial measures.

KEYWORDS

Non-GAAP, Overseas Listed Companies, Financial Measures, JD.com.

INTRODUCTION

With the deepening of internationalization, global allocation of resources has become a new trend. It’s an option for Chinese enterprises to finance through overseas listing. According to statistics, there are 116 Chinese enterprises listed overseas in 2016. As the information and corporate governance environment differ from different countries, overseas listed companies must comply with the requirements of listed exchanges, including investor protection, information disclosure and so on. Therefore, different choices of listing sites mean different choices of institutional and information environment, and then the financing constraints faced by enterprises may be different in severity [1]. The overseas listing of Chinese enterprises is mainly concentrated in Hongkong, Singapore and the United States, and there are obvious differences in institutional and information environment. For example, Li Peixin (2012) argues that, compared with Hongkong and Singapore, the United States have advantages in financial markets (financial market scale), institutional environment (including legal rules, insider trading management, execution of the contract and the political rights of the people and so on) and information environment (including accounting information transparency, timeliness and completeness of regularly report, financial analysts, and the freedom of media) [2]. If information and system environment can reduce information asymmetry and agency problems, we expect listing in the United States can better alleviate the financing constraints faced by enterprises. In order to implement the Sarbanes-Oxley Act enacted in 2002, SEC issued a rule, named...
“conditions for use of non-GAAP financial measures”. Followed this, SEC updated guidance on non-GAAP to avoid misleading investors. Combined with the relevant guidance, this paper focus on the application value and scope of non-GAAP financial measures, providing a theoretical reference for Chinese enterprises listed in America.

NON-GAAP MEASURES: DEFINITION AND SIGNIFICATION

Regulation G and Item 10(e) define a non-GAAP measure in the way that “a numerical measure of a registrant’s historical or future financial performance, financial position or cash flows that includes or excludes amounts from the most directly comparable GAAP measures” [3].

More companies supplement their reported earnings under U.S. generally accepted principles with non-GAAP financial measures. According to research data released by the Audit Analytics 2015, more than 88% of Companies in the S & P 500 index use non-GAAP financial measures. 82% of these companies using non-GAAP financial measures turn to better measure performance. A study published by FactSet determined that 67% of the companies in the Dow Jones Industrial Average present non-GAAP earnings per share, and the difference between the GAAP and non-GAAP measurement was approximately 30%, 14% higher than that in 2014.

Non-GAAP financial adjustments are defined by SEC, which aims to enable the company to convey more accurate information of corporate governance to investors. The following are three main points for the company.

First, non-GAAP financial measures reflect the company's operating conditions more accurately. In the process of business operation, lots of non-recurring issues will occur, such as mergers and acquisitions, asset disposal, asset impairment and so on, which do not belong to the company common business activities. When the amounts are huge, such items will have an impact on the company's profits and other financial measurements, and thus which couldn’t stand for the company operation for the accounting period. Management believes that the use of non-GAAP financial measures can eliminate the impact of non-operating factors so as to represent the companies’ reliable operating conditions in the financial statements.

Second, non-GAAP financial measures increase the comparability of information between enterprises. Different companies belong to different industries, which may decrease the comparability of financial information. For example, some companies are heavy-asset companies, which have more depreciation and less profit. In this case, there is no point in comparing the financial information of heavy-asset companies and asset-light ones. However, the comparability of companies’ business information will be enhanced if companies can take non-GAAP financial measures into consideration and remove nonoperation information.

Finally, non-GAAP financial measures help to mitigate the extent to which capital markets react to changes in corporate performance. For instance, once some items with huge amounts take place in companies, the capital market will react violently, and thus the stock prices and other market information will face great changes. The company maintains that non-GAAP financial measures provide additional useful information for shareholders on the underlying performance of business. They will adjust the profits and other information under GAAP, and disclose the reasons for the adjustment, and therefore, the response of the capital market to changes in performance will be slowed down.
There are many companies currently using non-GAAP financial measures, and management asserts that non-GAAP measures can provide valuable insight information they consider important in running the business. SEC aims to make the companies provide more accurate information through allowing them to use non-GAAP financial measures. However, the difference between non-GAAP and GAAP performance measures represent an increase. Meanwhile, most companies using non-GAAP financial measures have better performance in operating results and financial position, which may create the possibility of financial fraud. Therefore, it is necessary to strengthen the regulation of non-GAAP financial measures.

APPLICATION OF NON-GAAP FINANCIAL MEASURES TO JD.COM

Non-GAAP Financial Measures of JD.com

The non-GAAP financial measures are presented in JD.com unaudited financial results [5] and financial highlights [6], including non-GAAP net income (loss), non-GAAP income (loss) from operations, non-GAAP gross profit, non-GAAP net income (loss) per weighted average number of shares, non-GAAP EBITDA, free cash flow and so on. When JD.com make public a non-GAAP financial measure, it presents the most directly comparable financial measure calculated by GAAP and reconciles the difference between the non-GAAP financial measures and such GAAP financial measures.

These non-GAAP financial measures are clearly defined and calculated in the financial files. Non-GAAP net income (loss) is defined to exclude share-based compensation, amortization of intangible assets resulting from acquisitions, and certain other non-cash gain or loss items from net income (loss). Other non-GAAP financial measures are also defined to exclude the items that are non-recurring or that are not expected to result in future cash payments. The company believes that the non-GAAP financial measures can help the investors to evaluate the company’s current operating performance and future prospects as the management do.

Non-GAAP measures of JD.com: Advantages and Limitations

Non-GAAP financial measures provide management and investors with more relevant information, excluding certain expenses, gains and losses and other items that are not expected to result in future cash payments. These projects are non-recurring or may not represent the company's core business performance and business prospects. Besides, after controlling the non-recurring factors, the financial reports present JD.com business operations in a manner that shows more meaningful period-to-period comparisons.

While non-GAAP financial measures provides investors a fresh look at company’s operating performance through supplement other information in financial reports, non-GAAP measures also exit limitations as analytical tools. First, there is no unified provision for the adjusted items. The company decides to adjust the GAAP items according to their own judgments and therefore the reliability and comparability of the information may be slowed down. In addition, it may mislead investors when the disclosure of a non-GAAP measure more prominent than that of a GAAP measure.
**Non-GAAP Adjustments of JD.com**

JD.com announces fourth quarter and full year 2016 results. Gross profit for the full year of 2016 was RMB12.3 billion (US$1.8 billion). Non-GAAP gross profit in 2016 was RMB12.1 billion (US$1.7 billion), an increase of 58% from RMB23.8 billion for the year of 2015. Net loss for the full year of 2016 was RMB3.5 billion (US$0.5 billion). Non-GAAP net income in 2016 was RMB1.0 billion (US$0.1 billion), as compared to non-GAAP net loss of RMB0.9 billion in the full year of 2015.

JD.com achieved annual profit in non-GAAP measure, but in accordance with the general accounting standards, it still has a loss of RMB3.5 billion. As the media questioned, “Based on GAAP, JD.com 2016 year is in fact at a loss, so JD.com is likely to exist the problem of financial fraud.” JD.com official assert, “All the companies listed in America need to report GAAP and non-GAAP measures. That’s because the financial measures under GAAP include some non-cash costs. Otherwise, non-GAAP financial measures can better reflect the real business situation and provide useful information for management and investors.” The following is JD.com non-GAAP adjustments.

From the above table we can see that the difference between JD.com GAAP and non-GAAP financial measures mainly come from the share-based compensation (2.3 billion), amortization of intangible assets resulting from assets and business acquisitions (1.6 billion) and impairment of goodwill, intangible assets and investments (2.1 billion). After non-GAAP adjustments, JD.com net loss under GAAP turned into non-GAAP net income. At the same time, it can be seen that JD.com non-GAAP adjustment is in line with its non-GAAP accounting policies. However, the amount of the adjustment is huge, and even changed the nature of JD.com net profit, the reasonableness of which is challenged.

**The Impact on Non-GAAP Disclosure of JD.com**

As can be seen from the above table, JD.com turned a profit from the loss through non-GAAP adjustments. Such changes reflect on the capital market.

<table>
<thead>
<tr>
<th>TABLE 1. GAAP &amp; NON-GAAP RECONCILIATIONS.</th>
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<tr>
<td>Net Income (Loss)</td>
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<tr>
<td>Add: share-based compensation</td>
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<tr>
<td>Add: Amortization of intangible assets resulting from assets and business acquisitions</td>
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<tr>
<td>Add: Reconciling items on the share of equity method investments</td>
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<tr>
<td>Add: Impairment of goodwill, intangible assets and investments</td>
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<td>Reversal of: Gain on disposal of business</td>
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<tr>
<td>Reversal of: Revenue from business cooperation arrangements with equity investees, and income from non-compete agreement</td>
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<tr>
<td>Non-GAAP Net Income (Loss)</td>
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<td>Non-GAAP Net Margin</td>
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The chart shows that JD.com stock price grows steadily after announcing the good news of non-GAAP earnings in March 2017. In May 2017, JD.com announced its net income for the first quarter of 2017, leading the company's share price into a rapidly rising stage. Investors have positive response to non-GAAP earnings of JD.com, indicating that non-GAAP can send positive signals to reports users. The purpose of the non-GAAP adjustment is to convey the company's operating conditions more objectively to the information users. The non-GAAP adjustments of JD.com have made the investors more clearly aware of the operation of the Company and the impact of amortization of the intangible assets and so on. However, it is also debatable whether deducting these items is reasonable or not.

CONCLUSION

There are more and more companies using non-GAAP financial measures, and most companies' operating results are optimized for non-GAAP financial measures. The original aim of non-GAAP financial measurement is to highlight more accurate business information; therefore, non-GAAP financial measurement is necessary to be regulated.

Strengthen the regulations of non-GAAP financial measures, and avoid that non-GAAP adjustments become the company's means to manipulate profits. The SEC does not formulate the non-GAAP financial measures, and does not have a uniform specification for non-GAAP financial measures for the countries or sectors using non-GAAP adjustments. This is likely to cause that companies make non-GAAP financial adjustments according to their own interests, and thereby selectively convey the results of their operations. Therefore, the non-GAAP financial measurement regulations should be further strengthened so that non-GAAP financial measurement become the real way to display the company's financial information.

The prominence of non-GAAP financial measure disclosure shall not exceed the extent of the effect of GAAP disclosure so as not to mislead the investors. In 2016, the SEC defined the extent of the impact of non-GAAP financial measures in C&DIs and specifically defined the specific types of non-GAAP financial measures that affect the extent of the impact of GAAP indicators. However, the description of the situation is too vague and is not easy to identify in practice. Therefore, it is necessary to make further specific rules for the identification of the impact of non-GAAP financial measures.
REFERENCES


3. Regulation G and Item 10 (e). SEC.com.


