Earnings

Amazon and Facebook Now Mind the GAAP

- At a moment of strength, a switch to less favorable accounting
- "There's no better time to change your behavior"

For more than a decade, many of the largest technology companies have danced around the cost of paying workers, releasing profit numbers that don't account for the heaps of stock they dole out. Instead of conforming to the U.S. standards known as Generally Accepted Accounting Principles (GAAP), which include equity-based pay costs, roughly four in five of the 70 tech companies in the S&P 500 index use handpicked profit measures that make their earnings look better, according to data compiled by Bloomberg for their latest fiscal years. The non-GAAP measures raised the businesses' collective earnings 23 percent, to $239 billion.

In their latest quarterly earnings reports, **Amazon.com** and **Facebook** stopped eliding their stock-based compensation, joining exceptions such as **Netflix** and **Intel**. "We view it as a real expense," Facebook Chief Financial Officer David Wehner said on his April 27 earnings call. Unlike in previous reports, the CFO focused on GAAP numbers and said he would do the same on future calls. A day later, Amazon reported stock-based pay for its different businesses for the first time.

Equity Pay's Slice of Profits

EBay	**17%**
Alphabet	**26%**
Alibaba	**38%**
Facebook	**46%**
LinkedIn	**75%**
Yahoo!	**80%**
Amazon	**91%**
Twitter	**247%**

During the first dot-com boom, fast-growing tech startups argued that the option grants they were handing employees were too difficult to reliably value for the purposes of quarterly reports. That's still the default position in an era when most equity grants come in the form of restricted stock with a straightforward vesting schedule. The result: Some serious money is factored out of the bottom-line reporting. The average public U.S. company has a price-earnings ratio of 17—meaning its stock price is 17 times greater than its estimated 2016 earnings per share—or 18, when you count stock compensation, according to Sanford C. Bernstein. Facebook's p-e's are 35 and 50; Amazon's are 63 and 122.

So why make the change now? "If you can act from a position of strength, which Amazon and Facebook clearly are, there's no better time to change your behavior," says Denny Fish, a portfolio manager at investment firm Janus Capital Group. Facebook just reported one of its best quarters, and Amazon nearly doubled analysts' already bullish profit estimates. "They look more responsible, and it makes them accountable for how they issue stock for compensation," says Fish.

While investors rarely punish the industry for its creative accounting, Facebook's and Amazon's shifts also follow mounting criticism about overuse of non-GAAP numbers. In his latest shareholder letter, Warren Buffett called the omission of pay "the most egregious" example of non-GAAP accounting. James Schnurr, chief accountant for the U.S. Securities and Exchange Commission, said in a March speech that executives and directors should challenge use of the non-GAAP numbers.

An investor in Facebook and Amazon says both companies have privately acknowledged changing their accounting for competitive advantage as well as to soothe shareholders. A looser accounting approach made struggling companies look financially stronger than they really are and better able to compete for top talent. **Twitter** trades at about 36 times its estimated 12-month profit, but add in equity compensation and the company is expected to lose money. Its stock-based pay last year was more than twice its non-GAAP profit, according to Bernstein research. (Twitter didn't respond to an e-mail seeking comment.)

Fish cited **LinkedIn** as a company that should keep a tighter rein on its equity grants. Analysts estimate the business-focused social network will make $591 million in 2017, or a loss of $36 million when stock-based compensation and other costs are included, according to data compiled by Bloomberg. LinkedIn cut growth forecasts earlier this year, drawing more attention to long-term compensation costs. "When fundamentals deteriorate relative to high-growth expectations and stock-based comp is high as well, companies can be doubly penalized," Fish says. LinkedIn's stock price is down 45 percent this year, while Facebook's is up 12 percent.

LinkedIn spokesman Hani Durzy says that while the company doesn't plan to change its reporting practices, it's trying to reduce stock-based pay to 10 percent of revenue from 17 percent. Equity grants aren't going away, though. Says Durzy: "Talent is critical in this industry, and we want to make sure that we're balancing the trade-offs appropriately." *—Alistair Barr, with Sarah Frier*

The bottom line Profits for most public companies don't shift much when accounting for stock plans. Tech companies are different.

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