Stockholm School of Economics

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Is all that glitters gold?

An interview-based qualitative study of how investment professionals evaluate and use alternative performance metrics in their investment decision-making process

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Abstract

This paper explores how investment professionals evaluate and use alternative performance metrics (APMs) in their investment decision-making process. We adopt a qualitative inductive interview approach to investigate the informative and opportunistic perspectives on APMs. Our research collects data from ten private equity investors to add to the qualitative body of literature on APMs. While APMs can provide investors with valuable insights into a company's underlying performance, previous research has also identified that they may be reported with an intent to mislead investors. Therefore, our study aims to investigate potential risks associated with APMs by understanding how investors evaluate and use these metrics. Our findings reveal that investors use APMs to understand the performance of potential targets. What APMs that are used varies between investors and so does the definition and understanding of these metrics. Additionally, the way in which investors evaluate APMs varies between the different phases of the investment process and whether the process is structured or unstructured.

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Keywords: Alternative performance measures, investment professionals, use of accounting

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Table of Contents

1. Introduction

1.1 Background

The collective money flows created and transferred between actors in financial markets are vast and have a significant impact on society. Only within the private equity sphere, the global industry activity in 2021 reached more than $2 trillion in deal volume (McKinsey, 2022). For those with a curious mind, the internet can be a helpful tool to inform them of the fundamentals, such as what makes a company attractive, the core value drivers in deals, and how companies are valued. However, best practices and in-depth information on how these deals are made are often kept out of the public's view (Brown et al., 2016).

One of the major roles played by accounting information in market-based economies is that it allows investors to evaluate the return potential of possible investments (Beyer et al., 2010). The information is used to reduce the uncertainty regarding the outcome of a potential target project, and the more useful the information is, the more weight it receives in the valuation of the target company (Guttman, 2013). In addition to the required financial reporting set up in accordance with accounting rules and regulations, companies use additional metrics to convey their underlying financial performance (Cascino et al., 2021). In a report from the European Securities and Markets Authority (ESMA) (2019), it was found that all companies in the sample study used alternative performance measures (APMs) in their external communication with the market. The trend is also seen amongst S&P 500 companies, where 95% report APMs. Research by Imam and Spence (2016) indicated that an initial review of a company's results is performed early in the investment process, and according to Black et al. (2018), investors pay more attention to APMs rather than standard reporting numbers when they are looking for an overview of a company's performance.

For this reason, it can be said that whether a company is profitable has become increasingly difficult to answer. Pinterest, an American social media service, is an example of how difficult the evaluation of a company's financial performance can be when APMs are at pay. In their reported numbers for the fiscal year 2019, the initial report was a loss of roughly $1 billion. Through the use of APMs, they also presented an alternative scenario where the loss was converted into a profit of $17 million (Govindarajan et al., 2021).

1.2 Problematization and Research Question

Financial statements are less future-oriented than other sources of information and they are also published rather infrequently, making them less timely (Cascino et al., 2014). This could be one of the explanations as to why there has been an increase in the usage of APMs over the past decades and with this an increase in the acceptance of the usage of non-standard performance metrics as a tool to evaluate a company. Correctly disclosed APMs could be useful for investors to see the potential of a potential target company (Black et al., 2018). However, when deviating from established accounting rules and regulations the results are presented based on subjective judgments. In their research on the reporting of APMs, Black et al. (2018) refer to a speech from 2015 by ISAB Chairman Hoogervorst wherein he identifies APMs as a "threat to the integrity of IFRS financial reporting". Considering this, the question arises whether these alternative numbers are solely used with an informative purpose in mind, or if they are also presented as a practice trying to mislead investors. According to Black et al. (2018), both managers and analysts provide APMs with an informative purpose in mind, but there is also evidence of opportunism. Research on sell-side analysts shows, for example, that there could be incentives to distort the information to maximize trading commissions (Beyer et al., 2010). As proven, it is difficult to see where the line should be drawn and as Sherman (2018) concludes "in many settings, non-GAAP measures have taken on a life of their own".

There has been previous research conducted both within the field of investors' use of typical accounting and the usage of different APMs. However, most of the research has been predominantly quantitative and/or with an objective other than that of qualitatively examining the buy-side investment decision-making process. Cascino et al. (2014) even explicitly state that there is a need for "more research on the use of financial accounting information by different users for different objectives", where the ideal would be to find field-based evidence. We thus deem there to be a knowledge gap on the topic, and for this reason, our thesis aims to leverage the interview-based method to get closer to the minds of private equity investors as a representative sample for investment professionals and study the process of how they encounter APMs, with the goal of gaining an understanding of whether these numbers are used as an informative measure or if they constitute a risk for misleading information.

The research question of this thesis is thus: *How do investment professionals evaluate and use APMs in their investment decision-making process?*

1.3 Delimitations and Contribution

There are many aspects to an investment decision-making process. For this thesis, however, we have chosen to focus specifically on the parts related to APMs and will thus not investigate every aspect of the process such as managing the targets and the exit process.

This paper strengthens the conclusions of previous research about investors' need for additional sources of information in their decision-making process, particularly in terms of APMs. The main contribution of this paper is the depth at which it examines the evaluation and use of these metrics to give a more comprehensive understanding of how investment decisions are made. This is much due to the qualitative approach of this thesis, as the vast majority of research on the topic has been quantitative. Furthermore, this paper provides further evidence to prove the informative perspective of APMs and that these metrics are considered crucial for investors to evaluate a potential target.

1.4 Disposition

The introductory chapter of this thesis has provided an overview of the research problem and the research question. The second chapter will provide previous research within the field and the analytical framework used in this thesis. Chapter three will describe the research design, data collection, and data analysis. In chapter four we will present the empirical findings from our research. Chapter five will provide an analysis, which is followed by a conclusion in chapter six.

2. Theory and Previous Research

2.1 Prior Research

2.1.1 Investment Professionals' Use of Accounting

Financial reports – balance sheets, income, and cash flow statements – are some of the most common sources of financial information (Lev & Gu, 2016). The users of accounting information in the financial markets are many (see example Cascino et al., 2014). According to Gassen and Schwedler (2010), the professional investor population which uses financial accounting information in their decision-making is "unknown and even its size is hard to predict" and they suggest that defining this group of individuals is not straightforward. For this thesis, we have chosen to focus on investment professionals and define them as employees who in their job makes or participates in the making of investment decisions for the firm in which they are employed.

Cascino et al. (2014) examined the usage of financial reports for different capital providers on the financial market. The aim of investment professionals is to “maximize risk-adjusted returns relative to a benchmark or index and assess whether shares are over/undervalued with reference to uncertain future cash flows or earnings”. In relation to investment decisions, it is thus necessary to acquire information helpful in estimating future cash flows and earnings. Cascino et al. (2014) argue that one of the reasons behind the widespread use of accounting amongst this group is the fact that many valuation models use accounting data as inputs. Financial statements have also been deemed useful as reference documents when looking into the recent past, the present as well as when forecasting future earnings.

While this shows that financial statements are considered useful by the many investment professionals who apply them in their work toward maximizing returns, there are other useful sources of information as well. A survey conducted by Gassen and Schwedler (2010) examined the decision usefulness of financial accounting measurement concepts. They recognize the fact that it is difficult for the standard setters of reporting to identify accounting measurements that will be useful for all different users and for all different uses and focus their study on the perceived usefulness by professional investors. Based on relevance and reliability, respondents were asked to assess different types of information sources. The concepts of relevance and reliability have been further developed in later research on the same topic by Cascino et al. (2021). Referring to accounting standard setters such as the Financial Accounting Standards Board and the International Accounting Standards Board, the usefulness of accounting information can be evaluated based on two characteristics – relevance and representational faithfulness. Relevance is defined as “the ability of information to influence decision-making, assuming it is faithfully represented”. In turn, the information is considered to be faithfully represented if it is “complete, neutral, and free from errors”. The results from the two studies could be said to complement each other. The survey conducted by Gassen and Schwedler (2010) showed that the subjects differentiated between relevance and reliability and that the degree to which the information sources were audited played an important role. The most relevant source of information overall was the annual financial statements, followed by direct personal contact with the management, notes to the financial statements, and quarterly financial statements. When put in relation to reliability, the audited sources – the annual financial statements and the related notes – were considered about as reliable as they were considered relevant. However, the quarterly financial statements – which do not follow the same auditing rules – were considered less reliable than they were relevant. In the study by Cascino et al. (2021) eight different items in the financial reports were assessed and it was found that the information overall was perceived as highly relevant. However, during the conducted study, both regulated reporting figures as well as APMs were included due to previous research demonstrating the reliance on these figures by investment professionals (see for example Bradshaw & Sloan, 2002). According to the responses, how relevant a certain line item was deemed to be depended on its ability to assist the user in forecasting the company's ability to generate returns, and thus revenue and EBITDA were assessed as highly relevant, although at the same time considered less reliable.

Research by Brown et al. (2016) surveys the activities of buy-side analysts and what determines their recommendations. Nearly half of the respondents stated that financial reports were very useful for determining their recommendations and that they were more useful than quarterly conference calls, management earnings guidance, and recent earnings performance. Similar to the research by Cascino et al. (2021), Brown et al. (2016) showed that cash flows in support of the reported earnings were of great importance. In relation to this, a concerning fact for many of the analysts in terms of management efforts to intentionally misrepresent financial results was the occurrence of large gaps between earnings and operating cash flows. For earnings quality, the most important determinant is in fact the backing of earnings by the operating cash flow. For analysts with a background in accounting, recent restatements of financial results are another point of concern. One analyst disclosed that a comparison of multiple fiscal years' financial reports allows for an understanding of where there are potential inconsistencies that need to be examined further. However, despite the usefulness of financial reports, the responses by the surveyed analysts showed that the most useful determinant of their recommendations was their industry knowledge, followed by primary research.

One observable trend from this previous research is that traditional accounting and financial reports are a useful tool for investment professionals when trying to forecast their future returns - it is however neither the only tool nor the most relevant tool used. For this reason, it becomes relevant to further explore what other measures are used and what information they can provide that traditional accounting may not.

2.1.2 Alternative Performance Measures

The European Securities and Markets Authority (ESMA) defines APMs as follows:

> An alternative performance measure, according to the guidelines, refers to a financial measure of historical or future earnings, financial position, financial performance, or cash flows. It is not a financial measure defined by or specified in applicable rules for financial reporting.

EY (2018) gives a similar definition of APMs: “APMs are financial measures not defined in the applicable reporting framework”. As a result of this, what is to be considered an APM will depend on the applicable reporting framework.

Due to the different regulatory frameworks that exist, there are multiple ways to refer to the concept of APMs. The most common term in the literature is *non-GAAP measures* since most of the research in the field is centered around the US capital markets where the GAAP standard is the most prominent framework. Other alternative terms are *pro forma earnings* and *street earnings* (Sascha, Lorson & Pilhofer, 2022). While the exact definitions of the terms differ, the core concept is captured by referring to them as APMs. For this reason, we will use APM as an umbrella term throughout this thesis to be as consistent as possible.

As mentioned in the previous section, it is common for actors in the finance industry to assess a company’s earnings performance by using metrics beyond the financial measures defined by or specified in the applicable rules for financial reporting. In countries reporting under IFRS, APMs are generally widely accepted. As long as the regulated figures are given at least equal prominence as APMs the adjusted figures are allowed to be reported directly in a company’s income statements. Outside of audited reports, there are typically no restrictions on how APMs are disclosed to and discussed with investors (Young, 2014). This would mean that in theory, APMs could come to the attention of investors at any time.

Earlier research within the field supports the claim of the increasing importance of APMs for market participants, with Bradshaw and Sloan (2002) conducting the first large-sample empirical evidence on APM reporting. They found evidence that market participants have replaced traditionally reported numbers with APMs as a primary determinant of stock prices since 1992. Their research primarily showed that the reported APMs excluded several expenses which required reporting under accounting regulation. Bhattacharya et al. (2003) made a similar claim after they had analyzed 1 149 collected APM-earnings releases. They argued that APM earnings which are adjusted for “unusual” or “non-recurring” occurrences are perceived to be more informative than traditionally reported earnings, as they are deemed more representative of core earnings. More recent European research further supports this claim. A report from ESMA (2019) found that all 127 companies in the sample study used APMs in their external communication with the market, reflecting the widespread usage of APMs. However, APMs are only useful if they are credible and accurate, as these numbers would otherwise be discounted or disregarded (Black et al., 2018). Here, we can see a similar distinction as the one stated regarding accounting information – to be useful, the numbers need to be both relevant and reliable, or both credible and accurate. Throughout the research on APMs, the question of reliability is ever-present and the useful information they can provide for stakeholders is weighted against the concern of whether they accurately reflect a company’s financial performance.

Within previous research are both proponents and opponents of APMs, and we can thus identify the formation of two camps. The first one is the *informative* one, and the other is the *opportunistic* one. The informative perspective argues that managers who disclose APMs provide investors with more useful information by doing so, meaning that the adjustments for non-recurring events to reflect the “true” earnings of a company reduces the effects of the sometimes rigid accounting rules (see e.g., Black et al. 2018, Brown & Sivakumar, 2003).

On the contrary, the opportunistic perspective highlights the deceptive and misleading motives as to why APMs are disclosed – to portray a more optimistic picture than what matches the current state of the firm’s financial performance. While the informative perspective views the constructed APMs as a better reflection of earnings, the opportunistic perspective has found evidence that some managers disclose APMs to exclude recurring costs such as depreciation and R&D with the motives to either inflate earnings or to even out their results (see e.g., Barth et al., 2012, Black & Christensen, 2009, and Choi et al., 2007).

While both the informative and opportunistic perspectives are backed by empirical evidence, favoring one motive over the other has proven to be difficult (Young, 2014). There is evidence that shows that firms are more likely to “meet or beat” analysts’ estimates when they report APMs that are higher than the numbers reported in accordance with accounting regulations. Similar findings were presented by Bhattacharya et al. (2003) in terms of how reported APMs resulted in profit more often than audited numbers. Investors found the APMs less informative when this was the case. Furthermore, Doyle et al. (2013) suggest that not only does management opportunistically define APMs, but analysts also fail to fully take these definitions into account in their forecasts. Using a large dataset on the fourth quarter earnings announcement by firms in the S&P 500, Black et al. (2018) reports on the usage of APMs by investors and others to evaluate a company's earnings performance. These stakeholders typically start with ordinary earnings and later exclude earnings components that they consider to be transitory or non-cash. This process is performed with the intention of developing a more comprehensive evaluation of a company's financial performance. Market actors argue that these excluded items are less important for evaluating firm performance, and thus that the APMs reported are more suitable for their intended purpose. This is in line with what Bradshaw and Sloan (2002) reported in their research on earnings definitions and how they differed depending on whether they were computed under a regulatory framework or using APMs.

2.1.3 Private Equity Investors' Decision-Making Process

Private equity (PE) investors are one type of institutional investors who buy businesses with the intention of actively managing these before realizing the value created by selling them. As the name suggests, the capital is invested in private companies - either an initially unlisted company or a company that is taken private as part of the transaction (Gillian & Wright, 2020). In line with other researchers (e.g., Nama & Lowe, 2014 and Klein. et. al., 2013), we refer to PE firms as investors that as part of their strategy, either pursue buyout investments or growth equity investment, or a combination of the two. In buyout investments, the PE investor acquires a majority stake in the target and thereby has controlling rights, while in growth equity investments, the investors acquire a minority stake and co-own the business along with other stakeholders, who are also often the founders (Nama & Lowe, 2014).

The equity capital in a private equity firm is raised through funds in which most of the financial assets to be invested are committed by outside investors. Typically, the funds have a lifespan of ten years, during which time the firm normally spends five years investing the capital and the remaining five years returning the capital to the investors, before the fund is terminated (Kaplan & Strömberg, 2009). One distinctive attribute of PE firms is that they usually use a combination of debt and equity when making an investment. The use of debt increases the return profile for the investors; however, it also increases the risk profile of the investment (Gillian & Wright, 2020).

Nama and Lowe (2014) states that PE investors leverage their proprietary networks to source investments and describe it as a valuable way for the PE firm to find investment opportunities at reasonable prices. The PE investors not only face fierce competition from each other, but they are also competing against strategic corporates who are willing to pay high acquisition multiples due to the potential synergy effects. Additionally, most deals are done through investment banking networks, which pins the investors against each other in a bidding process and thus further drives up the selling prices (Nama & Lowe, 2014). The PE firms would look to find targets who are industry leaders or unexploited market opportunities. When the investors have identified a target and initiated or entered an investment process, they would typically have to get approval from their investment committee where the senior investment professional validates and challenges the work that the deal team presents (Nama & Lowe, 2014). If approved, the responsible members of the deal team will continue the process and face additional matters such as valuing the target. The most common valuation techniques include multiple valuations, and forecasting future cash flows derived from extensive models of the financial statements (Gillian & Wright, 2020)

Gillian and Wright (2020) argue that to truly understand the private equity model, one must carefully observe how the firms work with information – how it is collected, managed, and used. For example, prior to making an investment, a PE firm would often leverage expensive third-party consultants to conduct thorough due diligence. By possessing the most relevant, up-to-date, and highest-quality information as the foundation for their investment decision, the PE firm would gain an informative advantage over the vendor and its competition, thus yielding sustainable returns.

It is reasonable to presume that accounting figures and APMs are integral components in the exchange of information within private equity firms. By examining APMs in this context, we may gain insights into how to better evaluate their use.

2.2 Analytical Framework

To derive meaningful insights from our data, we have opted to employ an inductive approach. Thus, to help guide our analysis of the investment decision-making process and the role of

APMs, we have developed an analytical framework that takes inspiration from the work of Andersson et al., (2020). In their framework, they theorize how sell-side analysts account for acquisitions during three distinct phases (before, during, and after). Using this three-phase-division we have replaced the stages used by Andersson et al., (2020) with the most relevant phases that occur in PE investors' decision-making processes according to Caselli and Negri (2021). Caselli and Negri (2021) mention six phases: *origination, screening, valuation and due diligence, rating assignment, negotiation, and the decision to invest.* We have compressed these into three distinct phases which capture the core concepts of the decision-making process.

The three phases that investment professionals are expected to go through when investing in a company, and where APMs may be of high relevance, are the pre-acquisition/screening phase, the evaluation phase, and the negotiations and signing phase. The first phase involves identifying potential acquisition targets and gaining an overview of their financial performance. The second phase is where investors will have access to more target data, formulate a more robust view on valuation, and potentially initiate a due diligence process. Lastly, the third phase is where the final decision to acquire the target is made and the negotiation between the seller and the buyer happens. (Caselli & Negri, 2021, Nama & Lowe, 2014, and Gilligan & Wright, 2020).

Drawing on the framework by Andersson et al., (2020), we chose to use two dimensions on the vertical axis to analyze the role of APMs in each phase. As mentioned, previous research is divided in their opinion on APMs – there is the *informative* view and the *opportunistic* view. By examining the investment decision-making process through these two dimensions, the aim is to investigate how investors evaluate and use APMs throughout the process.

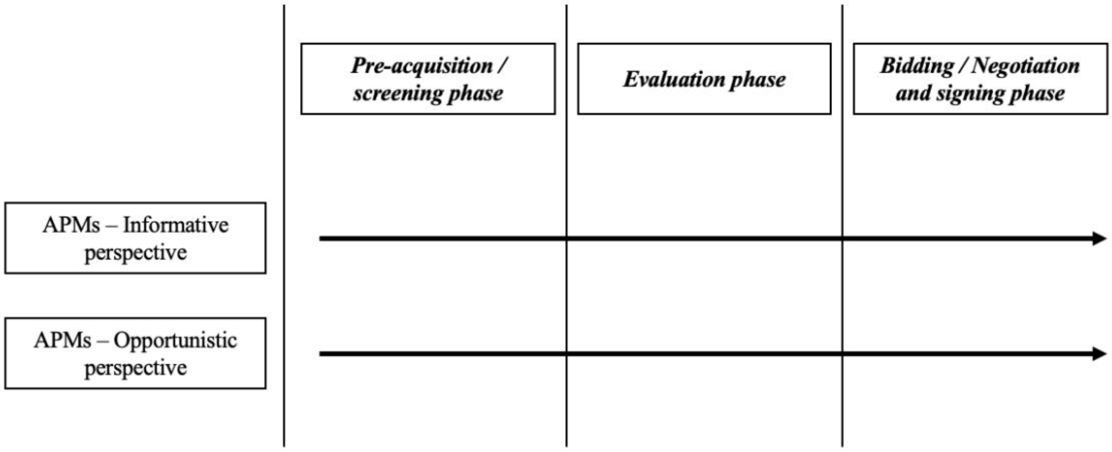

Figure 1. Analytical framework: Empirical study of the evaluation and use of APMs during the different phases in the investment decision-making process.

3. Research Methodology

3.1 Research Design

The field of accounting research has progressed from primarily relying on quantitative methods to adopting a more diverse and inclusive approach and evolved into a pluralist discipline that encompasses qualitative methodologies. The progression was partly driven by dissatisfaction with the limitations of the quantitative methods, such as the difficulties to understand the context of a phenomenon.

To our knowledge, research on how investment professionals evaluate and use APMs in their investment decision-making process is scarce, particularly from a qualitative perspective. Since this study aims not simply to convey what type of APMs investors use, but rather also why and how they are used, we leverage the qualitative methodology of an interview-based case study. This approach allows us to interpret how the experts answer questions, provide follow-up questions when clarifications are needed, and/or contextualize questions to ensure that the questions are correctly interpreted. Thereby, this method enables us to go beyond the limitations of the quantitative method.

By conducting a multiple case study, we examine cross-case patterns and can thus find similarities and contrast the differences against each other to see evidence in multiple instances. Qualitative research is particularly well-suited for studying the complexities of expert practices (Lee et al., 2006, Cooper & Morgan, 2008), such as the interpretation of APMs by investment professionals. This design has thus been used to answer the research question of how investment professionals evaluate and interpret APMs in their investment decision-making processes.

3.2 Data Collection

The data was collected through interviews conducted with investment professionals at investment firms with offices in Stockholm between March and April 2023. Initial contact was made through email, either directly to the interviewee or to the human resource department to be distributed amongst relevant interview candidates. In the email, we introduced both ourselves and the topic along with the request for an interview. On occasion, companies requested that we provide them with our intended interview questions prior to the actual interview. We have accommodated such requests to avoid potentially losing out on valuable candidates. Furthermore, when initially communicating with a representative from human resources, sharing our interview questions in advance helped them identify and select the candidate with the most relevant knowledge and experience of the subject.

We conducted a total of ten interviews with seven different private equity firms with an average duration of 50 minutes. Due to limitations in both time and space, we concluded that it was reasonable to limit the number of interviews, although it could be advantageous to conduct more interviews to increase the analytical depth and increase the field-based evidence. Six of the interviews were conducted in person and four of the interviews were conducted online upon the interviewees' requests. As Sturges and Hanrahan (2004) conclude, telephone interviews – and in our case video interviews – can be used productively and be a time-efficient method in qualitative research. Thereby, when our only option was to conduct the interview through a video call, we would accept it. However, if we got the opportunity to choose between an online or in-person interview we would always opt for conducting the interview in person.

Both authors were present during all interviews, where one had the main task of conducting the interview while the other one took notes. The interviewer’s main responsibility was to modify the style, pace, and ordering of the questions to evoke the richest response from the candidates (Qu & Dumay, 2011). The notetaker's main responsibility was to ensure that the interview stayed on topic, to ensure that all of the areas of interest were covered, and to assure that the timeframe was kept.

In accordance with the recommendation by Kvale and Brinkmann (2014), we reintroduced the purpose and aim of our thesis at the beginning of the interview. We also requested their permission to record the interview, with the guarantee that both the interviewee and the firm at which they worked would be anonymized to encourage openness from the interviewees. All interviewees agreed to being recorded. The recordings enabled us to carefully review each interviewee's responses, providing us with a more complete understanding of their perspectives and insights that otherwise would have been missed.

Interviewee:	***Title:***	***Investment firm:***	***Date of interview:***	***Medium:***	***Language:***	***Fund attribute:***
Interviewee 1	*Director*	*Investment Firm 1*	*2023-03-09*	*Video call*	*Swedish*	*Mid market - buyout*
Interviewee 2	*Director*	*Investment Firm 2*	*2023-03-15*	*Video call*	*Swedish*	*Mid market - buyout*
Interviewee 3	*Investment Manager*	*Investment Firm 3*	*2023-04-03*	*In-person*	*Swedish*	*Mid and large cap - buyout*
Interviewee 4	*Investment Associate*	*Investment Firm 3*	*2023-04-03*	*In-person*	*Swedish*	*Mid and large cap - buyout*
Interviewee 5	*Director*	*Investment Firm 4*	*2023-04-04*	*In-person*	*Swedish*	*Large cap - buyout*
Interviewee 6	*Vice President*	*Investment Firm 4*	*2023-04-04*	*In-person*	*Swedish*	*Large cap - buyout*
Interviewee 7	*Investment Manager*	*Investment Firm 5*	*2023-04-04*	*Video call*	*Swedish*	*Growth equity*
Interviewee 8	*Analyst*	*Investment Firm 5*	*2023-04-04*	*Video call*	*Swedish*	*Growth equity*
Interviewee 9	*Investment Professional*	*Investment Firm 6*	*2023-04-05*	*In-person*	*Swedish*	*Mid market - buyout and growth equity*
Interviewee 10	*Vice President*	*Investment Firm 7*	*2023-04-10*	*In-person*	*Swedish*	*Large cap - buyout and growth equity*

The average duration of interviews: 50 minutes and 16 seconds.

Table 1: Interview information

3.2.1 Interviewee Selection

All sample participants chosen shared the unifying factor that they are all investment professionals at a PE firm with offices in Stockholm. We have selected private equity investors as suitable representatives for the broad group of "investment professionals". The reason behind this selection was based on several factors. First, private equity firms are known for their thorough diligence processes. As such, they possess the experience and knowledge necessary to understand the potential implications of various adjustments and definitions of APMs that could pose different problems. Second, given the nature of private equity funds' investment strategy and structure, particularly buyout funds – which constitute most of our sample – typically involve greater downside risk compared to other market participants. Hedge fund managers have quicker exit opportunities since they trade on exchanges and VC firms generally make more investments and generally thus have a more diverse portfolio. Given these factors, private equity investors are well-suited to provide valuable insights into the challenges and opportunities of measuring and reporting APMs.

Most of the firms we interviewed constituted some of Stockholm's major PE firms, while some of the firms were somewhat smaller in terms of AUM and number of sectors covered. Some firms covered targets earlier in their business life cycle, while some of the firms entered later. All participants had several years of industry experience, and they mainly covered the sectors of tech, financial services, e-commerce, and healthcare. The choice of conducting interviews with participants from different firms as well as from different sectors was made to counteract the internal unified perspectives which can color the view of a homogeneous group as well as to capture differences between the sectors. While we have chosen to disclose the titles of the participants to showcase the width of experience amongst the interviewees, as opposed to much previous research, we will not be dividing the answers into different categories depending on the different roles of the interviewees. We have instead chosen to treat them all as participants of the larger group of investment professionals.

3.2.2 Interview Design

For the interviews, we adopted a semi-structured approach that entails a structured and methodical approach to asking questions based on predetermined topics, with the use of follow-up questions intended to prompt more detailed and extensive answers (Qu & Dumay, 2011). We used an interview guide with predetermined topics with broad themes we wished to cover – this guide was not strictly followed and should be seen as more of a guideline. This approach gave us the flexibility to adapt the questions toward the most critical subjects while keeping the conversation on topic and thereby ensuring that answers could be contrasted between interviewees later. In addition, one of the main benefits of using the semi-structured approach is that it allows the interviewees to elaborate on a specific answer when the interviewees deem it necessary (Alvesson & Deetz, 2000).

Furthermore, it is important to also acknowledge the limitations of the semi-structured approach. It can be time-consuming and difficult to contrast the answers between the candidates (Alvesson & Deetz, 2000). In essence, this approach requires us, the authors, to take on greater responsibility ensuring that the interviews are conducted in an impartial and unbiased manner. This includes not only conducting the actual interviews in that way but also evaluating the data collected in a fair and objective manner. Our goal is to extract the most valuable information from the data we collect while remaining as objective as possible. We recognize that this approach requires us to exercise careful judgment and to be mindful of our own potential biases, to ensure that the resulting analysis is accurate and reliable.

3.3 Data Analysis

The interviews were set up in such a way that one author was responsible for conducting the interview while the other author listened in and took extensive notes. This was done for two reasons - it allowed for an immediate review of the interview as well as an overview of the central parts of the interviewees' answers.

Following each interview, we engaged in internal discussions amongst ourselves to identify and agree upon the key insights, ensuring that we did not miss anything and to discover any potential discrepancies that would then be discussed further. Subsequently, we transcribed and translated the essential takeaways from each interviewee and applied a thematic approach by categorizing the quotes into each stage in our analytical framework. Qualitative research poses a significant challenge when it comes to analyzing transcripts in a way that allows for the identification of patterns within and across interviews, while also remaining sensitive to any unique and individual elements that could offer valuable insights. This requires us to strike a balance between identifying broader themes and patterns, while also remaining open to the nuances and details that may be present in the data. Failure to do so can lead to oversimplification of the data, potentially resulting in the loss of important information (Lee & Humphrey, 2006). Therefore, throughout the transcription and translation process, we frequently noted preliminary analyses, hypotheses, or general thoughts alongside the interviewee's quotations. This enabled us to keep track of more in-depth ideas and concepts, while also allowing us to zoom out at a later stage and capture the most prominent trends. Overall, this method allowed us to maintain a comprehensive understanding of the data and facilitate the development of more robust conclusions.

4. Empirical Findings

4.1 Background

Investors encounter APMs in different stages of their investment processes. Common to all our interviewees was the division of the process into three different phases – the *pre-acquisition/screening phase*, the *evaluation phase,* and the *negotiation and signing phase*. What separates private equity investors from most other investment professional groups is their thorough due diligence process. This was highlighted to be of utmost importance for our interviewees. One main reason for this is the investment strategy of private equity investors. Rather than depending on one lucky hit to carry the return of a whole fund, private equity investors strive for a more evenly distributed return profile in their relatively concentrated portfolio, requiring a careful review of each investment to leave as little as possible to chance.

There is also an important distinction that was made by one of the investors at Firm 4 to highlight the different types of APMs they encounter in their process, both in terms of their intended use and what roles they play for the investors in the decision-making process:

> “You have to differentiate between alternative performance metrics that help us understand a business and alternative performance metrics that include different adjustments which are mainly used in our valuation processes. “

4.2 Pre-acquisition/Screening Phase

4.2.1 Initial Information Gathering

The pre-acquisition phase is the starting point for every new potential investment. The screening process can take on many different forms as highlighted by Firm 1, who pointed out that they had no standardized process fit to work each and every time, as the projects themselves differed from time to time. The consensus amongst the majority of the firms was however that the investment process takes a funnel-like form which tapers off as the process progresses through the different phases.

The type of investments made by the firms in our sample differed in terms of size, maturity and whether the target company was listed or not - these are all factors that impact how much information is available for the investors to assess. There is also a difference in the gathering of information depending on whether the firm is part of an unstructured or structured process.

Listed companies generally provide the most information in their annual statements, including the usage of APMs. The annual statements of unlisted companies rarely provide APMs, although it might be the case where the company has a bond outstanding in the market or must uphold a covenant to a bank and the bank is particularly interested in a specific APM. The somewhat scarce information available to investors dealing with unlisted companies comes as no surprise to our interviewees, with one of the investors at Firm 5 explaining their view on information sharing:

> “For our portfolio companies, we almost see it as a sport to be as vague and show as little information as possible in the company fillings. We want to reap the benefits of being private a private company.”

Overall, however, what makes the Nordic market unique from an investor's point of view in terms of information gathering is the accessibility of the data of firms compared to other regions. Investors can leverage aggregators in their screening processes, which retrieve data from publicly accessible databases and feed the information directly into the investor's Excel sheets.

In an unstructured process, there is no advisor on the sell side who provides the investors with information, meaning that the investors themselves gather the information from the potential target companies. In a structured process, the potential target company is instead represented by an advisor - most often an investment bank. In this case, the investor is presented with a teaser – a rather short document presenting an overview of the company and its performance – which has been put together by the advisor. These documents often include APMs both in the form of adjusted reported numbers and different performance measures.

4.2.2 Information Usefulness and the Goal of the Pre-acquisition/Screening Phase

As for the perceived usefulness of the information gathered from the annual reports or quarterly filings in this initial phase, one investor at Firm 3 summarized it such as:

> "In the pre-dd or pre-research phase, accounting is not the most important aspect. We aim to understand the market and the company's positioning. Accounting such as revenue or EBITDA is used to give an indication of the size, however, that number is almost never accurate or true."

In line with this statement, most of our interviewees did not put too much emphasis on the absolute truthfulness of individual reported figures or APMs listed in the annual reports nor in the material provided by advisors in this initial step. When working "outside-in" - examining a business without internal access to the company - the investors seem to perceive both standardized accounting and APMs as indicators or small puzzle pieces used to form an overall view of a business rather than the single deciding factor. Firm 3 elaborated on this and stated:

> "We are trying to get as many APMs as fast as possible when we are looking at a new target. If these are interesting enough for us to move the process along, we dig further into the parts that make up the APMs during the DD process."

What our data shows here is thus that the pre-acquisition/screening phase mainly serves the role of pinpointing interesting target companies. The reported numbers, both in terms of standardized accounting figures and APMs, serve the role of helping an investor understand the position of the target and whether it is worth moving forward. It is however first in the evaluation phase where these numbers are scrutinized through an extensive due diligence process to conclude the actual value of the potential investment.

4.3 Evaluation Phase

4.3.1 Access to More Extensive Information

Just as in the pre-acquisition/screening phase, there is no one answer to precisely what the evaluation phase looks like. However, we define this phase to begin when the investor expresses interest to invest in a target company. As this interest is expressed, the investor is presented with more information and data. This will entail the investor at some point getting access to the company's internal finances and data files, and as our interviewee at Firm 6 stated, "It is first when we receive the data files that we actually can evaluate the company."

How this information is gathered differs, and the division into unstructured versus structured processes becomes even more important as the process moves forward into the evaluation phase.

4.3.1.1 Unstructured Processes

Our research shows that investors with the strategy of investing in unlisted, less mature companies and who enter at an earlier stage will usually prefer to pursue the investment through an unstructured investment process. This entails that the investor will be in contact with the owners and/or management of the target directly - the information will thus flow between the target and the investor without an advisor as the middleman. Firm 5, an investment firm focused on growth equity investments, almost exclusively works in this way:

> "In 90% of all our transactions the company has either approached us or we have been referred to speak to that specific company. This means that the target does not have a financial advisor, and thus that there is no information memorandum laying the foundation around which we can form an investment thesis."

Elaborating on this, Firm 5 believes that this gives them an information advantage with respect to valuation, financial management, and general board governance compared to the case of a structured process. In a process working closely with management, typical information sources could be various Excel files including budgets, extracts from accounting services, and different customer flow files. Using these numbers, the investors can then construct their own adjusted numbers and performance measures as a tool for evaluating and valuing the company as our data showed that it was very rare that management themselves provided any APMs. In this instance, the investors' perception of APMs is solely positive, as the metrics provide an informative foundation to build their evaluation.

4.2.1.2 Structured Processes

A somewhat different approach is taken toward the evaluation of APMs in a structured process. As previously mentioned, a financial advisor has in this instance packaged and presented a potential target to the investor. In this second phase, a more extensive information memorandum is developed and conferred to the investor. Our data showed a consensus amongst our sample participants on a somewhat more skeptical perception of APMs provided by these advisors. An investor at Firm 6 gives an explanation as to why this is:

> “In structured processes, there is a higher probability of encountering an adjustment that should not be there. Advisors in these processes are incentivized by the selling price and are tasked with maximizing it. On the management side, the communication and numbers presented are often more truthful, if errors occur, they are often unintentional, especially if they lack expertise in accounting.”

This view was explicitly shared by the majority of our interviewees, with one investor at Firm 3 stating that:

> “We expect to disagree with some of the numbers presented by the sell side. It is quite simple really - they present one picture and we as buyers present a different picture.”

The view amongst the buy-side investors thus seems to be that they recognize the sell-side investment banks to have incentives to sell for a high price, and therefore they do not expect anything else than the advisor to present APMs over which they might disagree on what is a reasonable adjustment and what is not. Despite reservations towards the presented APMs, none of the investors in our sample expressed any considerable concern in regard to their existence, much due to the extensive due diligence process which takes place as the evaluation phase continues.

4.3.2 Evaluation of APMs

When evaluating a company, investors will typically have several APMs in mind that they want to see. If these are not already showcased, the investor will either ask about these specific numbers or use the data available to calculate them on their own.

As mentioned previously, investors distinguish between two types of APMs - the performance metrics to help evaluate the future performance of a company, and the performance metrics in terms of different types of adjustments. As many of our interviewees were active in the tech industry, we found some specific ones to help them to evaluate the future performance of the target. These metrics somewhat overlap with so-called key performance metrics (KPIs) and included for example *net retention rate (NRR), gross retention rate (GRR), annual recurring revenue (ARR),* and *average revenue per user (ARPU).* One investor, specialized in e-commerce, instead based much of their evaluation on different gross margin measures. The other type of APMs mainly constitutes different types of EBITDA or EBITA adjustments.

When looking at how a company is performing, APMs will give the investor a considerably larger insight than if they were to only recognize the financial reports. While looking at the revenue from one year to another provides insight into whether the company has done better or worse in terms of absolute sales numbers, APMs can give the investor an acumen of different customer behaviors. Taking NRR in a tech company as an example, investors can see where the growth stems from. Using the NRR, the investor would in this case be able to look at two companies with the same growth and evaluate which one is more likely to perform best. If the growth mostly stems from existing customers implementing more software licenses across divisions or upgrading already existing licenses, this gives an indication that the product or service will most likely continue to appeal to customers. On the other hand, if the same level of growth is mainly coming from new customers, this also indicates a significant amount of churn - meaning that while new customers are coming in, a lot of customers are also leaving the platform. This could be an indication that there is something lacking in the target offering, making it less interesting for the investors. Using APMs investors can thereby analyze customer patterns and draw conclusions used to forecast the future.

We can conclude from our data that it is almost impossible to see how the different APMs are defined or what is included simply by the numbers presented. One investor at Firm 4 elaborates on the issue of defining the different measures:

> "These metrics are something we discuss with the sell side all the time - how the ARR is defined, what is included, and what is not. However, we usually work with one of the Big 4 that knows how we like to define ARR when conducting diligence on a company."

Digging deeper into the above statement, the investor mentions how one of the Big 4 "....knows how we like to define ARR". This would suggest that there exist different definitions of APMs, and that this lack of standardization entails an opportunity to interpret and construct the metrics based on one's own preference. While it is so that there is a lack of an official definition of how, for example, an ARR should be calculated - one investor at Firm 4 suggested that some kind of consensus is built up amongst investors over time:

"I think newcomers in the industry have a harder time understanding how to work with these metrics. Today, when we look at people who have worked with these different metrics for many years, we can find some type of common definition of what a specific APM is."

This consensus amongst experienced investors seems applicable in most cases, however, EBITDA in particular is a measure that stands out as highlighted by an investor at Firm 6:

"ARR is quite simple to define and dispel when it is questionably constructed. On the other hand, different EBITDA adjustments are not always as straightforward as they could include everything. I have seen companies have 0 MSEK in reported EBITDA and 150 MSEK in adjusted EBITDA."

The purpose of adjusting these numbers is to get closer to what the company would, or should, perform under "normal" circumstances. The metrics are thereby adjusted to include or exclude costs or incomes which have not been part of normal operations. What is to be considered normal circumstances is often up for discussion in the investment process. This is not only true in a seller-buyer relationship but also within an investment firm itself. One of our sample firms had recently conducted a case training for newcomers on what should be included in the EBITDA base. The results showed discrepancies of 15% from the highest to the lowest EBITDA. This suggests that it is a complicated area that goes beyond standard accounting knowledge, inviting ambiguity into the process. As one of the investors at Firm 3 stated:

"The basic definition and meaning of the different metrics that include adjustments are known in the investor community, however, what is included or excluded is not set in stone and we can see a spectrum of how aggressive people are when they make different adjustments."

4.3.3 APMs Pick up Where Accounting Ends

The role of APMs in the evaluation phase can be summarized in a quote by Firm 4:

"The way I would describe it is that APMs and accounting serve different purposes. The numbers reported in the financial statements show the target through a historical snapshot. APMs on the other hand are crucial in order for us to understand what the future will look like."

This implies that the reason for the somewhat laissez-faire attitude towards the historical financial statements used to lay the foundation in the screening phase could be due to the reason that they themselves are not enough to evaluate the future performance of a target. It is rather the more detailed data such as customer files or specific drivers that can reveal customer behaviors or capture different trends - information that cannot be understood by simply looking at the standardized reported numbers.

4.3.4 The Crucial Importance of the Due Diligence Process

In an investment process, there is to some extent an information asymmetry between the buy side and the sell side. However, this was not raised as a point of concern by any of the investors in our sample - rather, they spoke about the positive aspects of using APMs. All interviewees agreed that the most important thing when working with APMs is understanding what they mean and what they are meant to show. While they all agreed that there was a potential risk of the numbers presented to them being inflated to raise the target price, they all pointed to the part played by the due diligence process.

The due diligence process covers several areas - finances, legal and commercial interest, to name a few. As for the financial due diligence, much of the analysis at this stage is outsourced to third-party accountants who perform in-depth financial line-by-line analysis. The due diligence process will result in a quality of earnings report presented to the investors. In this report, through these thorough analyses, most of the ambiguous constructions and definitions would be flagged to be discussed between the parties. Here, investors emphasized the importance that they could trust their accountants and that these parties shared a common definition regarding certain APMs, rather than focusing on the definition given by the sell side.

As mentioned before, there are many different definitions and many different adjustments that are done in regard to APMs. The APMs which are particularly scrutinized in the due diligence process are the cash flow proxies such as EBITDA, EBITA, or EBITDAC and all types of adjustments made to these metrics. Examples of costs excluded, or incomes included in our data were related to COVID-19, acquisitions or divestments, and lay-offs. APMs were also used to discard different accounting treatments, like how companies treat their capitalized costs differently. To make the due diligence process more structured, some investors have implemented a formalized process around the different adjustments. Firm 4 was one firm with this approach, and the firm has categorized the adjustments as follows:

> “... our adjustments are segmented into three broad groups. The first adjustment group is normalized adjustments such as M&A costs or if there was a fire in one of the factories. What this

> means is that here, we handle costs that have occurred but are not part of the everyday operations. Thereafter, we do pro-forma adjustments to account for acquisitions that the reported EBITDA would not account for. Following this, we have run rate adjustments to handle investments in a new product or if the company has fired a lot of people to see what the future effect will be. This group is most discussed since the sell side and the buy side are willing to accept different adjustments. Lastly, we take an internal view on what we can accept and what we cannot accept, which will lead to the final negotiations regarding the price."

4.4 Negotiation and Signing Phase

In the third and final phase of the investment process, the investors are well-informed about the company. Whether the process has been unstructured or structured, this is the stage where the price that the investor will pay for the target is determined through negotiation tactics and the alignment of interests. Throughout the process, there has in most cases already been an indicative offer made from the investors - a signal as to how much they would consider paying for the company.

At this final stage of the investment decision-making process, our data showed that the investor sample has several different strategies and areas of focus. The negotiations depended on several factors - such as at which stage the investor enters the company, whether the investment is a majority or a minority one, which sector the target is operating in, and whether the bidding process is led by an advisor or not. These are all examples of factors that would impact how the investor would think and act and thus ultimately how they would evaluate and use different APMs in their investment making decision.

4.4.1 Negotiations in a Structured Process

When investors set the price of a target company, APMs feed into the decision in several ways. Firstly, on top of the typical LBO model where the APMs would feed into the model, investors typically look at different multiples to determine what they believe to be reasonable compensation for the target company. Here, the investors look to benchmark. They look at prior transactions they have made themselves, what competitors have done, or how listed companies are traded. Here, the APMs play an important role in deciding what the multiple should be. While different companies may appear similar on the surface when looking at their performance according to their reported numbers, they may differ substantially when it comes to how they are valued. At the end of the day, every investor in the sample agreed that what matters is how much money the target can be expected to generate. Firm 2 put it as:

> "In the end, it boils down to how much cash the company can make in the future. If we look at EBIT, EBITDA, or EBITA it doesn't really matter. You have to start with what the company makes today and from there understand the adjustments needed to predict the earning potential in the future."

Our data show that this method proved true for all of our investors. They would determine suitable sale or earnings metrics - this could be ARR, gross profit, EBITDA, or some other number - and adjust it accordingly to what they believed to be reasonable. This metric would constitute the base. This base would then be multiplied using a multiple resulting in the final acquisition price. How this multiple is determined depends on several factors. One important factor is the asset quality of the target – how much value the target can be expected to generate in the future. To assess the quality the investors could look at different APMs such GRR or NRR to forecast future performance.

While this part of the investment process might seem straightforward in theory, there are several factors the investors need to take into consideration in the negotiations. Firm 3 speaks on this as:

> "The negotiations can be a little bit of a bartering where we are more likely to implicitly adjust the multiple to make a deal happen. The most important thing is that we know that the EBITDA is correct. As an investment team, we are primarily evaluated on the business plan we have presented which includes the development of the key metrics such as adjusted EBITDA over time."

It is clear that it is essential for the investors to get the multiple base right. However, the price is not set based only on the preferences of the investor - the seller is very much involved in the discussions. In the negotiations to reach a deal, investors will essentially never agree to a higher base than what they deem reasonable but instead adjust the multiple they are prepared to pay on that base. In the end, the final price is ultimately the same, so the question arises why the investors are so set on not compromising the multiple bases. We found two primary factors that could explain this phenomenon. First, the investors could want a solid foundation to benchmark both prior and future investments against. Getting the base is in this sense one way to ensure that future deals are not distorted. The second factor could be the structure of the firm's incentives as stated in the quote above. If the deal team is evaluated primarily on the business plan of their target, this would include the forecast of whatever multiple bases they use. Thus, compromising with the base would entail putting the team at risk of a negative result in their evaluation.

In the discussions between the parties, the goal for the buyer can however not simply be to drive the base down as much as possible. Here, it is important to consider the deal dynamics and how competitive the process is. Firm 2 highlights this as a major factor to reach a successful outcome:

> “If we were to neglect all of the adjustments that other investors thought were fair, we would not win any deals”

How to look at the different adjustments can thus be said to be a part of the negotiation game. Where the investors would have a goal of not overpaying for a target based on questionable numbers, they would have to balance this against the characteristics of a competitive process and make sure to account for alternative views as well.

4.4.2 Negotiations in an Unstructured Process

In an unstructured process, the negotiation phase takes on a somewhat different form. These negotiations are often less formal as they are done through direct communication with either management or the owners of the target. Here, it is not unlikely that the owners have a specific and determined number in mind as exemplified by firm 5:

> “When we are in negotiation with the entrepreneurs, they can sometimes simply say that they could not care less about quality of earnings - they want 200 MSEK for their company, end of discussion.”

Firm 5 explains further that the number presented by the entrepreneurs in a situation like this could be based on highly subjective arguments - the number might “feel good” or they want to sell their company for a larger sum than what their friend did. One thing the investors would do in this case is use their expertise around certain APMs to effectively explain the reasons why or why not such a premium is reasonable. In this case, APMs are then used as both key metrics or for the investor to evaluate the company, but also as a tool to convey this to their counterpart.

In resemblance to the structured process, there are other factors at play when negotiating the price other than for the investor to get the best possible price. For firm 5, which exclusively takes on minority investments, this is central:

> "Since we take minority posts we have other incentives in our negotiations compared to if we would have bought 100% of the company. The founder generally stays in the company and will thus be a person we will work closely with for the coming years. As such, we are not as tough in the negotiations as we perhaps could have been otherwise."

As the unstructured processes are usually bilateral and as such only include the investor and the target company, it is per se not as competitive as a structured process. As substantiated by the quote above, it is instead rather relationship driven. Minority investors emphasize the importance of backing "the right horse" and not letting the negotiations hamper the future relationship with the target representatives.

4.4.3 Closing the Deal

The investment decision-making process comes to a close when the investor and the target have made it through the three stages of screening, evaluation, and negotiations. If the parties at the end of the process can find common ground, a deal will be made. What happens hereafter lies beyond the scope of this thesis, but there is one important thing to note. While the usage of APMs throughout the process is unregulated, many parties choose to agree among themselves on certain aspects as a type of failsafe. Many of the investors we interviewed disclosed that every deal they made included a legally binding agreement stating that the sell side was to face repercussions in cases where the seller intentionally deceives the investor regarding the target's finances.

5. Analysis

5.1 Looking Back or Seeing Forward

Through our research, it has become clear that the usage of different APMs is central throughout all the phases of an investor's decision-making process. The reason for this that we have found is the investors' need for information. This need for information amongst our interviewees aligns with the previous research conducted on investment professionals' use of accounting.

The overall trend we can see, both in previous research and in our own study, is the need not only for information in general but for specific information that will allow the investors to succeed in their aim of maximizing returns. Gassen and Schwedler (2010) recognized the fact that standardized accounting measures cannot accommodate all different users or all different uses. Throughout our study, we have seen clear examples of this regarding the usage of APMs among investors. Different investors use different APMs, and even more so different definitions and adjustments to those APMs to fit their needs. Amongst our interviewees, we particularly saw differences depending on what industry the investor was active in – investors within tech were interested in metrics that could help them understand user trends, while investors within e-commerce focused on different gross margin measures. This flexibility is what makes APMs so useful in the investment decision-making process, as it allows the investors to gain an understanding of the target in a way that standardized accounting measures cannot.

When evaluating different measures, this thesis aims to conclude whether APMs are considered informative or if they are seen as deceptive. Previously, both Cascino et al. (2021) and Gassen and Schwedler (2010) in their research discussed the usefulness of accounting in terms of relevance and reliability. Information is considered relevant if it has the ability to influence decision-making, and it is reliable if it is complete, neutral, and free from errors. Looking at EBITDA, an interesting example discussed by both previous research and our interviewees as a means of forecasting future returns, we can see that this is a measure that in previous research is considered highly relevant, but less reliable. Black et al. (2018) discuss APMs in their research and conclude that these metrics are only useful if they are credible and accurate, as they would otherwise be disregarded. This proved to be true also in our research, where the investors made it very clear that they would only invest based on APMs that they both understood and found reasonable. Something worth highlighting here is the difference in which one talks about standardized accounting numbers and APMs in terms of reliability. As for accounting, the numbers are reliable if they are complete, neutral, and free from errors, while APMs are judged on whether they are credible and accurate. This is an important distinction, as one can question whether APMs can ever be truly complete or neutral considering their nature. APMs are not used for the purpose of providing a neutral picture, but rather to see to the specific need of its users. Whether the metric is seen as informative or deceptive rather depends on the parties' understanding of the metric more than anything else.

Overall, the results from our research largely align with previous research on investment professionals' use of accounting and their use of APMs. However, previous research has sufficed in concluding that there is widespread use of APMs, or that some of these alternative metrics are deemed more useful than numbers reported in the financial statements. Our study goes further in contributing to a deeper understanding of APMs and how they are used. Through our research, we found an important distinction between two different types of APMs – the alternative performance metrics that include different adjustments used to find the multiple bases and the alternative performance metrics used to understand the business and to evaluate the quality of the target.

The adjusted earnings metrics initially have low credibility with investors as these adjusted metrics can include or exclude just about anything, thus indicating that the investors believe there to be a deceptive side to these metrics. However, all the interviewees concluded was that as the process moves forward, these adjustments are demystified through thorough due diligence. Throughout the process, these adjusted metrics were very much used as a tool of negotiations and thereby adjusted up and down. One important result of our study was however that if an adjusted metric was to be used as the multiple bases, the investors were very set on not accepting a number which they did not agree with. We found three main explanations as to why this was the case. First, the incentive structure of the investment firm matters – if the deal team was evaluated based on the future development of the selected multiple bases (adjusted earning metric), they had a personal stake in setting the bases as close to the actual expected outcome of the target's performance as possible. Second, the benchmarking role of the adjusted metrics is relevant. As part of the investment decision-making process, investors benchmark a potential target against their previous deals. If the investors were then to set multiple bases they did not believe to be accurate this would risk distorting future deals. This is an example of a situation where APMs would give the wrong information, and perhaps thus could be considered somewhat deceptive – even though the investor might not have meant for this to be the case. In a situation like this, the lack of standardization and the flexibility of these metrics could have a negative impact on the investment decision-making process. Therefore, investors would like to avoid setting multiple bases that they do not find reasonable. The third reason we found to explain the importance of setting the multiple bases right is that a wrongful base and lack of understanding of its components is one of the major risks for a private equity firm, due to their investment strategy. Their combined use of debt and equity increases both the return and the risk profile, and making investments based on too questionable numbers would mean an unacceptable risk.

The other group of APMs – the alternative performance metrics used to understand the business is largely used to decide what multiple to pay on the bases decided by the adjusted metrics. For these metrics, we could see a somewhat more standardized view – although there is no official definition. The main role of these metrics – e.g., NRR or ARR – is to help the investors determine the quality of the target. The more standardized view implies that they are generally considered less deceptive as this makes it easier for investors to quickly reject them if they deviate from the industry standard. These metrics are today a must have when presenting the investment to the investment committee, as it is through these numbers the firms call tell how the target is expected to perform in the future. A company can present a great financial result, but without understanding the quality of these earnings the valuation will be difficult – using these metrics is simply a way for the investors to make sure they understand what will drive the future generation of returns.

At the end of the process, if the parties decided to go through with the deal, the perception among investors was that the misleading nature of the metrics was remedied, and they instead had played a crucial part in providing the investors with the information they needed in their evaluation of the target. As one of the interviewees stated, APMs serve a different purpose than standardized accounting. While Beyer et al. (2010) point to accounting information as allowing investors to evaluate the return potential of possible investments, our research shows that the most effective way to forecast the future is by using metrics that go beyond that of what is found in the financial reports.

5.2 Different Parties – Different Opinions

Amongst our interviewees, we found that the knowledge about APMs differs, depending on both the industry in which the investor is operating and on the level of experience an investor possesses. A clear example of this was the investment firm that had performed an internal exercise to determine EBITDA, with discrepancies within the team of 15% as a result. To counteract this, some firms had very distinct internal definitions of APMs and how they were to be adjusted. The potential misalignment of different metrics between parties – be it internally or in relation to the seller – was however of minimal concern to the investors. The difference in the understanding and the perceptions of APMs are also part of the deal dynamics in the investment process. Each investor must consider how their competitors evaluate different APMs, as they need to consider these alternative views when negotiating the price. Being too set on negotiating either low multiple bases or a low multiple could result in the investor losing the deal, as someone else might be willing to pay a higher price. Here it is thus an important balance to be struck.

The investors explicitly stated that during the initial phase of the investment decision-making process the absolute truthfulness of specific numbers, be it figures from the financial statements or APMs, was of no major importance. The reason for this being that the actual decision to invest is made later in the process when the investors have gathered extensive information and performed thorough due diligence. When looking at this initial phase through the lens of the APMs being either informative or deceptive, it becomes relevant to take a step back and look at it from the seller's perspective. The sell-side has an obvious incentive of setting a high valuation and receiving a high purchasing price. This could entail a risk of the seller inflating the performance of the target, e.g., through the use of deceptive APMs. However, in doing so the seller exposes themselves to the risk of losing out on a potential buyer. Considering the course of the investment process, it is not uncommon for investors to place an initial bid early in the process to indicate what they are willing to pay for the target. If the initial expectations of a target by an investor are high, the investor might place a rather substantial initial bid and thus get more attention and be selected to further funnel through the process. However, as the process reaches the evaluation phase and thorough due diligence is undertaken, the bidding investor might uncover information leading them to lower their bid or even pull out of the process completely. This can result in the seller receiving a lower sales price compared to what might have been offered by the investors who withdrew or were not selected, had the initial high bid not preemptively eliminated them from the process. Here, the seller's deceptive use of APMs negatively impacted their sales price. Looking at it from this perspective, we can see that also the sell-side has incentives to use APMs in an informative way rather than a deceptive one.

5.3 The Difference Between an Unstructured and a Structured Process

The third large trend we found was how the view on APMs differed depending on whether they were a part of an unstructured or a structured process, where the skepticism towards them was considerably larger in the structured processes. We found that the difference in attitude depended on two main factors.

Firstly, the incentives for the investors' counterparts are different. Despite the previously made argument about the sell-side having incentives to use APMs in an informative rather than a deceptive one, this does not say that there are no incentives for the sellers to sell at such a high price as possible. In a structured process the advisor – in most cases an investment banker – has both the knowledge and the incentive to argue their case. As a result, investors know to be skeptical of these numbers – like many of our interviewees pointed out they expect nothing else than to see figures with which they will not agree. This is different compared to an unstructured process where the management or the entrepreneur is the direct counterpart and where the investors do not see the same incentives. In this type of process, it is often so that the investors and the sellers have more aligned incentives, as they will be working together during the period that the investment firm owns a stake in the company. In situations like these, neither party is as likely to be as tough in the negotiations as they perhaps would have been had this not been the case.

The second factor is the way in which the investor is initially presented with the APMs. In a structured process, an investment bank will most often present them with a teaser containing several of these alternative metrics. This entails that the investor thus already has a sort of blueprint for the process – much work will go into deciphering the sellers' APMs and negotiating back and forth before reaching consensus. In an unstructured process, the owner/management rarely has enough knowledge about neither financial reporting nor APMs to provide the investor with their view on the matter. This gives the investor more freedom in producing their own APMs that they find relevant.

6. Conclusion

This paper has investigated the role of APMs in the investment decision-making process of investment professionals through a multiple case study of private equity firms in Stockholm. Our study contributes to the somewhat scarce previous research in such that it enhances the results on investors' use of accounting and the usage of APMs by looking deeper into the subject than any other studies we have seen. Conducting our study, we reached three main conclusions. Firstly, we show that investors use APMs to a large extent in the investment decision-making process as a way of understanding the underlying performance of a potential target to be able to effectively forecast the potential generation of returns. Secondly, we expand on the different views of the parties in the process – both within the investment firm and between counterparts. Third, we acknowledge the differences between different types of processes and how both incentives and the nature of negotiations affect investors attitude towards APMs.

Overall, this paper shows that investors value the information provided to them through the use of APMs, all while having little to no concern about the potential deception by the sell side. We believe this contributes to the research by Young (2014) in such a way that it provides empirical evidence which does favor the informative perspective.

We acknowledge the limitations of our study, which in turn opens possibilities for further research on the subject. Firstly, we suggest doing an extended multiple case study to examine the investment decision-making process of a larger amount of investment professionals. This would help provide evidence that is even more generalizable. It would also be interesting to conduct research on the ecosystem – credit facilitators and advisors – that is the investment process and look further into the possibilities and challenges of moving further towards industry standards. We thus encourage future research on the subject to continue to build a wider and deeper understanding of the use of APMs in different investment processes.

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8. Appendix

8.1 Interview Guide

Background

- Are you familiar with alternative performance metrics or non-GAAP measures, and how do you define them?

- What is your firm's investment strategy, and what does a typical investment process look like for you?
- What are the most common APMs for your respective sectors?
- Can you give specific examples of APMs that you have used in previous investments?

Investment decision-making process

- How are APMs used in:
  - The screening phase
  - Discussions with management
  - IC presentation
  - Due diligence processes
  - Negotiation and closing
- What factors influence your decisions to use or ignore APMs in these situations?
- What strategies do you use to reduce information asymmetry between you and the companies?
- In what way and to which extent can APMs affect your returns?
- Are there any risks or limitations associated with the use of APMs that you consider for different actors?

Looking ahead

- How do you think the use of APMs may evolve in the future, and what new types of APMs do you think may become relevant in future investment decisions?
- Something you think we have failed to understand and/or something you would like to add?