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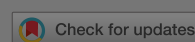
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Original Articles

# The drivers, consequences and policy implications of non-GAAP earnings reporting

Steven Young 

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## Abstract

Non-generally accepted accounting principles (GAAP) (pro forma) earnings form an increasingly important part of firms' performance reporting narrative. This paper reviews the academic and professional debate surrounding non-GAAP earnings reporting by management. I argue that the demand for customised performance reporting is a natural response to constraints imposed by a one-size-fits-all reporting system and that the non-GAAP phenomenon forms part of a long-standing debate over the definition of earnings. This research suggests that the use of non-GAAP earnings is motivated by opportunistic motives, which may lead to misreporting and lower quality of financial reporting. The government's higher quality of financial reporting is evident in many financial reporting contexts because they threaten the integrity of the underlying reporting

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Keywords: pro forma earnings street earnings adjusted EPS transitory items Regulation G

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† This paper has been prepared for the ICAEW Information for Better Markets Conference held on 16-17 December 2013.


earnings. Second, conditional on management reporting non-GAAP earnings, street earnings adjustments differ from managements' exclusions in approximately 35% of cases (Bhattacharya et al. [2003](#), Choi et al. [2007](#)). I focus specifically on understanding non-GAAP earnings disclosed by management, although papers employing street earnings constructs are discussed where appropriate.

3. Responding to criticism of non-GAAP earnings, Groupon CFO Jason Child argued such disclosures supplement GAAP metrics and help investors better evaluate company performance ([http://www3.cfo.com/article/2012/2/accounting-tax\\_groupon-cfo-jason-child-defends-non-gaap-metrics](http://www3.cfo.com/article/2012/2/accounting-tax_groupon-cfo-jason-child-defends-non-gaap-metrics)).

4. The SEC has brought two enforcement actions relating to non-GAAP reporting. The first was against Trump Hotels and Casino Resorts, Inc. in 2002; the second was against SafeNet, Inc. in 2009 under Regulation G.

5. IAS 33 borrows heavily from FRS 3 in UK GAAP. Including non-GAAP earnings as a part of the financial statements is not universally accepted. For example, New Zealand's Financial Market's Authority (FMA) proposes that non-GAAP earnings should not be included in the statutory financial statements; and inclusion in the notes to the financial statements should be restricted to cases where supplementary information is necessary to provide a true and fair view of the financial statements (but not to rectify accounting policies that are inconsistent with a true and fair view in the first place) (FMA [2012](#)). It is an open question whether non-GAAP earnings disclosures substitute to some degree for the fair presentation override in IAS 1 and related concepts in the European Union Fourth Directive, and in UK and German law (Evans [2012](#)).

6. For example, the Committee of European Securities Regulators issued guidance in 2005 that non-GAAP financial measures should be disclosed in a way that is appropriate and useful for investor decision-making but has stopped short of issuing Reg G-type



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securities regulations deal explicitly with non-GAAP reporting ([http://www.osc.gov.on.ca/en/SecuritiesLaw\\_csa\\_20120217\\_52-306\\_non-gaap.htm](http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20120217_52-306_non-gaap.htm)).

7. The sample used by Bhattacharya et al. (2003) and Bhattacharya et al. (2004) comprises 1149 quarterly non-GAAP earnings disclosures identified using keywords “pro forma”, “pro-forma” and “proforma”. Further analysis leads Bhattacharya et al. (2003, p. 297) to estimate that their search string captures approximately half of all possible non-GAAP EPS figures reported during their sample period. Marques (2006) confirms this conjecture. Specifically, of the 4234 observations in her sample of S&P 500 firms from 2001 to 2003, 2475 disclose some type of non-GAAP financial measure (with the most common being net income, either in its per share or aggregated form).

8. Christensen et al. (2011, p. 505) cite Akamai, Inc. (4 February 2009), where management argue that depreciation and amortisation are based on estimates of useful economic lives of tangible and intangible assets, and that these estimates could vary from actual performance of the asset. Management also argue charges are based on the historic cost incurred to build up the company's deployed network, and may not be indicative of current or future capital expenditures. Whether errors due to prevailing measurement rules exceed the error from assuming such items to be zero is moot.

9. The likelihood, prominence and aggressiveness of non-GAAP reporting are also positively associated with market sentiment (Brown et al. 2012). Findings are consistent with firms’ facing lower disclosure-related costs during periods of investor optimism resulting from a decline in the rigour with which non-GAAP disclosures are evaluated by optimistic investors. Brown et al. (2012) also find that managerial optimism accounts for part of the positive association between non-GAAP earnings reporting and market sentiment.

10. Abarbanell and Lehavy (2007) and Cohen et al. (2007) argue that tests using street earnings

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12. Christensen et al. ([2011](#)) link non-GAAP earnings with attempts to influence analysts' earnings forecasts but remain silent on whether such influence assists or biases analysts' estimates and investors' stock valuation.
13. Isidro and Marques ([2013](#)) demonstrate that country-level institutional and economic factors also affect non-GAAP reporting incentives. In particular, they document a stronger link between non-GAAP earnings to achieve earnings benchmarks in environments characterised by greater pressure to achieve earnings benchmarks and less opportunity to manipulate GAAP earnings.
14. Researchers as a rule do not undertake methodical financial statement analysis aimed at determining whether a particular non-GAAP exclusion or set of exclusions is appropriate. Instead, they rely on the law of large numbers coupled with empirical designs that condition on reporting incentives to identify predominant reporting motives. It is possible that investors operating at the firm level are better able to discriminate between reporting incentives.
15. In addition to highlighting concerns about the impact of non-GAAP earnings on the efficient allocation of capital, evidence of mispricing also raises a dilemma for a large fraction of empirical research on non-GAAP disclosures that relies on the assumption that stock prices are efficient and unbiased.
16. A degree of caution is warranted when interpreting results in Heflin and Hsu ([2008](#)) given that they use IBES actual EPS to proxy for non-GAAP disclosure, and in Kolev et al. ([2008](#)) because their evidence that firms which ceased disclosing non-GAAP earnings following Reg G had lower quality exclusions in the pre-intervention period is based on just 28 cases where management stopped disclosing.
17. In contrast, Fortin et al. ([2009](#)) find no evidence that Reg G deterred REIT firms from reporting
18. It has been argued that the use of non-GAAP earnings is a metric mean-  
whereas changes in  
consistency of services. CPI  
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19. In the UK, the Office of Fair Trading announced on 14 August 2009 that Jet2.com had agreed to ensure that customers are made aware of fixed, non-optional costs early in the booking process and to provide a link at the start of booking process to a web page showing that the prices of all optional charges passengers may incur on top of the standard flight cost. Effective 26 January 2012, the US Department of Transportation decreed that all mandatory taxes and fees assessed on a per-passenger basis must be included in the first published fare passengers see. Three low-cost operators subsequently filed lawsuits arguing that pre-tax prices are standard practice in other sectors and that airlines should not be treated differently.

20. Consistent with this risk, the FASB has expressed concern that the proliferation of non-GAAP earnings disclosures is undermining the quality of financial reporting (FASB [2002](#)).

21. Non-GAAP earnings disclosures also raise questions about the boundaries of regulatory intervention more generally. For example, Section 404 in the Sarbanes-Oxley Act dealing with internal controls over financial reporting is restricted to GAAP earnings; no requirement currently exists for management to comment on controls over non-GAAP reporting (Bryan and Lilien [2005](#)). Similarly, while Reg G requires reconciliation to GAAP earnings, it is silent on the placement and format of graphical disclosures containing non-GAAP information. Dilla et al. ([2013](#)) present experimental evidence that graphical non-GAAP disclosures influence both professional and non-professional investors' judgements.

22. On 19 January 2002, the SEC issued a cease-and-desist order against Trump Hotels & Casino Reports, Inc. for violation of the anti-fraud provisions of the Securities Exchange Act of 1934 following its 25 October 1999 quarterly earnings announcement in which Trump stated that earnings exceeded analysts' expectations after excluding a one-time charge of \$1.4 million related to the sale of a hotel. While the SEC associated

press releases that included non-GAAP earnings numbers, however, the earnings numbers included were not a subset of GAAP earnings. In a subsequent restatement of earnings, the company disclosed that the non-GAAP earnings numbers were not a subset of GAAP earnings. In the restatement, the company disclosed that the non-GAAP earnings numbers were not a subset of GAAP earnings. In the restatement, the company disclosed that the non-GAAP earnings numbers were not a subset of GAAP earnings.

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included in mandated disclosures such as the 10-Q/K (Chen et al. [2012](#)). Whether such consistency is upheld in practice is an open question.

24. In related work, Petaibanlue et al. ([2013](#)) document how the value relevance of non-GAAP earnings disclosed by UK firms on the face of the income statement is lower than non-GAAP earnings disclosed solely in the notes when the disclosing firm is suspected of earnings management.

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