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

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in many settings, I argue that such disclosures create particular risks in a financial

reporting context because they threaten the integrity of the underlying reporting system. Prevailing regulatory approaches are reviewed and factors limiting disclosure transparency are highlighted. The paper concludes with suggestions for further research.

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

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Notes

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earnings availability is independent of managements’ decision to disclose non-GAAP 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).

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
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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).

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.

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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.

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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 gra … ofessional investor…

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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.