On Wednesday 11 November 05:00-22:00 GMT, we'll be making some site updates on Taylor & Francis Online. You'll still be able to search, browse and read our articles, where access rights already apply. Registration, purchasing, activation of tokens, eprints and other features of Your Account will be unavailable during this scheduled work.

6,046 Views | 63 CrossRef citations to date | 0 Altmetric

Original Articles

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

Steven Young

Pages 444-465 | Published online: 21 May 2014

Cite this article https://doi.org/10.1080/00014788.2014.900952 Check for updates

Sample our Economics, Finance, Business & Industry Journals >> Sign in here to start your access to the latest two volumes for 14 days

Full Article Figures & data References Citations Metrics Reprints & Permissions Read this article Share

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 and presentation of periodic performance. A review of extant research suggests non-GAAP disclosures are driven by informative reporting and opportunistic motives. Opaque presentation of non-GAAP earnings is associated with earnings

mispricing, particularly among unsophisticated investor groups. Regulations and governance systems designed to ensure transparency are associated with higher quality disclosures and less mispricing. While customised reporting behaviour is evident 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

Acknowledgements

I am grateful for guidance from the conference organisers, as well as comments and suggestions from Gilad Livne, Gunnar Miller, Fred Nieto, Peter Pope, Stephen Taylor and in particular from David Alexander.

Notes

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

1. The Canadian Securities Administrators' Staff Notice 52–306 (revised) partitions management-reported adjusted earnings metrics into non-GAAP financial measures and additional GAAP measures, with the former presented outside the financial statements and the latter reported as a part of the published financial statements (http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20120217_52-306_non-gaap.htm). I do not adopt this useful distinction here to avoid introducing unnecessary complexity.

2. Many studies use the terms pro forma earnings, non-GAAP earnings, additional or adjusted GAAP earnings, and street earnings interchangeably when referring to adjusted earnings metrics produced by management or reported by commercial analyst

tracking services such as IBES, First Call and Zacks. Research demonstrates a high degree of consistency between management-produced non-GAAP earnings and analyst-produced street earnings metrics (Bhattacharya et al. 2003, Choi et al. 2007) and consequently studies have used street earnings to proxy for management-reported non-GAAP earnings (Doyle et al. 2003, Frankel et al. 2011). Several factors make street earnings a noisy measure of management-disclosed non-GAAP earnings. First, street 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 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 rules. While the Autorite des Marches Financiers in France has issued guidelines

requesting reconciliation between non-GAAP and GAAP earnings, in practice such reconciliations are rare (Aubert 2009). In Germany, the securities act prohibits disclosure of misleading information but does not specifically refer to non-GAAP earnings (Hitz, 2010). While regulators in Australia and New Zealand have issued guidelines on non-GAAP reporting, no formal securities rules exist that govern non-GAAP earnings disclosures. Canada is one of the few countries outside the US where 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.

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 as a proxy for non-GAAP disclosures are likely to be biased in favour of concluding higher value relevance for non-GAAP earnings over its GAAP counterpart.

11. Serafeim (2011) also finds that information asymmetry is decreasing in the quality and comparability of embedded value methods, and that the economic effect of embedded value reporting is larger than that from either IFRS or US GAAP adoption. However, results hold only for firms that certify embedded value calculations by hiring an outside auditing or consulting firm.

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 non-GAAP information, while the quality of such measures increased.

18. It has been argued that CPI is a more accurate measure: it uses a geometric mean whereas RPI uses an arithmetic mean, with the former better reflecting changes in

consumer spending patterns relative to changes in the price of goods and services. CPI is also internationally more comparable because it employs methodologies and structures that follow international legislation and guidelines. Sceptics, however, highlight how the structurally lower CPI metric limits increases in index-linked government spending such as pensions and public sector wages.

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 $81.4 million relating to closure of Trump World Fair. An associated press release attributed the positive results to operational improvements. However, the earnings release failed to disclose that the quarterly non-GAAP earnings number

included a $17.5 million one-time gain resulting from termination of a lease of a restaurant tenant at one of its casinos.

23. In the US, auditors are potentially responsible for ensuring consistency of non-GAAP earnings in voluntary disclosures such as press releases with any non-GAAP numbers 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.

Related research

People also read | Recommended articles | Cited by 63

The Role of Institutional and Economic Factors in the Strategic Use of Non-GAAP Disclosures to Beat Earnings Benchmarks >

Helena Isidro et al.
European Accounting Review
Published online: 14 Mar 2014

Alternative Performance Measures: Determinants of Disclosure Quality – Evidence from Germany >

Stephanie Jana et al.
Accounting in Europe
Published online: 17 Nov 2020

Auditors' perceptions of alternative performance measures – alternative truths and professional skepticism >

Antti Rautiainen et al.
Accounting in Europe
Published online: 13 Aug 2023

View more

Information for

Authors

R&D professionals

Editors

Librarians

Societies

Open access

Overview

Open journals

Open Select

Dove Medical Press

F1000Research

Opportunities

Reprints and e-prints

Advertising solutions

Accelerated publication

Corporate access solutions

Help and information

Help and contact

Newsroom

All journals

Books

Keep up to date

Register to receive personalised research and resources by email

Sign me up

Copyright © 2026 Informa UK Limited Privacy policy

Cookies Terms & conditions Accessibility

Registered in England & Wales No. 01072954
5 Howick Place | London | SW1P 1WG

Taylor & Francis by informa