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

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Abstract

We use hand-collected data for a sample of large European firms to investigate the influence of countries' institutional and economic factors on managers' non-generally accepted accounting principles (GAAP) disclosures. We find that managers are more likely to use non-GAAP measures to meet or beat earnings benchmarks that GAAP earnings would miss in countries with efficient law and enforcement, strong investor protection, developed financial markets, and good communication and dissemination of information. We also find that managers in countries with developed institutional and economic conditions are more likely to adjust non-GAAP earnings for recurring expenses such as R&D, depreciation, and stock-based compensation expenses. Our findings suggest that in environments in which there is more pressure to achieve

earnings benchmarks and less opportunity to manipulate GAAP earnings, managers use more non-GAAP earnings disclosures to meet the benchmarks.

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Notes

[1]In the USA, the first regulatory intervention was a cautionary warning, issued in December of 2001 by the Securities and Exchange Commission. This was followed by a rule (Regulation G) on the topic of disclosure of non-GAAP financial measures that became effective in March 2003.

[2] http://www.esma.europa.eu/system/files/2012-275.pdf.

[3]Furthermore, in the USA, and under the provision of Statement of Auditing Standards 8, auditors are potentially responsible for ensuring consistency of non-GAAP reporting in voluntary disclosures, such as press releases, with the non-GAAP figures reported in mandated disclosures. Analysing the consequences of this standard, Chen et al. (2012) find that the disclosure of more optimistic non-GAAP numbers is associated with higher audit fees.

[4]J. S. Flemmons, Associate Chief Accountant, in a speech in the 2009 AICPA National Conference warns that 'non-GAAP measures are used as a mechanism to obscure financial results'.

[5]An example of the latter is seen in the first enforcement action brought by the SEC pursuant to Regulation G against SafeNet (SEC, 2009). It is alleged that SafeNet represented to investors that 'non-GAAP earnings results excluded certain non-recurring expenses when, in fact, SafeNet had misclassified and excluded a significant amount of recurring, operating expenses from its non-GAAP earnings results, in order to meet or exceed quarterly EPS targets.'

[6]Analysts' consensus is defined as I/B/E/S median forecast of earnings per share.

[7]We do not estimate a single logistic regression model of the effect of meeting or beating the earnings benchmark on a non-GAAP basis on the probability of disclosing non-GAAP earnings because this approach would create a mechanical relationship between the dependent and independent variables. Typically, the literature defines benchmark meeting on a non-GAAP basis as an indicator coded as one if non-GAAP earnings meet or beat the benchmark when GAAP earnings fall short. That definition implies that the independent variable in the model is conditional on the firm disclosing a non-GAAP figure. Our approach of estimating two separate models avoids this mechanical relationship.

[8]When more than one non-GAAP earnings measure is disclosed in the same press release we use the measure disclosed with higher emphasis. Section 5 explains this choice in more detail.

[9]We do not consider the case when non-GAAP earnings is used to portray better financial performance (i.e. non-GAAP earnings is higher than GAAP earnings) because most of the non-GAAP adjustments have the purpose of eliminating expenses. These adjustments mechanically lead most non-GAAP earnings values to be higher than their comparable GAAP figures. In Table 1 Panel D we show that non-GAAP earnings exceed GAAP earnings in 72% of the cases.

[10]The appendix shows the detailed components of the country factors with the principal component index presented in italics.

[11]We do not include analyst coverage in the model because analyst activity is used in one country factor. However, we include the book-to-market ratio, which controls for

analyst preference for successful and large firms (Doyle et al., 2013).

[12]We conducted a number of detailed checks to ensure correctness of the data. We also avoided wire services that transmit shortened or edited versions of press releases, and when non-GAAP information was available from various sources we cross-checked information.

[13]It is important to note that we have collected only non-GAAP measures that portray firms' earnings. Thus, we ignore measures representing other aspects of firms' performance (e.g. sales, cash measures, and financial ratios).

[14]We measure emphasis given to the non-GAAP measures following the six-point scale of Marques (2010), where 6 stands for 'disclosures in the title of the press release'. This scale is an adaptation of the one originally created by Bowen et al. (2005). In our sample the average number of non-GAAP earnings disclosed in the same press release is 1.18.

[15]For nonlinear models the accuracy of MEM to measure of the effect of the country factor on the probability of using non-GAAP for benchmark beating depends on the specific value of the country factor. For that reason it is preferable to compute the marginal effect at specific values such as the minimum and the maximum values (Cameron & Trivedi, 2010, p. 343).

CEO skills and non-GAAP disclosure decisions

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