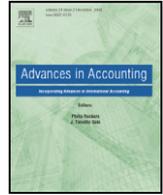




Contents lists available at ScienceDirect

Advances in Accounting, incorporating Advances in International Accounting

journal homepage: www.elsevier.com/locate/adiac

The role of reconciliation quality in limiting mispricing of non-GAAP earnings announcements by EURO STOXX firms

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ARTICLE INFO

Available online 31 March 2014

Keywords:

Pro forma earnings
Reconciliations
Mispricing
Analyst earnings forecasts
Street earnings
Investor interests

ABSTRACT

This empirical study investigates the relationship between the market mispricing of pro forma earnings announcements and the degree to which pro forma earnings are quantitatively reconciled with GAAP (Generally Accepted Accounting Principles) earnings. For a sample of EURO STOXX Fixed Index companies we find evidence of positive abnormal returns related to pro forma earnings disclosures, and, upon further analyses, conclude that this evidence is generally more consistent with the notion of market mispricing than omitted risk factors. Moreover, when reconciliation quality is controlled, market mispricing is found to be prevalent and pronounced only for low quality reconciliations. This finding suggests that reconciliation is important in reducing market mispricing.

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1. Introduction

Pro forma or non-GAAP incomes are alternative earnings measures to those prohibited by the Generally Accepted Accounting Principles (GAAP hereafter). With increasing frequency, companies report pro forma earnings in the same press release as their GAAP earnings figure.

In response to the growing prominence in Europe of pro forma earnings disclosures as an alternative summary measure of financial performance (see Fig. 1), we investigate in this study the extent to which investors fail to fully understand the pro forma earnings disclosures by EURO STOXX Fixed Index corporations. We then examine whether an incomplete understanding of the time-series properties of pro forma earnings disclosures is mitigated by the extent to which pro forma earnings are reconciled to GAAP earnings numbers.

We believe that this research contributes to the literature in several ways. First, this paper provides first-time evidence of market outcomes related to pro forma earnings disclosures for companies traded on major European equity markets. This evidence is generally consistent with the U.S. market experience prior to regulatory action on pro forma earnings disclosures. Second, the paper addresses whether protection of investors' interests might be enhanced by enactment of supranational pro forma earnings disclosure legislation. Potential legal liability is proxied by the extent to which the laws of the jurisdiction in which a company's securities are issued protect minority investor rights. While the effect of

legislation requiring increased disclosure of pro forma earnings can only be inferred, we report that for our sample market mispricing seems to be most prevalent and intense for European companies producing low-quality pro forma earnings reconciliations. Overall, we conclude that reconciliation is important in reducing market mispricing.²

2. Background and prior literature

2.1. Types of metrics and motivations for pro forma earnings disclosures

Pro forma numbers are voluntarily disclosed, are without formal definition and are not subject to mandatory audit. Pro forma earnings also represent either an adjusted-GAAP or a non-GAAP measure. The most common form of adjusted-GAAP earnings measurement is the metric of earnings before or EB. EB metrics, such as EBIT (earnings before interest and taxes), typically appear as income statement subtotals or can be determined by reference to the income statement and supplementary notes. In contrast to EB metrics, non-GAAP measures such as underlying earnings before special items, adjusted recurring earnings, permanent group profit and organic net income do not lend themselves to GAAP reconciliation because they represent idiosyncratic adjustments to earnings based on management's access to private information.³

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² We sincerely thank an anonymous reviewer for bringing up this important insight.

³ Although reporting latitude is believed to be more limited on EB than non-GAAP metrics, recent evidence indicates a substantial number of instances in Europe where even EB metrics cannot be easily reconciled to financial statement GAAP numbers (Hitz & Jenniges, 2008).

**Chart of Number of Pro Forma Disclosures In Europe
(5, 896 Surviving Firms)**

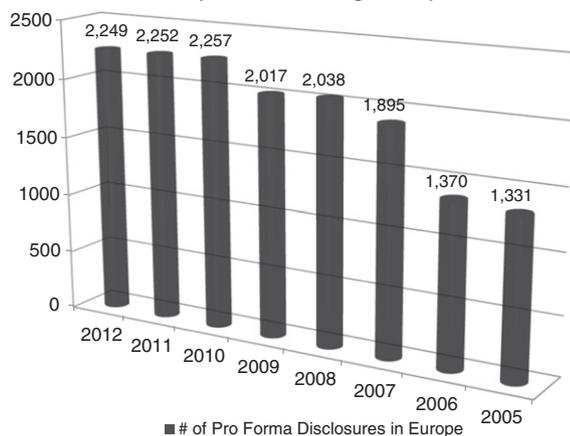


Fig. 1. Chart of number of pro forma disclosures in Europe (5896 surviving firms).

The issue as to whether pro forma earnings add value has two sides (Bradshaw & Sloan, 2002; Hirshleifer & Teoh, 2003). Proponents of the informative side of pro forma earnings claim that when items are excluded because they are unrelated to an entity's future economic prospects, a worthwhile purpose is served by improving earnings quality (Holthausen, 1990; Johnson & Schwartz, 2005). Skeptics of the informative side of pro forma earnings claim that adjusted earnings numbers often serve more of a strategic purpose; namely, to affect market perceptions that are favorable to a company (Allee, Bhattacharya, Black, & Christensen, 2007; Bowen, Davis, & Matsumoto, 2005). For instance, the earnings management literature contends that a company may be highly motivated to use pro forma numbers to portray its performance in an overly optimistic manner when, in fact, its GAAP earnings fall short of forecast earnings (Dechow, Richardson, & Tuna, 2003), or to report an earnings loss (Burgstahler & Dichev, 1997; Jacob & Jorgensen, 2007).

2.2. Pro forma earnings disclosures and market reaction

Prior research has shown that markets may fail to fully understand how pro forma earnings disclosures impact firm value. This lack of understanding is manifested by a company's stock being systematically overpriced. For example, Doyle, Lundholm, and Soliman (2003) investigate the informational properties of large expense exclusions from pro forma earnings. They find that when investors fail to fully appreciate the cash flow implications of these exclusions at the time of disclosure, large positive abnormal returns persist following the disclosure.

The study by Landsman, Miller, and Yeh (2007) confirms Doyle et al.'s finding of mispricing when GAAP expenses are excluded from pro forma earnings. Additionally, when Lougee and Marquardt (2004) examine the ability of pro forma disclosures to predict future profitability and returns, they report that at the time of the press release investors fail to incorporate the information about future returns contained in the disclosure. This finding causes Lougee and Marquardt to conclude that their results are only weakly consistent with the notion of the market mispricing pro forma earnings.

2.3. Antecedents of regulation on pro forma earnings reporting

An important question pertaining to the use and usefulness of pro forma disclosures is whether regulation is necessary to protect investor interests. The U.S. answered this question in the form of Regulation G, which was part of the Sarbanes–Oxley Act of 2002. Regulation G mandated the U.S. Securities and Exchange Commission (SEC) to enact regulatory action requiring companies listed on the U.S. capital markets to reconcile their pro forma to GAAP earnings numbers effective as of March, 2003.

Coincident to the application of Regulation G in the U.S., in Europe a release by the Technical Committee of the IOSCO (International Organization of Securities Commission) suggested that a company choosing to include an alternative earnings measure in its press release, periodic report or filing, should provide additional information so that investors could gain a better understanding of its financial performance over reporting periods and in comparison to other companies.⁴ The IOSCO release made the following statement about reconciliation of non-GAAP to GAAP earnings disclosures:

... whenever financial performance indicators of a non-GAAP nature are published in press releases or speeches, etc., they should always be accompanied by the indication of the net consolidated income/loss figure for the same period calculated in accordance with GAAP. [IOSCO (2002, p. 2).]

In 2003 and 2005 the French market regulator, AMF – *Autorité des Marchés Financiers*, released a guide echoing the IOSCO's recommendation about non-GAAP disclosures. This guide mandated French-listed companies to disclose pro forma earnings measures and net consolidated income group share for the same period in their financial reports.⁵

In 2005 the Committee of European Securities Regulators (CESR) issued a document in support of IOSCO's release on the presentation of alternative performance measures. Among CESR's recommendations was the following statement:

Where possible, issuers should present alternative performance measures only in combination with defined measures. Furthermore, issuers should explain the differences between both measures; this might be through a reconciliation of figures to provide investors with enough information to fully understand the results and financial position of the company. [CESR (2005, p. 6).]

With the growing perception of pro forma disclosures being potential mechanisms for adversely influencing investor behavior, a number of studies, principally within a U.S. context, have examined the use and interpretation of these disclosures by market participants. Although several papers contribute to a growing body of literature on the impact of Regulation G on pro forma disclosures (Heflin & Hsu, 2008; Kolev, Marquardt, & McVay, 2008; Marques, 2006; Yi, 2007), only the research by Zhang and Zheng (2011) directly addresses whether Regulation G achieved its stated purpose of reducing the extent of mispricing from pro forma disclosures.

The research by Zhang and Zheng is divided into three parts. In the first part of their study they investigate if, prior to Regulation G, mispricing of pro forma disclosures is related to the quality of reconciliation. In the second part of their study they shift their focus to the period in which Regulation G required a high level of reconciliation quality. Finally, in part three, Zhang and Zheng apply a difference-in-difference approach to investigate the degree to which mispricing of pro forma disclosures was reduced if companies improved their reconciliation quality from the pre-Regulation G period. The results of all tests generally support the notion that reconciliation quality reduces mispricing of pro forma disclosures and thereby meets the stated purpose of regulatory intervention by the SEC.

The most relevant recent research on reconciliation of pro forma disclosures in Europe is the comprehensive study by Hitz (2010). Using a sample of companies listed on the Frankfurt Stock Exchange and a year-to-year analysis of 2005–2006 quarterly pro forma disclosures, Hitz compares the quality of reconciliations before and after

⁴ IOSCO Technical Committee Release, "Cautionary Statement Regarding Non-GAAP Results Measures," May, 2002.

⁵ COB (*Commission des Opérations de Bourse*), "Issuers' Financial Reporting and Earnings Measures," March 12, 2003, and AMF (formerly COB), "Issuers' Financial Reporting and Earnings Measures," September 20, 2005.

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