Disclosure strategies among S&P 500 firms: Evidence on the disclosure of non-GAAP financial measures and financial statements in earnings press releases

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Abstract
This paper examines the prominence of non-GAAP financial measures in press releases, testing whether managers emphasize these adjusted performance measures relative to GAAP numbers in four different settings where their disclosure helps managers reach strategic earnings benchmarks on a pro forma basis when they would otherwise fall short using GAAP numbers. Moreover, this research investigates the information content of disclosures reconciling non-GAAP to GAAP earnings (and other financial statements). The data is hand collected from quarterly earnings press releases of a sample of S&P 500 firms during the 2001–2003 period. In this particular sample, the disclosure of non-GAAP financial measures is frequent. The results suggest that managers strategically give more prominence to non-GAAP measures than to GAAP figures when the GAAP earnings number falls short of a benchmark but the non-GAAP earnings number does not. This disclosure strategy may influence the perception of the firm’s financial results. Furthermore, the results suggest that both the reconciliation and the non-GAAP income statement contain information useful for users.

1. Introduction
Non-GAAP financial measures, frequently called “pro forma” numbers, are performance measures created and disclosed by managers, which are not calculated in accordance with GAAP (Generally Accepted Accounting Principles). Bowen, Davis, and Matsumoto (2005) find that managers emphasize the metric (GAAP or pro forma) that portrays the better firm performance. Elliott’s (2006) experimental evidence reveals that when more prominence is given to non-GAAP measures than to GAAP values in press releases, non-professional investors’ reliance on non-GAAP values increases. This, in turn, affects their judgments and decisions. However, this influence is mitigated by the disclosure of a side-by-side reconciliation. This type of reconciliation includes three columns of values: the non-GAAP figures, the value of the adjustments made by managers and the GAAP figures. Allee, Bhattacharya, Black, and Christensen (2007) use archival data and find that the trading decisions of less-sophisticated investors are influenced by the relative placement of the non-GAAP number in the press release, which is consistent with Elliott’s (2006) experimental evidence. Given that Elliott finds a mitigating effect for the disclosure of a reconciliation, Allee et al. (2007) also investigate this practice. However, they find no significant impact of this disclosure. The authors then suggest that a more detailed investigation on this topic is a fruitful area for research.

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This paper extends the results of these prior studies. First, I examine the prominence of non-GAAP financial measures in press releases and investigate whether managers strategically emphasize these non-GAAP measures when their disclosure helps their firms reach strategic earnings benchmarks on a “pro forma” basis that they would otherwise miss based on GAAP numbers. Second, I answer Allee et al.’s (2007) call for research on the information content of non-GAAP reconciliations disclosed by managers. Moreover, I assess the information content of all financial statements disclosed in earnings press releases.

The sample consists of quarterly earnings press releases of S&P 500 firms from the 2001–2003 period. I use this timeframe because it includes two separate interventions by the Securities and Exchange Commission (SEC) on the topic of the disclosure of non-GAAP financial measures. The first was an SEC warning to investors issued in December of 2001, because the Commission was worried that investors could be misled by non-GAAP financial measures. The second intervention was the implementation of a new regulation on the conditions for using non-GAAP financial information. This regulation was implemented in January of 2003 as directed by the Sarbanes-Oxley Act of 2002. Regulation G requires that, when a non-GAAP financial measure is disclosed, the firm must also provide a reconciliation between the non-GAAP number and the closest corresponding GAAP number.

Descriptive evidence on the pattern of disclosure of non-GAAP financial measures reveals that 68% of the sample firms disclosed some non-GAAP financial measure in at least one quarter during each of the three sample years. Thus, contrary to Allee et al.’s (2007) sample, I find that the disclosure of non-GAAP figures among S&P 500 firms during this period was not sporadic, but frequent. In fact, only 7% of the S&P firms disclosed a non-GAAP financial measure just once. The fact that Allee et al.’s sample firms are smaller, on average, suggests the existence of a size effect associated with non-GAAP disclosures.

My evidence on the prominence managers give non-GAAP financial measures indicates that the strategic emphasis of non-GAAP earnings metrics is negatively associated, on average, with the level of SEC scrutiny of non-GAAP disclosures. Regardless of this trend, the results indicate that managers strategically position the non-GAAP metric first in the earnings press release when they have strong incentives to provide a positive performance signal. Specifically, when non-GAAP earnings are higher than strategic earnings benchmarks while the GAAP number falls short of these strategic targets, managers strategically position the non-GAAP first in the earnings announcement press release. These results suggest that managers attempt to influence readers’ perceptions of the financial results of the firm by strategically emphasizing non-GAAP numbers in order to help their firms appear to meet strategic earnings targets that they otherwise would miss based on GAAP numbers.

This investigation of reconciliations disclosed in earnings press releases indicates that after the implementation of Regulation G, there was a significant increase in the frequency of reconciliations, which is not surprising since they were mandated by the SEC. Nevertheless, in 2003 not all firms that disclosed a non-GAAP financial measure included the required reconciliation in their press releases. As mentioned previously, I also examine all other supplementary financial statements disclosed. These results reveal that some firms also include a non-GAAP income statement in their press releases, although the frequency of this particular disclosure decreases during the 2001–2003 period. This is perhaps because this statement was not mentioned by the SEC as a necessary complement to a non-GAAP disclosure. This trend persists even after taking into consideration an already documented (e.g., Marques, 2006) decrease in the frequency of disclosure of non-GAAP financial measures among S&P 500 firms during this period.1 Furthermore, while the frequency of disclosure of the income statement is relatively stable, both the disclosure of the balance sheet and the statement of cash flows have increased during the three-year sample period. My analysis of the information content of reconciliations and the non-GAAP income statements reveals that both of these disclosures have information content.

The results add to the growing literature on non-GAAP disclosures on three dimensions. First, I document that the largest US firms disclose non-GAAP measures frequently, although other studies document that smaller firms disclose these numbers less frequently. Second, my analysis of the prominence given to non-GAAP financial measures in earnings press releases suggests that when managers use these numbers to reach different strategic earnings benchmarks, they tend to strategically emphasize the non-GAAP number relative to the GAAP figure. This analysis of prominence using archival data complements Elliott’s (2006) results, providing evidence of their external validity. Finally, this study is the first to document the information content of non-GAAP reconciliations. I also find that the information content of reconciliations is higher for side-by-side reconciliations and that the non-GAAP income statement has more information content than the standard GAAP income statement. These results on the voluntary disclosure of non-GAAP performance metrics and non-GAAP income statements has implications for policy makers, the business community, and academics, as they can be used in assessing the impact of Regulation G. The findings should also be of interest to regulators from other countries that are considering ways to improve the credibility of financial reporting.

Two existing papers examine the disclosure of non-GAAP earnings in the United Kingdom. Walker and Louvari (2003) study the determinants of voluntary disclosure of adjusted earnings per share measures by UK quoted companies and conclude that firms with GAAP losses seem to be concerned to divert investor attention by reporting a non-GAAP earnings number that is positive. Choi, Lin, Walker, and Young (2007) focus on the discrepancies between management and analysts over the classification of earnings components and find that the majority of management-specific adjustments reflect

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1 Brown, Christensen, Elliott, and Mergenthaler (2009) find that this decrease in the frequency of disclosure was not permanent. In fact, the authors observe a sharp rebound in non-GAAP disclosures in 2004 and 2005 and this rebound is attributed largely to firms that started reporting non-GAAP earnings in the post-SOX period.
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