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Non-GAAP Earnings Disclosures on the Face of the Income Statement by UK Firms: The Effect on Market Liquidity☆

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ABSTRACT

This study benefits by a special feature of the UK information environment which allows UK firms to disclose non-GAAP earnings on the face of the income statement to examine two interrelated questions. First, we ask whether the decision to disclose non-GAAP earnings on the face of the income statement is related to the firm's financial performance and corporate governance characteristics, and second, we investigate the effect of this disclosure decision on market liquidity. Using a dataset of 1227 hand-collected firm-year observations during the period 2006–2013, we show that better governed firms and firms with weaker financial performance are more likely to disclose non-GAAP earnings. Our evidence also suggests that this disclosure is associated with increased levels of market liquidity and the results hold after controlling for self-selection bias. We conclude that firms' decision to disclose non-GAAP earnings on the face of the income statement is more consistent with the incentive to provide information than to mislead the market.

1. Introduction

Prior research provides evidence that non-GAAP earnings disclosures are becoming more prevalent as an increasing number of firms choose to disclose pro forma earnings in a number of forms and different venues.[1] Extant literature though has not yet settled on what drives the decision to disclose non-GAAP earnings and how it affects the firm's information environment. Non-GAAP earnings capture the “core” or “permanent” part of earnings by excluding components of GAAP earnings that are deemed exceptional or non-recurring. However, given their discretionary and voluntary nature, the disclosure of non-GAAP earnings falls within the realm of positive accounting theory (Watts & Zimmerman, 1978), and it centers around the question of whether such choice is made to benefit managers against the interests of investors or to increase firm value (Bowen, Rajgopal, & Venkatachalam, 2008). Choi and Young (2015) define the former incentive as strategic and the latter as informative. That said, extant literature has been inconclusive as to

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[1] Non-GAAP earnings are also known as pro forma earnings, street earnings, or adjusted earnings.

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which of the two incentives can better explain a firm's decision to disclose non-GAAP earnings. In essence, the issue of whether non-GAAP earnings disclosures provide new and value relevant information to the market or whether they are merely intended to mislead capital market participants is still an open research question. Thus, the aim of this paper is to provide more evidence on this debate by examining the determinants of non-GAAP earnings disclosures and their effects on market liquidity, a market characteristic that is especially affected by changes in the firm's information environment, making it a better indicator of information quality. Specifically, we examine these questions using a sample of UK firms which choose to make non-GAAP earnings disclosures on the face of the income statement.

Even though in recent years a number of studies examined the economic consequences of non-GAAP earnings, there is only scant research in the UK, since the majority of related studies employ US data (Young, 2014). Nevertheless, research on non-GAAP disclosure in the UK is of particular importance, because the corresponding European legislative framework is very different from that of the US. First, the UK is a country with strong legal enforcement and developed capital markets, characteristics that set it apart from other European countries. More importantly though, UK financial reporting is based on IFRS, which is mandatory for the consolidated accounts of public companies across Europe. In sharp contradiction to the requirements regarding non-GAAP earnings in the US, IFRS allow such disclosures to be shown on the face of the income statement. Given their more prominent place in the financial statements, the incentives and effects associated with disclosures of non-GAAP earnings on the face of the financial statements may be fundamentally different from those associated with disclosures which are sparsely incorporated in the notes or which are made in venues other than the financial statements.

Using a hand-collected dataset of 1227 firm-year observations during the years 2006–2013, we first examine whether financial and corporate governance characteristics are associated with the decision to disclose. We conjecture that weaker financial performance drives firms to disclose non-GAAP earnings regardless of whether their incentive is to better inform or mislead investors. On the other hand, better corporate governance should be negatively associated with the disclosure of non-GAAP earnings if the intention is to mislead but positively related to the likelihood of disclosing if the intention is to provide more information to the market. Results show that better governed, less profitable, and higher leveraged firms are more likely to disclose non-GAAP earnings. In our second set of analyses we examine the effects of non-GAAP disclosures on market liquidity controlling for self-selection bias. We hypothesize that if disclosures are motivated by informational (opportunistic) incentives, the effect on liquidity should be positive (negative). Our evidence suggests that disclosing pro forma earnings on the face of the income statement is associated with higher firm liquidity and, hence, lower information asymmetry. We conclude that firms disclose non-GAAP earnings as a means of providing more value relevant information to the market when financial performance is weaker and hence when the need for more information is greater.

Our study contributes to the related literature in a number of ways. First, we examine non-GAAP earnings disclosed on the face of the income statement, a medium of disclosure that has not been examined thus far. We posit that the incentives behind, and the effects of, these non-GAAP disclosures may be fundamentally different from other types non-GAAP disclosures due to their prominence and position in the firm's financial statements. Second, we examine the incentives explaining, and the effects of, the decision to disclose non-GAAP earnings together in a single framework. By examining financial reporting and corporate governance incentives on the decision to disclose and then linking the decision to market liquidity, we obtain a more complete picture of the effects of such decision on the firm's information environment. Third, we examine the effects of the disclosure choice on market liquidity, a market characteristic that is especially affected by changes in the firm's information environment, making it a better indicator of information quality (Daske, Hail, Leuz, & Verdi, 2008). Finally, the effect of non-GAAP disclosures on market liquidity is obtained after correcting for self-selection bias, in essence alleviating concerns that a non-random assignment of the sample firms to the two subgroups may be affecting inferences. Our results should be of particular importance to regulators and accounting standard setters across the world as they have important implications on the information content of different earnings measures.

The remainder of this paper is organized as follows. The next section describes the institutional framework for non-GAAP disclosure in the UK, Europe, and the US. Prior literature, contribution, and expectations are presented in Section 3, while the dataset and the empirical models can be found in Section 4. Results are discussed in Section 5. Section 6 concludes the study.

2. Institutional framework

Regulation and governance systems vary across countries but the common objective of regulators is to improve market efficiency via better disclosure quality and transparency. The manifestation of transparency over non-GAAP earnings metrics is consistent under the philosophies of both the US securities regulations and IAS 33 (Young, 2014). Nonetheless, there are salient differences in the regulations which govern non-GAAP earnings disclosure between the UK and the US. Thus, different legal systems and the use of diverse accounting standards internationally provide increased opportunities for non-GAAP disclosure in some countries and less in others.

The first regulation on non-GAAP earnings disclosure in the UK was part of Financial Reporting Standard (FRS) 3 entitled "Reporting Financial Performance" and went into effect in 1993 (Accounting Standards Board, 1993). The objective of FRS 3 was to highlight the importance of the core components of financial performance in order to assist users in understanding the firm's financial position and to aid them in forming more accurate expectations of the firm's future performance. According to this standard, non-GAAP earnings can be shown as additional measures of earnings per share (EPS). These EPS measures should depict all items used in the calculation in order to facilitate a reconciliation with the GAAP amount. Also, the non-GAAP metric calculation should be presented on a consistent basis over time with less than or equal prominence to the GAAP measure, and firms should adequately explain the reasons behind the decision to present this additional version of EPS. For accounting periods starting on or after January