Corporate Financial Disclosure: The Importance of GAAP Mandated Earnings Amidst Declining Value-Relevance

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ABSTRACT: The predilection of management, analyst, and investor alike towards non-GAAP earnings has queried the need for the regulation of corporate financial disclosure. Whilst non-GAAP earnings are increasingly value relevant, the need for regulation centres on the consistency, accountability, and impartiality required for investor decision-making. This paper reviews the literature surrounding value relevance and corporate financial disclosure, ultimately concluding that the regulation of corporate financial disclosure provides an important benchmark for non-GAAP earnings to be weighted against.

Bradshaw and Sloan's (2002) article titled 'GAAP versus The Street: An Empirical Assessment of Two Alternative Definitions of Earnings' has been pivotal in recognising the growing association between non-GAAP earnings and value relevance. Moreover, these findings are consistent with research documenting the declining value relevance of GAAP earnings (Bradshaw & Sloan 2002). As Albring, Caban-Garcia & Reck (2010) find, non-GAAP earnings, such as Street and pro forma, are more value relevant because reported earnings are robust and adjustable for potential outliers. Observing the predilection of management, analysts, and investors alike toward non-GAAP earnings, a strong theoretical case can be made for a free market approach to corporate financial disclosure. However, it would be irresponsible to completely deregulate financial reporting, given the risk of information asymmetry between principals and agents. GAAP standards create a benchmark that all financial information releases are weighted against. No other reporting mechanism offers the same level of consistency, accountability, and impartiality required for investor decision-making (AASB 2015). This essay will explore the arguments for a free market approach, as well as analysing the benefits of regulatory intervention in corporate financial disclosure. This essay finds that despite a free market approach offering superior value relevance, the existence of GAAP is required as a standards-based check to mitigate potential market failures and to protect vulnerable investors. As Godfrey et. al. (2010) argue, however, 'optimal market regulation is an art rather than a science'.

The chorus of management, analyst, and investor criticism levelled at GAAP earnings is centred on its inability to characterise the true efficiency of the firm. Inherent problems include the incorporation of special charges, inconsistent capitalisation rules, and an ambiguous concept of other comprehensive income (Ohlson 2006). Non-GAAP earnings typically deviate from GAAP earnings through the omission of charges such as write-downs, as well as restructuring charges (Frederickson & Miller 2004). The result is the removal of transitory components from earnings, affording greater insight into the firm's future cash flows (Bradshaw & Sloan 2002). Despite the value-relevance of non-GAAP earnings measurements, bodies such as the Financial Accounting Standards Board (FASB) have outlined concerns that non-GAAP earnings are not consistent in their presentation and there remains no consensus regarding the inclusion of performance measures in non-regulated financial statements (Cornell & Landsman 2003). This has led regulators such as former Securities and Exchange Commission (SEC) Chief Accountant Lynn Turner to suggest creators and distributors of non-GAAP financial statements appear to be attempting to lead investors away from true net income (in Cornell & Landsman 2003). This trend may signal efforts by managers and analysts to attract higher valuations by reporting higher non-GAAP earnings numbers (Bradshaw & Sloan 2002).

In accordance with the efficient market hypothesis, Malkiel (2003) argues that efficient financial markets impede the ability of investors to earn above-average returns without the acceptance of above-average risk. It is assumed all financial information, regardless of its composition, is considered, weighted, and reflected accordingly. However, where management holds more information than other sources, and does not release said information to the market, information asymmetry exists. Firms are able to mitigate information asymmetry through the voluntary disclosure of information (Gasbarro, et al. 2013). Therefore, management's interest in the disclosed information is likely to render it biased (Gasbarro, et al. 2013). Moreover, the roles investors play in calculating non-GAAP earnings are not generated for the welfare of investors, but with their own self-serving interest (Lambert in Baik, et al. 2008). When different accounting techniques are used to convey near identical numbers, naïve investors are unlikely to correctly compare accounting numbers (Briloff 1976 in Leftwich 1980). Therefore, 'governmentally enforced disclosure improves the ability of the capital market to discriminate between firms and to allocate capital appropriately' (Watts & Zimmerman 1986). Despite the superior value-relevance of non-GAAP earnings, the existence of GAAP mandated earnings releases ensures investors of all competencies are able to access accurate and consistent numbers pertaining to the firm. Further, the delivery of these numbers reduces the information asymmetry between principal and agent.

Proponents of an efficient market approach to corporate financial disclosure point to agency theory as the unregulated relationship between the principal and agent (Watts & Zimmerman 1979). Accordingly, any bias in reporting is nullified through the agent's interests being aligned with the firm (Watts & Zimmerman 1979). This is evidenced by the voluntary release of financial information by firms prior to the installation of GAAP mandated requirements. Within an efficient market, sufficient information could be generated to establish a socially ideal equilibrium point where the cost of collecting and distributing the information is equal to the benefits (Godfrey, et al. 2010). If the cost of distributing information were zero, the 'optimal allocation would call for unlimited distribution of the information without cost' (Demsetz 1969). However, risk minimisation is not attainable at zero cost, and firms will only produce information that transfers risk when the economic gain outweighs the expenditure (Demsetz 1969). Oppositely, in a regulated environment, a free-rider problem exists whereby the cost of providing information exceeds the marginal benefits (Godfrey, et al. 2010). The nonzero costs involved to produce GAAP mandated earnings are significantly greater than the equilibrium produced through the zero price mechanism. Despite the theoretical reduction in compliance costs and the alignment of principal-agent interests, regulated financial reporting ensures timeliness in how value is recorded and how promptly, as well as asymmetric timeliness, whereby bad news is incorporated relative to good news (Ball 2006). This serves to reduce managerial opportunism, as well as providing investors with a timely indicator of the firm's economic reality.

Critics of a free market approach to corporate financial disclosure are also concerned with the fervent pronouncement of non-GAAP earnings by firms. The emphasis of non-GAAP earnings in press releases has led some to argue that companies are manipulating investors' perceptions of the firm (Pitt 2001 in Elliott 2006). Subsequently, the SEC adopted Regulation G that mandated rules for non-GAAP information to be reconciled with relevant GAAP information (Elliott 2006). This resulted in a decline of non-GAAP earnings releases in 2003, and the provision of greater information to accompany non-GAAP earnings releases to better enable investors to make decisions (Marques 2006). Recent corporate failures and the misuse of non-GAAP earnings motivated the legislation of Section 401(b) of the Sarbanes-Oxley (SOX) Act, devoted to the regulation of non-GAAP numbers (Kolev, Marquardt & McVay 2008). Heflin & Hsu further establish that SOX 401(b) produced a downwards trend in the enormity of GAAP and non-GAAP earnings differences as well as a modest reduction in the probability companies signal earnings that satisfy or exceed forecasts (2008). The timing and emphasis of pro forma earnings also have a greater influence on nonprofessional investors' judgements (Elliott 2006). However, this is offset by the reconciliation of GAAP and non-GAAP earnings, whereby nonprofessional investors perceive greater reliability in the reports (Elliot 2006). To this extent, it can be argued that the intervention from regulators in earnings measurement has created a greater safeguard against corporate collapses than a free market approach. Similarly, a recent publication by Gasbarro et. al. (2013) has found that during times of market volatility, such as the global financial crisis, investors are placing greater value relevance on GAAP earnings. This is further evidence of the assurances of balance and consistency provided by GAAP earnings comparative to non-GAAP earnings.

Recent literature has found a strong relationship between non-GAAP earnings and value relevance, as well as a sharp disassociation between GAAP earnings and user preference. In the wake of this research, a strong theoretical case can be made for the deregulation of corporate financial disclosure. However, the requirements for GAAP earnings serve to reduce the consequences of information asymmetry and to protect vulnerable investors. GAAP mandated earnings provide a benchmark for consistency, accountability, and impartiality, allowing users to determine the efficiency of the firm. Despite the compliance costs involved, financial information users are provided with consistent earnings measurements to ascertain efficiency between firms. Further, legal and professional requirements pursued by the SEC for the reconciliation of GAAP and non-GAAP earnings, such as SOX 401(b) and Regulation G have improved the standard of financial reporting, ensuring firms are truthful in signalling their efficiency to investors.

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