Book Review

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Reporting non-GAAP financial measures: A theoretical and empirical analysis in Europe

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by Alessandro Gaetano*

Since the '*Accounting Revolution*' in the mid of the seventies (Beaver and Demski, 1974), financial reporting has been playing a fundamental role in providing cost-effective information useful to support capital providers in making their investment decisions (*decision usefulness approach*). Within this theoretical framework, the main objective of the standard setting process has been to single out relevant and reliable alternatives among several accounting choices, enhancing at the same time intra- and inter-firm financial performance comparability. This steady march toward uniform accounting standards has surely increased transparency of financial reporting and investor confidence, lowering barriers to investments and the cost of capital (Leuz and Wysocki, 2006). Yet, accounting standardization has also come at costs, forcing diverse firms and the heterogeneous information needs of diverse investors onto the same standard (Ray, 2018).

In response to the constraints imposed by the *one-size-fits-all* approach, firms often use unstandardized and unaudited earnings (non-GAAP earnings or Alternative Performance Measures-APMs such as EBITDA, EBIT, operating or cash earnings) to capture important firm-specific aspects of performance and to meet the demand of customised financial metrics (Young, 2014). In this respect, non-GAAP measures (also known as '*adjusted*', '*pro-forma*', or '*street*' earnings) can be a useful tool to help companies monitor their business and explain their performance. However, several anecdotal evidence also underlines an opaque presentation of non-GAAP earnings that threatens the integrity of the reporting system and creates particular risks in a financial reporting context. For example, in 2017 *WeWork Companies Inc.* declared a '*community-adjusted EBITDA*' of $233 million, although its audited financial reports showed a net loss of $933 million; one year later, the absence of an agreed definition of '*operating profit*' has allowed *Carillion Plc* to communicate a healthy profit shortly before its 2018 collapse (Bloomberg, January 28, 2020).

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When non-GAAP metrics are not used appropriately, they are open to misunderstanding and abuse and can contribute to cloud the view of a company's performance, to the detriment of naïve and unsophisticated investors groups (in these cases, financial analysts express their concerns on non-GAAP metrics using particular expressions such as '*everything but bad stuff* [EBBS]', '*fantasy maths*' or '*phoney-baloney financial reports*'). Not surprisingly, regulators and standard setters worldwide express strong concerns about the potential misuse of non-GAAP earnings and require some form of regulation on non-GAAP disclosure (e.g. in the last 8 years, in the U.S.A., the percentage of comment letters issued by the SEC referencing non-GAAP measures has increased by about 20 points).

Be that as it may, in addition to the regulated and audited financial information, non-GAAP measures represent nowadays an important (and even increasing) part of the periodic financial disclosure by companies worldwide, and an examination of the overall quality of firms' performance cannot, therefore, ignore the information content of these metrics.

To this end, the book "*Reporting Non-GAAP Financial Measures: A Theoretical and Empirical Analysis in Europe*", Moscariello N., Pizzo M. (edited by), Cambridge Scholars Publishing (2020) offers an in-depth, original and timely analysis of alternative performance measures (APMs) and contributes in several ways to the ongoing debate over non-GAAP disclosure.

First, contrary to the main research stream focusing its attention on US markets, the book analyses APMs in Europe, being non-GAAP earnings of particular interest in an IFRS context. The IFRS are in fact principle-based by nature and allow companies a wide margin of discretion in the preparation and presentation of financial statements. This leaves much room for voluntary use of alternative performance measures by European companies, with a potential impact on the investors' decision-making process. Not surprisingly, recently the European Securities and Markets Authority (ESMA) has published guidelines and reports on APMs for listed issuers, while the International Accounting Standard Board (IASB) has started its *Primary Financial Statements* project to tackle the widespread use of non-GAAP/IFRS earnings.

Second, within an IFRS context, the book examines the main issues related to APMs through the lens of thirty-six authors having different professional backgrounds and experience (academics, standard setters, regulators, auditors, financial statement preparers). Therefore, the book is not intended to be a research product written by academics for academics. Rather, it is a volume for scholars and interested non-academics who wish to gain a deeper understanding of the main issues related to the economics and regulation of non-GAAP disclosure.

Finally, the book contributes to the accounting literature using both a theoretical and empirical approach and providing not only a detailed picture of the state of the art but also original findings concerning determinants and consequences of APMs in Europe.

In more details, the book is structured in four parts hereafter described:

Part I provides a detailed theoretical analysis of non-GAAP/IFRS performance indicators. By analysing the theoretical reasons behind the current trends in the supply and demand of APMs, the first part of the book examines the competing hypotheses about non-GAAP (*information hypothesis* vs. *opportunistic hypothesis*) and presents an extensive literature review of the topic.

Part II is instead devoted to an in-depth examination of the latest security regulators' requirements and standard setters' projects on non-GAAP disclosure. An extensive analysis of the ESMA guidelines – compared to the US rules – is firstly carried out. Then a detailed examination of the current IASB project to tackle the widespread use of non-GAAP/IFRS earnings is presented. Also, in this part, the potential role played by non-GAAP measures in the integrated reporting is described.

Part III describes the internal controls procedures and the external auditor involvement in presence of non-GAAP measures. The Big Four's points of view on this topic is firstly analyzed, critically assessing to what extent non-GAAP metrics should be audited to preserve their information content and protect investors from misleading information.

Finally, in *Part IV,* the book provides several original empirical studies on non-GAAP/IFRS financial measures and disclosure in Europe, including two case studies showing the preparers' perspectives on this topic. *Part IV* is divided into two sections. *Section A* contains some original essays on non-GAAP reporting in Europe. These papers detect a widespread and uniform use of APMs by European listed companies. The ESMA guidelines have probably contributed to increasing the overall quality of non-GAAP disclosure, although some evidence about an opportunistic use of APMs – particularly related to earnings benchmark beating – are still found. *Section B* analyzes non-GAAP disclosure from a preparer's perspective, focusing on the case of the Eni Group (an entity from the energy sector) and the case of Intesa Sanpaolo (a banking group).

This book contains and offers a large number of interesting and useful insights on the economics of APMs and their impact on financial markets, providing an essential point of reference for post-graduate students, scholars, and practitioners interested in cutting-edge financial accounting and reporting issues.

References

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