ABSTRACT

GAAP earnings often contain transitory items that can distort firms’ investment decisions when a manager cares about his firm’s stock price. Non-GAAP earnings can alleviate investment distortions because they allow the manager to remove transitory items. In addition to removing transitory items, the manager can also opportunistically bias non-GAAP earnings. We quantify this trade-off by estimating a dynamic model in which the manager makes an investment and a non-GAAP disclosure decision, and where the stock market rationally anticipates the manager’s incentives. The estimated parameters suggest managers care about stock prices significantly more than fundamentals. In the estimated model, investment and non-GAAP disclosure serve as complements. Because of that, relative to a scenario where managers can only provide GAAP earnings, managers who can provide non-GAAP earnings increase investment, but do so opportunistically. We find that permitting bias in non-GAAP earnings creates inefficient investment choices and destroys firm value. We estimate the magnitude of the loss in the firm value at 57 basis-points.

(Copies of the paper are available in the AOIS Department offices)