Voting on Reporting

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Studies show that the usefulness of public companies' annual reports has been consistently declining. In the past, financial metrics disclosed in regulated financial statements, such as a company's book value or operating income (GAAP metrics), provided a meaningful explanation of stock prices and thus allowed for an efficient market-based allocation of capital among publicly traded firms as well as the economy at large.

Disturbingly, GAAP metrics no longer provide a strong correlation with stock prices or with the economy at large. While enjoying a booming economy, nearly half of all U.S. public companies reported losses in their pre-Covid financial statements.

Meanwhile, publicly traded companies have been increasing disclosures of alternative metrics—i.e., newly-created adjustments to GAAP metrics (non-GAAPs) appearing in press releases and in formats other than audited statements—thereby exacerbating the potential for opportunistic and misleading reporting by managers. The reporting and content of non-GAAPs are carried out at the discretion of management alone, do not follow any consensually binding practices, and are not the result of negotiations with stakeholders. Not surprisingly, findings show managers opportunistically disclose non-GAAP earnings to conceal reported losses and meet or beat analysts' expectations.

When faced with deficiencies in regulated financial disclosure, private parties can negotiate alternative novel metrics that substitute the use of GAAP metrics in contractual arrangements. Executives of publicly traded firms act alike and use tailor-made financial indicators in compensation schemes. Investors in publicly traded companies, however, do not enjoy similar privileges, cannot negotiate the financial metrics disclosed, and remain bound to a flawed generic financial disclosure regime.

Juxtaposing private parties' negotiation over the financial metrics used in voluntary contracts with the limitations investors in public companies face, this Article proposes a novel approach for financial disclosure regulation—a Voting on Reporting regime under which companies, after gaining the consent of their shareholders, are allowed to report alternative but audited financial metrics that replace GAAP metrics and better fit their shareholders' information needs.

Currently, financial metrics disclosed by publicly traded companies are either dictated by the regulator (GAAP) or opportunistically used and governed by managers alone (non-GAAPs). By allowing shareholders to participate in devising and regulating a company's financial reporting, the new regime could kill two birds with one stone: (i) it would allow financial statements to better cater to investors' interests and information needs; and (ii) it would curtail managers' opportunistic reporting of non-GAAPs.

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I. INTRODUCTION

In June 2019, Golden Rule Financial Corporation ("Golden"), a Delaware subsidiary of UnitedHealth Group—America's second-largest healthcare company[1]—acquired USHEALTH Group, Inc. ("US Health"), another Delaware corporation owning several insurance companies.[2] As part of the transaction, Golden entered into an agreement with the stockholders of US Health under which Golden acquired their stocks for a base

1. *See* Mark Kolakowski, *10 Biggest Healthcare Companies*, INVESTOPEDIA (Dec. 27, 2022), https://www.investopedia.com/articles/markets/030916/worlds-top-10-health-care-companies-unh-mdt.asp [https://perma.cc/3LZQ-H94L] (reporting that UnitedHealth Group LLC is the second largest company "in the healthcare field based on revenue as of Dec. 21, 2022").

2. Golden Rule Fin. Corp. v. S'holder Representative Servs., C.A. No. 2020-0378, 2021 WL 305741, at *1–2 (Del. Ch. Jan. 29, 2021).

purchase price of $750 million, subject to a post-closing true-up.[3]

A "true-up" is a payment made post-closing to adjust for any difference between the purchase price—determined on the transaction's closing date and based on estimated financial metrics—and the actual purchase price, determined by metrics known only after the closing date.[4] The mechanism for determining the true-up is subject to negotiation.[5] Commonly, at signing and based on the existing financial statements prepared by the seller, the parties define target metrics that can affect the deal's final consideration;[6] for example, the purchaser agrees to pay $2 billion under the seller's warrant that the company's working capital is $100 million. Then, if the metrics are found to be different in the post-closing statements prepared by the purchaser, the purchase price is adjusted according to the true-up mechanism; for example, for every $10 million of reduced working capital reported in the post-closing statements, the deal's overall consideration is reduced by $10 million.

The US Health transaction closed in August of that year, and the parties awaited the accounting metrics in order to finalize the purchase price. Only that, while working on the closing metrics, Golden—now the owner of US Health—discovered that the company had prepared its pre-closing financial statements[7] by recognizing revenues from customer contracts (including the value thereof) differently than required by proper accounting practices—i.e., as required by the Financial Accounting Standards Board's (FASB) Accounting Standards Codification 606—Revenue from Contracts with Customers (ASC 606).[8]

The difference between US Health's accounting practices prior to closing and the proper revenue recognition under ASC 606 was almost a $40 million difference in the deal's final purchase price.

In front of the Delaware Court of Chancery, Golden—the buyer now required to pay additional consideration according to the parties' true-up contractual mechanism—argued the same revenue recognition practice that was applied by US Health at signing should apply to the true-up payment estimate. US Health's former stockholders, however, argued that the parties explicitly stipulated in their agreement a list of accounting standards—

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3. *Id.* at 1–2, 9–11.

4. *See, e.g.*, Gene T. Barton, Jr., *Working Capital Adjustments: One Size Doesn't Fit All*, 16 J. PRIV. EQUITY 33, 33 (2013) ("The problem is that the purchase price is typically based on historical and projected earnings and a normalized balance sheet. Most transactions contemplate a certain amount of time between signing, and closing and financial statements are rarely available for the exact moment when a purchase agreement is signed.").

5. *See* Nils Patschureck, Friedrich Sommer & Arnt Wöhrmann, *Contract Design As a Risk Management Tool in Corporate Acquisitions: Theoretical Foundations and Empirical Evidence*, 26 J. MGMT. CONTROL 279, 279 (2015) ("[A]dequate contract design can effectively reduce acquisition risk, particularly with respect to target valuation uncertainty stemming from asymmetric information."); A. VINCENT BIEMANS & GERALD M. HANSEN, M&A DISPUTES: A PROFESSIONAL GUIDE TO ACCOUNTING ARBITRATIONS 297 (2017) ("The parties can also carve out an item from net working capital altogether if the underlying accounting is perceived as either inappropriate from a business perspective or too uncertain.").

6. *See generally* Barton, *supra* note 4 (discussing, generally, common considerations and negotiations during certain deals); BIEMANS & HANSEN, *supra* note 5 (same).

7. *Golden*, 2021 WL 305741, at *3 ("The Seller allegedly made that proposal because ASC 606 was already reflected in the Company's financial statements that the Buyer was relying on during negotiations.").

8. REVENUE FROM CONTRACTS WITH CUSTOMERS, Acct. Standards Codification § 606 (FIN. ACCT. STANDARDS BD. 2014).

among them ASC 606—to be implemented in the companies' financial statements and for the purposes of the true-up calculation; therefore, once agreed on by the parties, ASC 606 must be implemented correctly.

Notably, US Health, a private company at the time, was not required to implement ASC 606 in its financial statements neither during negotiations nor prior to closing.[9] Rather, it was the parties' explicit agreement that required ASC 606 to be implemented in the statements.[10] Accordingly, the parties' active involvement in deciding on the exact accounting standards to be applied in the post-closing statements—and for the purposes of the true-up payment—played a substantive role in the Chancery's decision of the case:

> The unambiguous language of the Agreement requires the final purchase price adjustment to reflect the application of ASC 606 . . . . [T]he Buyer [Golden] is requesting this court to compel a concededly incorrect implementation of ASC 606 as a contractually agreed-upon implementation of ASC 606. The Agreement does not permit such a deviation from its terms. The Buyer [Golden] urges a construction that is contrary to the plain meaning of the contract and, thus, contrary to what the parties intended.[11]

Thus, when asked to decide the accounting practices that govern the true-up mechanism, the Chancery ignored US Health's past implementation practices as well as the applicable regulatory requirements and turned to the parties' agreed list of accounting standards—seeing it as a conclusive financial framework for the purpose of the transaction.

The *Golden* case's outcome should not be seen as trivial, at least not when considered along with a previous case involving the dispute of parties over a post-merger true-up's estimation of financial metrics, decided by the Delaware Supreme Court a few years earlier.[12]

In *Chicago Bridge*, the buyer discovered after closing that the acquired company had incorrectly implemented some accounting standards that, if properly implemented as required by GAAP, would have resulted in a true-up payment of more than two billion dollars.[13] Following the parties' agreement on the method of financial metrics estimation, the Delaware Supreme Court resolved that the contract's provisions pertaining to the pre-closing financial statement and the post-closing financial statement all emphasized the requirement that metrics calculations be consistent with past practices.[14] Thus, in this specific agreement, the parties did not agree on a list of standards (which must be properly implemented in accordance with GAAP), but rather that past practices would continue to be consistently implemented whether in accordance with GAAP or not.[15]

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9. *Golden*, 2021 WL 305741, at *3 ("Private companies, such as [US Health], were not required to adopt ASC 606 until the annual reporting period ending December 31, 2019, which meant that the Company was not required to implement ASC 606 in its financial statements during negotiations or prior to closing.").

10. *Id.* at *5.

11. *Id.* at *5–6.

12. Chicago Bridge & Iron Co. N.V. v. Westinghouse Elec. Co., 166 A.3d 912 (Del. 2017).

13. *Id.* at 915–16.

14. *Id.* at 929 ("[W]hen read together, these parts of the Purchase Agreement require Westinghouse and Chicago Bridge to continue using the accounting approach Chicago Bridge had been using in the normal course of business before the transaction for the calculations up to and through closing.").

15. *Id.*; *see also* Robert S. Reder & William Pugh, *Delaware Supreme Court Bars Buyer from Using Narrowly-"Cabined" Working Capital Adjustment to Attack Seller's Alleged Non-Compliance with GAAP*, 72 VAND. L. REV. EN BANC 19 (2018) (reviewing Chief Justice Strine's analysis of the *Chicago Bridge* case).

Although resulting in different outcomes, the *Chicago Bridge* and the *Golden* cases both demonstrate how private parties substitute the use of existing generic reporting, regulated by the FASB and the Securities and Exchange Commission (SEC), with per-contract negotiated accounting provisions that constitute *ad-hoc* financial metrics that govern their contracts. In *Golden*, it was the parties' agreement on the implementation of a specific accounting standard that was not regulatory required at the time. In *Chicago Bridge*, the parties explicitly agreed on a consistent implementation of past practices that overrode any other implementation, even if it was a regulatory requirement.

Private parties' contractual use of *ad-hoc* alternative financial reporting in place of the "ready-to-use" GAAP disclosure framework reinforces findings that show the overall usefulness of the generic disclosure and its GAAP metrics have been consistently deteriorating in recent decades.[16]

In the past, prominent GAAP financial metrics, such as a company's book value and operating income, strongly correlated with stock returns—i.e., companies reporting high profits on their regulated financial statements were those whose share price rose. Disturbingly, current financial metrics no longer provide such predictive explanations for stock returns.[17] Moreover, the market appears to not use these financial statements,[18] as reflected by the number of downloads of U.S. annual reports from the EDGAR system.[19] Findings show the report is downloaded less than 30 times on the day of and the day after its release on average.[20]

Unlike private parties that can overcome deficiencies in the generic disclosure by negotiating alternative financial metrics (e.g., *Golden*, *Chicago Bridge*), capital market investors remain bound to the existing mandatory generic disclosure.

Meanwhile, although some investor informative needs could presumably be met by disclosing adjustments to the regulated GAAP measures,[21] adjustments generally known as "non-GAAP" metrics (non-GAAPs),[22] the informative content of such disclosures is

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16. *See infra* Part III.

17. *See generally* BARUCH LEV & FENG GU, THE END OF ACCOUNTING AND THE PATH FORWARD FOR INVESTORS AND MANAGERS (2016) (reporting contemporary financial accounting disclosures' continuous deterioration in relevance to investors' decisions).

18. *See infra* Part III.C.

19. *Important Information About EDGAR*, SEC, https://www.sec.gov/edgar/searchedgar/aboutedgar.htm [https://perma.cc/9DBK-5ETR] ("EDGAR, the Electronic Data Gathering, Analysis, and Retrieval system, performs automated collection, validation, indexing, acceptance, and forwarding of submissions by companies and others who are required by law to file forms with the U.S. Securities and Exchange Commission (SEC).").

20. *See infra* Part III.C (analyzing studies indicating the low number of downloads of U.S. annual reports from the EDGAR system).

21. *See generally* Seanna Asper, Chris McCoy & Gary K. Taylor, *The Expanding Use of Non-GAAP Financial Measures: Understanding Their Utility and Regulatory Limitations*, CPA J. (July 2019), https://www.cpajournal.com/2019/07/24/the-expanding-use-of-non-gaap-financial-measures [https://perma.cc/DBA6-PCGE] ("Initially, non-GAAP measures highlighted material changes in a company's operating structure or accounting method."); Paul Hribar et al., *Do Managers Issue More Voluntary Disclosure When GAAP Limits Their Reporting Discretion in Financial Statements?*, 60 J. ACCT. RSCH. 299 (2022) (studying how managers use voluntary disclosure channels to convey information when GAAP limits their ability to recognize such information in financial statements).

22. *See, e.g.*, Theresa F. Henry et al., *The Gap Between GAAP and Non-GAAP*, CPA J. (Mar. 2020), https://www.cpajournal.com/2020/03/18/the-gap-between-gaap-and-non-gaap [https://perma.cc/WT6M-RS83] ("A non-GAAP financial measure adjusts the most directly comparable GAAP measure reported on the audited financial statements by excluding items the company believes are not good indicators of its performance.").

limited. The SEC's existing regulation of non-GAAP disclosures, Regulation G, prohibits an adjustment from constituting a genuine metric that substantially differs from known GAAP measures.[23] Moreover, the specific adjustments, including the decision whether to disclose any adjustment at all, are decided solely by managers, and the non-GAAPs disclosed are not audited by the company's independent auditor.[24] Not surprisingly, empirical studies show that, although non-GAAPs provide some useful information in addition to that disclosed by GAAP,[25] corporate managers opportunistically disclose and adjust non-GAAP earnings to conceal losses and meet or beat analysts' expectations.[26] The reporting of non-GAAPs has been the number one topic addressed by SEC comment letters in each of the last two years.[27]

By juxtaposing private parties' negotiation over the financial metrics used in contracts with public investors' access solely to unsatisfying generic financial reporting and non-GAAPs, this Article proposes a new approach for financial metrics disclosure regulation—a "Voting on Reporting" regime.

This Article advocates for the replacement of the existing financial disclosure regime that allows either generic reporting of GAAP metrics governed by the FASB and the SEC or non-GAAP adjustments thereof governed solely by managers with a more representative disclosure regime that allows companies to provide investors with alternative novel financial metrics.

Under the proposed regime, both management and shareholders can propose alternative financial metrics to be disclosed and replace those of GAAP. However, to assure reporting is not opportunistically driven by managers' self-interests—such as achieving target metrics used in executive bonus schemes or used to offset unflattering generic numbers and mislead investors—the reporting of alternative financial metrics will only

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23. *See infra* Part II.D (discussing companies that are precluded from using parameters and how they differ fundamentally from accepted reporting principles).

24. According to PCAOB Auditing Standards, applicable to auditors of publicly traded companies, the auditor should read other information the company publishes in addition to audited financial statements and consider whether such information is materially inconsistent with the financial statements; however, the auditor's responsibility "does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information . . . ." *See* OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS, Statement on Auditing Standards No. 2710 (Pub. Co. Acct. Oversight Bd. 2022).

25. *See generally* Claudia Arena, Simona Catuogno & Nicola Moscariello, *The Unusual Debate on Non-GAAP Reporting in the Current Standard Practice. The Lens of Corporate Governance*, 25 J. MGMT. & GOVERNANCE 655 (2021) (reviewing non-GAAP reporting practices); *See, e.g.*, Jeremiah W. Bentley et al., *Disentangling Managers' and Analysts' Non-GAAP Reporting*, 56 J. ACCT. RSCH. 1039, 1043 (2018) (providing evidence that most I/B/E/S-provided non-GAAP EPS metrics agree with managers' non-GAAP disclosures and that these numbers are generally informative).

26. Arena, Catuogno & Moscariello, *supra* note 25, at 658 ("Empirical evidence shows that managers disclose pro forma earnings to conceal losses, report positive earnings growth, meet or beat analysts' expectations, and increase investor perceptions of earning credibility.").

27. *See* ERNST & YOUNG LLP, SEC REPORTING UPDATE: HIGHLIGHTS OF TRENDS IN 2021 SEC COMMENT LETTERS 3 (2021), https://assets.ey.com/content/dam/ey-sites/ey-com/en_us/topics/assurance/accountinglink/ey-sru13789-211us-09-23-2021.pdf?download [https://perma.cc/6AM4-KA7N] (showing that the SEC commented on non-GAAP financial measures more frequently than any other topic in 2020 and 2021); *SEC Comment Letter Trends*, PWC (Sept. 30, 2022), https://viewpoint.pwc.com/dt/us/en/pwc/sec_comment_letters/comment_letter_trends_DM/SEC_comment_letters.html [https://perma.cc/LB55-YDNH] (discussing recent SEC comment letter trends).

apply after being approved by shareholder voting and in prospective reports. This would ensure the alternative reporting truly benefits investors' interests and not those of others.

This Article continues as follows: Part II discusses the supply of financial information, the important role financial disclosure plays in facilitating effective contracting between stakeholders, and the resulting patterns of reporting that evolved: the mandatory reporting of generic metrics governed by GAAP and the voluntary reporting of their adjustments. Next, based on an extensive review of empirical studies, Part III argues that severe problems exist with the current disclosure regime and the supply of financial information. Generic GAAP-based financial metrics provided in regulated financial statements no longer adequately meet the current demands of financial reporting, but any positive contribution of the voluntary statement of their adjustments—i.e., non-GAAPs—is also seriously questionable in light of studies showing non-GAAPs are opportunistically reported by managers. Following the appearance of private parties' contractual accounting provisions for *ad-hoc* financial reporting, Part IV reviews some prominent examples of alternative metrics that investors in public companies are likely to prefer, were they able to choose, over the generic metrics and non-GAAPs currently provided. Part V presents the Article's proposal for a novel financial disclosure regime that allows companies to cater to their investors' information needs without harming disclosure reliability or exposing it to manipulation or fraud. Part VI discusses the issue of comparability that the reporting of alternative metrics supposedly raises and explains why the proposed regime shifts the burden and the costs associated with creating comparability, rather than eliminating it altogether. Lastly, Part VII concludes.

II. THE SUPPLY OF FINANCIAL INFORMATION

Information about the corporation is asymmetrically distributed depending on proximity to a corporation's inner circle of decision-makers.[28] Members of a corporation's inner circle—e.g., company executives—enjoy direct, uninterrupted access to comprehensive information. Meanwhile, those outside the circle—although frequently providing funding to the entity or dependent on its continued existence and stability—e.g., company investors/suppliers and employees/customers—have only limited access to information about the corporation.[29]

Unavailability of information and the lack of disclosure can result in suboptimal contracting[30] or prevent it altogether.[31] With respect to non-voluntary contracting, a lack of disclosure can result in *de facto* reduced accountability towards external parties,

28. ISRAEL KLEIN, *The Privatization of Accounting Standard-Setting*, *in* THE CAMBRIDGE HANDBOOK OF PRIVATIZATION 286, 286 (Avihay Dorfman & Alon Harel eds., 2021) (discussing the privatization of accounting standards).

29. *Id.*

30. *See generally* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984) (discussing how the adoption of a mandatory disclosure system reduces price dispersion and thereby enhances the allocative efficiency of capital markets); *see also* Urooj Khan et al., *Do the FASB's Standards Add Shareholder Value?*, 93 ACCT. REV. 209, 214–15 (2018) ("[E]vidence suggests that a 'one-size fits all' reporting policy imposed by the FASB can actually make it easier for insiders to divert profits.").

31. *Cf.* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970) (stating the quality of goods traded in a market can degrade in the presence of information asymmetry between buyers and sellers, leaving only "lemons" behind).

preventing them from monitoring the entity and those who manage it,[32] or, to say the least, make such extrinsic-monitoring more expensive due to the need to independently collect undisclosed information.[33]

When market failures prevent effective voluntary disclosure by the inner circle[34] or when public interests justify extended disclosure[35] and efficient contracting, as occurs with companies that raise capital from the public (public companies), regulations require members of the inner circle—i.e., company management—to disclose information about the company to the outside circle.[36]

A. Public Companies' Financial Disclosures

Public companies are subject to an extensive disclosure regime—set by the Securities Acts and SEC regulation—intended, *inter alia*, to cater to investor needs for financial information.[37] Public companies are legally required to prepare and disclose audited financial statements[38] as well as a management report that discusses and analyzes

32. *See* Khan et al., *supra* note 30, at 210–11 (discussing the disclosure equilibrium shift and its impact).

33. KLEIN, *supra* note 28, at 287.

34. *See* Robert E. Verrecchia, *Discretionary Disclosure*, 5 J. ACCT. & ECON. 179, 181–83 (1983) (describing how the existence of disclosure-related costs offers an explanation as to why managers exercise discretion in disclosing information even though traders have rational expectations about their motivation to withhold unfavorable reports); Ronald A. Dye, *Disclosure of Nonproprietary Information*, 23 J. ACCT. RSCH. 123, 125–27 (1985) (presenting several reasons why managers possessing nonproprietary information will not disclose that information).

35. *See, e.g.*, Ann M. Lipton, *Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure*, 37 YALE J. ON REGUL. 499, 504–19 (2020) (recommending widespread acknowledgment of the importance of disclosure for non-investor audiences and discussing the feasibility of designing a disclosure system geared to their interests); *see also* Israel Klein, *A Change in Accounting, A Change in Law*, 42 DEL. J. CORP. L. 51, 58–59 (2017) (discussing the epistemological role financial accounting plays in the legal system).

36. *See, e.g.*, Colleen Honigsberg, Robert J. Jackson, Jr. & Yu-Ting Forester Wong, *Mandatory Disclosure and Individual Investors: Evidence from the Jobs Act*, 93 WASH. U. L. REV. 293, 326 (2015) (discussing how mandatory disclosure encourages individual investors to participate in stock markets); *see also* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2361 (1998) (advocating for a competitive federalism approach that would expand the role of the states in securities regulation); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 680–700 (1984) (discussing some of the most prominent arguments for a mandatory disclosure system); Hadar Y. Jabotinsky & Mathias Siems, *How to Regulate the Regulators: Applying Principles of Good Corporate Governance to Financial Regulatory Authorities*, 44 J. CORP. L. 351, 365 (2018) ("[F]or larger companies in particular, there are often special requirements of accountability, for example, disclosure requirements for the benefit of the shareholders and the public . . . ."); *see generally* Gregg A. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J.L. & ECON. 613 (1981) (finding that, historically, SEC regulations imposed higher registration costs on relatively risky new issues).

37. *See* Lipton, *supra* note 35, at 504–19 (describing the functions of mandatory corporate disclosure for both investor and non-investor audiences); Paul G. Mahoney, *Mandatory Disclosure As a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048 (1995) (explaining that the principal purpose of mandatory disclosure is to address certain agency problems that arise between corporate promoters and investors, and address problems between corporate managers and shareholders); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 737–40 (2006) (analyzing how disclosure duties reduce information traders' costs of searching and gathering information).

38. *See, e.g.*, Securities Exchange Act of 1934, Pub. L. 73-291, §§ 10A, 13(a)(2), 48 Stat. 881 (describing audit requirements under 10A and, requiring reporting "if required by the . . . commissioner" under 13(a)(2)); 17 C.F.R § 210.2-01(a) & § 210.3-02(a) (defining and applying Regulation S-X and the commissioner's reporting requirements).

additional material information relevant to the assessment of the company's financial condition and performance.[39] All in all, financial measures disclosed by public companies can be sorted into two general types:[40] the first is mandatory and contains closely regulated financial measures that are estimated and reported according to a defined set of reporting norms followed by all reporting entities—i.e., GAAP;[41] these constitute a uniform financial disclosure provided by all public companies.[42]

The second type, which, along with the mandatory metrics, many companies voluntarily disclose, [43] are measures that "exclude amounts, or are subject to adjustments that have the effect of "exclud[ing] amounts . . . that are included in the most directly comparable measure calculated and presented in accordance with GAAP"[44]—i.e., non-GAAP measures. Although companies are not obligated to disclose these additional metrics, for reasons discussed below, many opt to do so. While securities regulations require the additional disclosure not to be misleading,[45] disclosed metrics differ among issuers and are derived from each issuer's selective editing of the GAAP measurements[46] and thus constitute a second type of disclosure of adjusted GAAP figures—non-GAAPs.

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39. *See* 17 C.F.R § 249.310 (2021) (Item 7 of Form 10-K) (asking the filer to furnish the information required by Item 303 of Regulation S-K); 17 C.F.R § 229.303 (2021) ("The objective of [Item 303 of Regulation S-K, management's discussion and analysis of financial conditions and results of operations (MD&A),] is to provide material information relevant to an assessment of the financial condition and results of operations of the registrant."); *see also* Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information, 86 Fed. Reg. 2080 (Jan. 11, 2021) (to be codified at 17 C.F.R pts. 210, 229, 230, 239, 240, 249) (eliminating duplicative disclosures and modernizes and enhances MD&A disclosures for the benefit of investors, while simplifying compliance efforts for registrants).

40. *See* James J. Park, *Insider Trading and the Integrity of Mandatory Disclosure*, 2018 WIS. L. REV. 1133, 1156–63 (2018); Carl W. Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254, 270–73 (1972) (both discussing the general distinction between mandatory and voluntary disclosure).

41. *See* Israel Klein, *The Gap in the Perception of the GAAP*, 54 AM. BUS. L.J. 581, 594–603 (2017) (reviewing GAAP norms and their prescribers).

42. 17 C.F.R. § 210.4-01 (2023) ("Financial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided.").

43. *See* PWC, TO GAAP OR TO NON-GAAP COVID-19: WHAT YOU SHOULD KNOW 1 (2021), https://viewpoint.pwc.com/dt/us/en/pwc/in_the_loop/assets/nongaapitlupdated.pdf [https://perma.cc/W4ZM-BDNR] (noting that "94% of S&P 500 [companies reported] at least one non-GAAP measure" in 2020).

44. 17 C.F.R § 229.10(e)(2)(i) (2023); s*ee also* Conditions for Use of Non-GAAP Financial Measures, 68 Fed. Reg. 4820, 4821 (Jan. 30, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 244, 249) (adopting Regulation G to address public companies' disclosure of financial information that is calculated and presented on the basis of methodologies other than in accordance with GAAP).

45. 17 C.F.R. § 244.100(b) (2023) ("A registrant . . . shall not make public a non-GAAP financial measure that, taken together with the information accompanying that measure and any other accompanying discussion of that measure, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading."); *see also* Bo Shen v. Exela Techs., Inc., No. 3:20-CV-0691-D, 2021 WL 2589584 (N.D. Tex. June 24, 2021) (ruling on an attempt to argue that adjusted EBITDA disclosures violated Regulation G and Item 10(e) of Regulation S-K).

46. *See, e.g.*, Ironworkers Loc. 580—Joint Funds v. Linn Energy, LLC, 29 F. Supp. 3d 400, 426 (S.D.N.Y 2014) ("[T]here is no 'right' formula [for non-GAAP metrics] because, unlike GAAP metrics, they have no uniform definition.").

B. The Generic GAAP-Based Disclosure

The bulk of the generic financial disclosure is made in the company's financial statements.[47] Under the Securities and Exchange Acts, issuers are required to file financial statements with the SEC as part of their registration statement[48] which then becomes public, as well as disclose updated financial statements in periodic reporting, such as the issuer's annual and interim reports.[49]

The form and content of the statements are set in Regulation S-X.[50] In part, the regulation sets the periods for which financial metrics should be reported–for example, the company's financial position (balance sheet) must be reported as of the last day of the two most recent fiscal years[51] and the comprehensive income and cash flow metrics for three fiscal years preceding the date of the most recent balance sheet being filed.[52] The regulation also requires financial statements filed with the SEC to be prepared in accordance with GAAP unless the SEC has provided otherwise.[53]

Meanwhile, in regard to the GAAP accounting practices used for estimating the statements' metrics, although the SEC is authorized to set these practices,[54] it has historically looked to the accounting profession to provide leadership in establishing and improving accounting principles.[55] Accordingly, the content of the statements, or more

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47. While financial disclosure is also provided in other reports filed by the issuer—including other parts of the annual report, e.g., MD&A39—such financial disclosures are more limited in nature and are based on information included in the current and past financial statements of the company. 17 C.F.R. § 229.303 (2023); *see generally* Rigers Gjyshi, *The Integrated Disclosure System*, *in* RESEARCH HANDBOOK ON SECURITIES REGULATION IN THE UNITED STATES 47, 67–108 (Jerry W. Markham & Rigers Gjyshi eds., 2014).

48. 17 C.F.R. § 239.11 (2023) (requiring that the S-1 registration form shall be used for registration unless otherwise described); *see* 17 C.F.R. § 210 (2023) (requiring that registrants furnish statements that meet S-X requirements).

49. *See, e.g.*, Securities Exchange Act of 1934, 15 U.S.C. § 78(m)–(o) (1934); Forms for Annual and Other Reports of Issuers Required Under Sections 13 and 15(d) of the Securities Exchange Act of 1934, 17 C.F.R § 249 (2023); *see also* Requirements for Regulation S-X, 17 C.F.R. § 210 (2023) (outlining the form and content of and requirements for financial statements filed as a part of registration statements, annual reports and other reports under the Securities Act of 1933, the Securities Exchange of 1934, and the Investment Company Act of 1940).

50. Application of Regulation S-X, 17 C.F.R § 210.1–01 (2023).

51. Consolidated Balance Sheets, 17 C.F.R § 210.3–01 (2023).

52. 17 C.F.R. § 210.3–02 (2023).

53. 17 C.F.R. § 210.4–01(a)(1) (2023) ("Financial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided."); *see generally* Klein, *supra* note 41 (explaining generally accepted accounting principles).

54. *See, e.g.*, Special Powers of Commission, 15 U.S.C. § 77s(a) (2018) (granting the Commission authority to prescribe the items or details to be shown in the balance sheet and the earnings statement, and the methods to be followed in the preparation of such financial reports submitted to the Commission and published to investors); *see also* Arthur Andersen & Co. v. SEC, No. 76C-2832, 1978 WL 1073 (N.D. Ill. Mar. 1, 1978) (ruling on a failed attempt to challenge the SEC's decision to delegate accounting standards setting power to the private sector).

55. *See, e.g.*, Admin. Pol'y on Fin. Statements, Accounting Series Release No. 4, [1937–82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,005 (Apr. 25, 1938); Statement of Pol'y on the Establishment & Improvement of Acct. Principles and Standards, Accounting Series Release No. 150, 3 SEC Docket 275 (Dec. 20, 1973); Comm'n Statement of Pol'y Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Securities Act Release No. 8221, Exchange Act Release No. 47,743, 80 SEC Docket 139 (Apr. 25, 2003) (explaining how the SEC determines that the FASB satisfies the criteria in section 108 of the Sarbanes-Oxley Act of 2002 and thus FASD standards are recognized as "generally accepted" for purposes of the federal

accurately—the practices followed in generating the disclosed numbers appearing in the statements—are currently governed by standards established by the FASB, while the SEC maintains a general oversight role.[56]

In accordance with the requirement to implement GAAP, the Securities Acts, and regulations further require[57] the statements—prepared by the management—to be audited[58] by an independent auditor.[59] The auditor, a certified public accountant (CPA) who is independent of the company both in fact and in appearance,[60] provides a professional opinion, in the form of an accountant's report accompanying the audited statements, stating whether the financial statements are presented in conformity with GAAP,[61] including the consistency of GAAP's application in the financial statements, or indicating any deviation from the principles which have a material effect on the statements.[62]

Overall, these regulatory requirements result in three prominent advantages of generic disclosure: high levels of *efficiency*, *effectiveness*, and *credibility*. Reporting using GAAP, and not any other comprehensive basis of accounting (OCBOA),[63] results in measures that have been estimated using principles well known to consumers of these statements,[64] thus providing an *efficient* disclosure method that allows the company to process the information for the users, summarize it, and then disclose it through widely known GAAP

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securities laws which registrants are required to continue to comply with in preparing financial statements filed with the SEC unless the SEC directs otherwise); *see also* Klein, *supra* note 41, at 595–96 (describing multiple layers of norms that govern the accounting consensus and the GAAP); *see generally* Hadar Y. Jabotinsky, *The Federal Structure of Financial Supervision: A Story of Information-Flow*, 22 STAN. J.L. BUS. & FIN. 52 (2017) (discussing information-flow within and among financial regulatory authorities).

56. Foreign issuers enjoy a distinct but similar reporting regime where they are required to follow standards set by the International Accounting Standards Board (IASB) rather than the FASB. *See generally* SEC, ACCESSING THE U.S. CAPITAL MARKETS — A BRIEF OVERVIEW FOR FOREIGN PRIVATE ISSUERS (2013) (discussing how private issuers, generally, should report to remain compliant).

57. *See, e.g.*, Securities Exchange Act of 1934, §§ 10A, 13(a)(2) (codified as amended at 15 U.S.C. §§ 78j–1, 78m); 17 C.F.R §§ 210.2-01(a), 210.3-02(a) (2023) ("There shall be filed, for the registrant and its subsidiaries consolidated and for its predecessors, audited statements . . . .").

58. 15 U.S.C. § 78m(i) ("Each financial report that contains financial statements, and that is required to be prepared in accordance with (or reconciled to) generally accepted accounting principles under this chapter and filed with the Commission shall reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with generally accepted accounting principles and the rules and regulations of the Commission."). Interim financial statements may be unaudited. 17 C.F.R §§ 210.3–02(b), 210.10–01 (2023).

59. 17 C.F.R § 210.2-01 (2023).

60. 17 C.F.R § 210.2-01 sets forth restrictions on financial, employment, and business relationships between an accountant and an audit client and restrictions on an accountant providing certain non-audit services to an audit client. *Id.*

61. An accountant's report, included in an annual report containing an assessment by management of the effectiveness of the registrant's internal control over financial reporting, should generally also include an attestation report by the auditor on the internal control over financial reporting. *See* 17 C.F.R § 210.2-02(f) (2023).

62. 17 C.F.R § 210.2-02 (2023).

63. *See* Israel Klein, *It's Time to Mind the GASB*, 54 SAN DIEGO L. REV. 565, 579 (2017) ("OCBOA . . . is not systematically promulgated by any recognized accounting body but is, rather, the accounting method used de facto by the entity.").

64. *See, e.g.*, Robert H. Heidt, *Damned for Their Judgment: The Tort Liability of Standards Development Organizations*, 45 WAKE FOREST L. REV. 1227, 1264–72 (2010) (discussing the social value of standards in the context of products manufacturing).

metrics.[65] In addition, the shared use of GAAP in a standardized disclosure by many reporters[66]—e.g., all public companies are required to report each respective Earning Per Share (EPS) metric—allows the measures of one company to be compared to another and thus, provides a better understanding of the financial information[67] and more *effective* use of the information in decision making. In addition, GAAP metrics reported in the statements are audited by the company's external auditor who therefore bears responsibility, possibly even criminal, should the statements contain a material misstatement due to fraud or error.[68] Consequently, audited statements enjoy relatively high *credibility*.

That said, generic disclosure has its shortcomings. By its nature, GAAP-based statements provide retrospective disclosure about the company's performance.[69] Reported numbers are assessed using the company's recording of past events with almost no consideration of whether the same events will recur and affect the company's future performance.[70] Therefore, in contrast to their stewardship function in documenting past performance,[71] generic metrics have rather limited use in predicting a company's future performance.

For example, in August 2021, Apogee Enterprises (Apogee), a publicly traded Minnesota company making glass panels for building exteriors, announced that it will close two of its existing plants as part of a larger corporate reorganization.[72] The closings are expected to save the company $20 million to $30 million a year in prospective manufacturing costs, but involve a one-time loss of $30 million to $35 million due to the write off of assets and workers' severance payments.

While closing the plants improves the firm's overall status and is expected to improve its future performance, Apogee's 2021 financial statements—prepared under GAAP's

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65. For the sake of efficiency, consensual accounting terminology contains a finite number of symbols representing the entity's infinite financial affairs. *See* CHARLES W. CHURCHMAN, *Why Measure?*, *in* MEASUREMENT: DEFINITIONS AND THEORIES 83, 88–92 (Charles W. Churchman & Philburn Ratoosh eds., 1959) (analyzing measurement processes); WILLIAM ANDREW PATON, ACCOUNTING THEORY WITH SPECIAL REFERENCE TO THE CORPORATE ENTERPRISES 28 (1922) (discussing accounting's symbols).

66. *See* QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION, Statement of Fin. Standards No. 8, ¶ QC20 (FIN. ACCT. STANDARDS BD. 2010) ("Users' decisions involve choosing between alternatives, for example, selling or holding an investment, or investing in one reporting entity or another. Consequently, information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.").

67. *See* Klein *supra* note 41, at 587–88 ("The ability to compare information generated by distinct firms, all following the same financial accounting rules, enhances overall understanding and improves the usefulness of the information in decision making.").

68. Responsibilities and Functions of the Independent Auditor, Statement on Auditing Standards No. 1001, § .02 (Pub. Co. Acct. Oversight Bd. 2002).

69. Arena, Catuogno & Moscariello, *supra* note 25, at 656 (stating that GAAP involves "retrospective and not future-oriented information").

70. *See generally* Eli Amir, Eti Einhorn & Itay Kama, *Extracting Sustainable Earnings from Profit Margins*, 22 EUR. ACCT. REV. 685 (2013) (proposing a measure of sustainable earnings based on deviations from normal profit margins).

71. KLEIN, s*upra* note 28.

72. *Minnesota Company to Close Glass Plants in Georgia, Texas*, ASSOCIATED PRESS NEWS (Aug. 15, 2021), https://apnews.com/article/business-health-texas-minnesota-georgia-9648860fe209cadd1698178623ac9bce [https://perma.cc/E26F-5ZJ7].

reflection of past events—will disclose reduced profitability due to the closings.[73] The singular nature of the loss or its expected future benefits do not exclude it from being reported and negatively affecting Apogee's present GAAP metrics.[74] Therefore, although shutting down two plants is expected to contribute to the firm's future performance, the current reported loss negatively affects any predictions regarding the firm's future profitability as based on the generic disclosure.

C. Non-GAAPs

Shortcomings of the generic metrics, as seen with Apogee's regulated reporting, motivate managers to report more precise information relating to core recurring earnings. Such information is arguably more useful in estimating the company's future performance. Accordingly, along with providing measures estimated by GAAP, in an attempt to convert historical performance measures into forward-looking information,[75] managers revise and adjust generic metrics and provide additional non-GAAP disclosures.

Following Apogee's financial disclosure, along with reporting a GAAP-based loss due to the shutdowns, the company might opt to disclose in its reporting for 2021 a number of additional "rosy" non-GAAP performance metrics that exclude the shutdown's financial effect on profitability. For example, the company might disclose a 2021 non-GAAP earnings metric that excludes "special charges" associated with the closing of the plants. This would provide investors with additional information that arguably better reflects the company's core performances and better fits an estimation of the company's future performance.

Not surprisingly, additional, voluntarily disclosed numbers tend to be more positive and appealing to investors than the generic numbers. A recent online review covering non-GAAP data from 2010 to 2019 showed that almost a fifth of firms that reported GAAP losses turned their generic losses into positive non-GAAP numbers.[76] To take one specific example, for the fiscal years 2019 and 2020, Pinterest reported losses of $1361 million and $128 million, respectively, in its generic statements. However, by adjusting costs associated with share-based compensation and amortization of acquired intangible assets, Pinterest's 2019 and 2020 GAAP-based losses became non-GAAP profits of $16 million and $305 million, respectively.[77]

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73. The exact effect depends on whether Apogee terminates its activity in a sector of a certain glass. Since 2015, only disposals of businesses that represent *strategic shifts* that have a major effect on an organization's operations and financial results will be reported in discontinued operations. Reducing the volume of an operation—for example, by the closure of some plants—does not qualify as a strategic shift and therefore is not excluded from the general metrics. *See* ACCT. STANDARDS CODIFICATION § 205-20-45-1B (FIN. ACCT. STANDARDS BD. 2018) ("A disposal of a component of an entity or a group of components of an entity shall be reported in discontinued operations if the disposal represents a strategic shift…")

74. *Id.* at 1–2.

75. Arena, Catuogno & Moscariello, *supra* note 25, at 656.

76. *See* Vijay Govindarajan, Anup Srivastava & Rong Zhao, *Mind the GAAP*, HARV. BUS. REV. (May 4, 2021), https://hbr.org/2021/05/mind-the-gaap [https://perma.cc/U33D-2FZ3] ("Hand-collected data from 2010 to 2019 shows that almost a fifth of firms that report GAAP losses turn their GAAP loss into a positive non-GAAP number."); *see also* Edith Leung & David Veenman, *Non-GAAP Earnings Disclosure in Loss Firms*, 56 J. ACCT. RES. 1083, 1083 (2018) (finding that non-GAAP earnings disclosures are particularly informative about loss firms).

77. Pinterest, Inc., Annual Report 50 (Form 10-K) (Feb. 4, 2021).

As early as 2001, concerns over investors being misled by non-GAAP disclosures[78] caused the SEC to issue a warning to public companies that presented earnings and results of operations in earnings releases using methodologies other than GAAP (referred to, at the time, as "pro forma" financial information).[79] Later, in mid-2002, as part of Congress's response to the accounting scandals of the early 2000s (Enron and WorldCom), the Sarbanes-Oxley Act of 2002 (SOX) required the SEC to issue regulations for the disclosure of pro forma financial information by registrants.[80] At the end of the same year, in line with its mandate under SOX,[81] the SEC issued Release No. 33-8176—"Final Rule: Conditions for Use of Non-GAAP Financial Measures," now known as "Regulation G."[82]

While companies are not prohibited from publishing interpretations of their results or summaries of their GAAP financial statements, securities regulation requires companies to be particularly mindful of their obligation not to mislead investors with any additional disclosure.[83] Among other things, Regulation G requires a company that discloses a non-GAAP measure to accompany the measure with the presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP,[84] along with a quantitative reconciliation of the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure.[85] In addition, managers are required to explain why the "presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations."[86]

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78. *See* Arena, Catuogno & Moscariello, *supra* note 25, at 656 (discussing early concerns with non-GAAP disclosures); FREDERICK RYAN CASTILLO, NON-GAAP EXPLAINED 1–2 (2017), https://media.mofo.com/docs/pdf/171023-iflr-non-gaap-booklet/471F08845E84E88DC9B64B5EB5E9128E/171023-iflr-non-gaap-booklet.pdf [https://perma.cc/N685-XGGQ] (reviewing the history of non-GAAP regulation).

79. Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases, 66 Fed. Reg. 63731 (Dec. 4, 2001).

80. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 401(b), 116 Stat. 786 (codified at 15 U.S.C. § 7261(b)) ("Not later than 180 days after [July 30, 2002], the Commission shall issue final rules providing that pro forma financial information included in any periodic or other report filed with the Commission pursuant to the securities laws, or in any public disclosure or press or other release, shall be presented in a manner that-(1) does not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the pro forma financial information, in light of the circumstances under which it is presented, not misleading; and (2) reconciles it with the financial condition and results of operations of the issuer under generally accepted accounting principles.").

81. CASTILLO, *supra* note 78, at 3.

82. Conditions for Use of Non-GAAP Financial Measures, 68 Fed. Reg. 4819, 4821 (Jan. 30, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 244, 249); *see also* DIV. OF CORP. FIN., SEC, FINANCIAL REPORTING MANUAL § 8110.1 & 8110.2 (2017), https://www.sec.gov/corpfin/cf-manual/topic-8 [https://perma.cc/3GBB-JCAH] ("Authoritative guidance regarding the use of non-GAAP financial measures can be found in: a. Regulation G; b. S-K 10(e) c3. Exchange Act Release No. 47226, Conditions for Use of Non-GAAP Financial Measures. Staff guidance regarding the use of non-GAAP financial measures can be found in the Division of Corporation Finance's Compliance and Disclosure Interpretations, Non-GAAP Financial Measures.").

83. 17 C.F.R. § 244.100 (2023).

84. 17 C.F.R § 244.100(a)(1) (2023) ("Whenever a registrant . . . publicly discloses material information that includes a non-GAAP financial measure, the registrant must accompany that non-GAAP financial measure with . . . . A presentation of the most directly comparable financial measure calculated and presented in accordance with Generally Accepted Accounting Principles (GAAP).").

85. 17 C.F.R § 244.100(a)(2) (2023).

86. 17 C.F.R § 229.10(e)(1)(i)(C) (2023).

D. (Prohibited) Alternative Disclosures

While the use of non-GAAPs allows managers to report core financial information and arguably provide more adequate measures for prospective estimates, managers are nevertheless still subject to restriction and cannot invent their own novel metrics.

Securities regulations prohibit the disclosure of a measure that adjusts reported numbers "that substitute individually tailored revenue recognition and measurement methods for those of GAAP."[87] Specifically, rule 100(b) of Regulation G prohibits a registrant from disclosing a non-GAAP measure that "contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading."[88] The SEC's interpretation of rule 100(b) is that "individually tailored recognition and measurement methods for [other] financial statement line items may also violate rule 100(b) of Regulation G for being misleading."[89]

Accordingly, managers are precluded from using improvised parameters that differ fundamentally from accepted reporting principles, and the SEC enforces that prohibition on the reporting of any such alternative performance metrics. Two recent analyses of SEC comment letters issued with respect to Form 10-K and Form 10-Q filings, conducted by Ernst & Young and PWC, identify the reporting of non-GAAPs as the number one topic addressed by the SEC staff in each of the last two years.[90]

To dwell on one representative example:[91] For the year ending December 31, 2019, Papa John's International, Inc.'s (Papa John's) reported non-GAAP operations results that excluded lost revenue due to royalties waived by the company when supporting some of its franchisees during 2019.

The Company's franchisees needed support after Papa John's faced a severe decline in its North American sales during 2019, following extensive negative publicity and consumer sentiment as a result of statements made the year before by the Papa John's founder and former spokesman.[92] Accordingly, the company justified the exclusion of the

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87. DIV. CORP. FIN., SEC, NON-GAAP FINANCIAL MEASURES: COMPLIANCE & DISCLOSURE INTERPRETATIONS § 100.04 (2022) (detailing how the SEC's Compliance & Disclosure Interpretations comprise the SEC staff's interpretations of the rules and regulations on the use of non-GAAP financial measures).

88. 17 C.F.R § 244.100(b) (2023).

89. DIV. CORP. FIN., SEC, *supra* note 87 (showing that—when asked by an issuer whether a non-GAAP performance measure that is "adjusted to accelerate revenue recognized ratably over time in accordance with GAAP as though it earned revenue when customers are billed" can be presented in documents filed with or furnished to the Commission or provided elsewhere—the SEC replied that "[n]on-GAAP measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could violate Rule 100(b) of Regulation G . . . .").

90. *See* sources cited *supra* note 27.

91. *See also* George Wilson, *An SEC Comment Challenge: Find the Non-GAAP Measure Issue – Post Four*, PRO. GRPS. (Oct. 6, 2020), https://secprofessionals.org/news/329552%20-%20Papa%20Jones [https://perma.cc/YHG7-5BAR] (reviewing non-GAAP measure problems and related SEC comments).

92. *See* Chandelis R. Duster, *Papa John's Founder Resigns As Chairman of the Board Amid Backlash After Admitting He Used the N-Word*, NBC NEWS (July 11, 2018), https://www.nbcnews.com/news/nbcblk/papa-john-s-founder-apologizes-using-n-word-conference-call-n890681 [https://perma.cc/8K7A-JV8Y] (detailing aftermath of Papa John's founder's use of the n-word in a conference call); *see also* Letter from Steve Coke, VP, Inv. Relations & Strategy (Interim Principal Fin. & Acct. Officer), Papa John's Int'l, Inc., to Blaise Rhodes & Rufus Decker, Div. Corp. Fin., Off. Trade & Servs., SEC (Apr. 13, 2020),

waived royalties as necessary to reflect Papa John's core performance—being "above and beyond the level of franchise support the Company would incur in the ordinary course of its business."[93]

Nevertheless, a short time after releasing its annual report for 2019, the company received a comment letter from the SEC requesting that the company clarify the considerations it gave to the SEC's interpretation of Rule 100(b) when "adjusting [their] non-GAAP measures to add revenues [they] did not receive due to royalty relief."[94]

Although at first the company tried to claim the adjustment is not a prohibited tailored metric—arguing that "the adjustment reflects the add-back of contractually due and waived franchise royalties in our financial statements rather than the tailoring of the recognition or measurement principles under GAAP"[95]—and further offered to include an elaborated disclosure which would better explain the adjustment in future reporting,[96] the SEC did not accept the argument. After further negotiation with the SEC, the company reported that "[a]s discussed during the phone conversation between the [SEC] Staff and the Company . . . beginning with the Company's earnings release for the first quarter of fiscal 2020, the Company will no longer present adjusted (non-GAAP) financial results adjusted to add revenues we did not receive due to royalty relief."[97]

III. Shortcomings in the Supply of Financial Information

As discussed, the generic financial disclosure provides retrospective information about the reporting company and enhances comparability to other reporters; non-GAAPs allow managers to exclude non-recurring items and therefore arguably, provide investors with more suitable information for estimating a firm's future performance.[98]

Nevertheless, existing literature shows the usefulness of public companies' financial metrics has been consistently deteriorating, as has investors' overall attention to public

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https://www.sec.gov/Archives/edgar/data/0000901491/000115752320000500/filename1.htm [https://perma.cc/8MJ9-F4UJ] (detailing loss of income correlating in time with founder's use of the n-word).

93. Papa John's Int'l, Inc., Annual Report (Form 10-K) 41 (Feb. 19, 2020).

94. Letter from Div. of Corp. Fin., Off. Trade & Servs., to Steven Coke, Interim Principal Fin. & Acct. Officer, Papa John's Int'l, Inc. (Mar. 16, 2020), https://www.sec.gov/Archives/edgar/data/0000901491/000000000020002324/filename1.pdf [https://perma.cc/A2RM-E7BU].

95. Letter from Steve Coke to Blaise Rhodes & Rufus Decker, *supra* note 92, at 2.

96. *Id.* at 3 ("To help further clarify the nature of the royalty reductions, beginning in our Form 10-Q for the quarter ended March 29, 2020, we will revise the footnoted description of the royalty relief in our 'Special charges' table as follows: 'Represents financial assistance provided to the North America system in the form of temporary royalty reductions that are above and beyond the level of franchise support the Company would incur in the ordinary course of its business.'").

97. Letter from Steve Coke, VP, Inv. Relations & Strategy (Interim Principal Fin. & Acct. Officer), Papa John's Int'l, Inc, to Blaise Rhodes & Rufus Decker, Div. of Corp. Fin., Off. Trade & Servs., SEC (May 1, 2020) at ¶ 2. https://www.sec.gov/Archives/edgar/data/0000901491/000115752320000633/filename1.htm [https://perma.cc/R6UD-MANE].

98. *But see* Mary E. Barth, Ian D. Gow & Daniel J. Taylor, *Why Do Pro Forma and Street Earnings Not Reflect Changes in GAAP? Evidence from SFAS 123R*, 17 Rev. Acct. Stud. 526 (2012) (reporting evidence consistent with managers opportunistically excluding stock-based compensation expenses to increase earnings, smooth earnings, and meet earnings benchmarks, without evidence that these exclusions result in an earnings measure that better predicts future firm performance).

companies' annual reports. Moreover, the proliferation[99] of non-GAAP metrics, included in press releases and elsewhere, raises a concern that opportunistic disclosures, effected according to managers' self-interests, have been taking over the financial disclosures.

A. The Diminishing Usefulness of the Generic Disclosure

In their 2016 thought-provoking book titled *The End of Accounting and the Path Forward for Investors and Managers*, Professor Baruch Lev of New York University and Professor Fang Gu of the University at Buffalo, generated a great deal of unrest within the accounting profession.[100] Lev and Gu's main argument was that financial reporting no longer provides investors with useful financial information. Among different analyses that support their argument, Lev and Gu examine the explanatory power GAAP financial metrics have on stock prices. They use a multivariable regression model to estimate the connection between a company's market value and its net income, book value, sales, and some other prominent generic metrics.[101] Then, for the years 1950 to 2013, they compare changes in the explanatory power of the model, that is, the model's adjusted coefficient of variations—represented by the regression models' R^2 value. Lev and Gu found a steady decline:[102] until the early 1980s, generic metrics' explanatory power was about 80%; meaning that until the early 1980s generic metrics explained 80% of the variation in traded companies' market value (stock price).[103] However, since then, the explanatory power of generic metrics started dropping to about 50%, where it presently holds;[104] meaning that today, generic metrics can explain only half of the variation in companies' market value. The other part of the variation in the stock price of traded companies has no connection to the information disclosed by the generic metrics.

Lev continued the crusade against existing "outdated and harming" accounting rules in another later study,[105] in which he argued that accounting's resistance to change seriously harms investors and the economy-at-large. Lev's argument focuses on the accounting treatment of intangibles, and he argues that the FASB standards—which require the immediate expensing of all expenditures on internally-generated intangibles such as "R&D [Research and Development], information technology, brand creation and enhancement, business designs and processes, employee training and other human resources development costs, artificial intelligence and 'big data' development and

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99. Jessica McKeon, *Long-Term Trends in Non-GAAP Disclosures: A Three-Year Overview*, AUDIT ANALYTICS (Oct. 10, 2018), https://blog.auditanalytics.com/long-term-trends-in-non-gaap-disclosures-a-three-year-overview [https://perma.cc/WL57-VKQE] (reporting that 97% of companies in the S&P 500 used non-GAAP financials in 2017, up from 59% in 1996, while the average number of different non-GAAP metrics used per filing rose from 2.35 to 7.45 over two decades).

100. *See, e.g.*, Arthur Radin & Thomas Selling, *The End of Accounting and the Path Forward*, CPA J. (Dec. 2016) ("Published this past June, Baruch Lev and Fang Gu's *The End of Accounting and the Path Forward for Investors and Managers* (Wiley) has generated a great deal of controversy within the profession.").

101. LEV & GU, *supra* note 17, at 38–39.

102. *Id.* at 31–32 (discussing how the model's explanatory power declined from over 90% during the 1950s to around 50% in recent years).

103. In their model, Lev and Gu included all U.S.-listed companies retrieved from two leading accounting databases (Compustat and CRSP). *Id.* at 39.

104. *Id.* at 31–32.

105. Baruch Lev, *Ending the Accounting-for-Intangibles Status Quo*, 28 EUR. ACCT. REV. 713, 734 (2019).

exploitation, customer acquisition costs, etc."[106]—need to be changed in order to make GAAP reporting relevant again.[107] Arguing that current generic disclosure results in investors not knowing "how much did the firm spend on employee training or IT, or whether the brand value is maintained or left to atrophy,"[108] Lev examines analysts' forecast dispersions[109] and shows that even sophisticated investors, such as financial analysts,[110] are unable to overcome the deteriorating usefulness of reported earnings.[111]

Further evidence of the poor performance of generic disclosures is seen in the findings of another critical study[112] which examines whether the promulgation of FASB standards and the standardized disclosure they lead to has "had a net beneficial impact on shareholder value."[113]

While standards-based disclosure can reduce managers' manipulations and thus benefit investors,[114] it may increase a firm's overall contracting costs[115] inter alia by requiring investors and other stakeholders to subsidize alternative information sources for any information other than that provided in the standard disclosure. Or, if such alternative sources are unavailable, they may need to invest in additional monitoring of the company or simply insist on higher returns to mitigate the additional risk. At the same time, companies' compliance costs might also increase as they are required to invest additional resources in procedures that assure compliance with the standards.[116]

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106. *Id.* at 713.

107. *Id.*

108. *Id.* at 715.

109. "Analysts forecast dispersions" is a measure of analysts' uncertainty or ambiguity regarding the future performance of the firms they follow. It can be calculated as the average dispersion (variability) of individual analysts' earnings forecasts around the consensus estimate for the company. Higher dispersion indicates a low level of information available to analysts, who are forced to increase discretionary-based estimations in their forecasts. *See generally* Orie E. Barron & Pamela S. Stuerke, *Dispersion in Analysts' Earnings Forecasts As a Measure of Uncertainty*, 13 J. ACCT., AUDITING & FIN. 245 (1998) (examining the extent to which dispersion reflects uncertainty about future economic performance).

110. *See* Eli Amir, Baruch Lev & Theodore Sougiannis, *Do Financial Analysts Get Intangibles?*, 12 EUR. ACCT. REV. 635, 654–57 (2003) (identifying the most serious deficiencies of analysts' information in (a) sectors with low-R&D intensity, and (b) among the sectors with high-R&D intensity, including "industrial machinery and computer equipment, in electrical equipment, and in transportation sectors . . . .").

111. In this study, Lev shows that over the past 40 years, despite the significant progress made in the technology and information sources available to analysts, forecast dispersion has been on the rise. BARUCH LEV, INTANGIBLES: MANAGEMENT, MEASUREMENT, AND REPORTING ch. 4 (2001). This indicates that alternative sources of information, other than the generic disclosure, such as non-GAAPs, do not compensate for the current deficiencies of the generic disclosure that leave statement users perplexed.

112. Urooj Khan et al., *Do the FASB's Standards Add Shareholder Value?*, 93 ACCT. REV. 209, 242 (2018).

113. *Id.* at 211.

114. *Id*. at 210 ("[S]upporters argue that the absence of standard setting presupposes a voluntary reporting regime that may engender greater costs for investors because firms may (1) choose nondisclosure as an option, (2) choose different ways to account for and disclose similar transactions, (3) incur substantial costs to ensure the credibility of the accounting system they choose, and (4) default to a race to the bottom in terms of reporting by manipulating or falsifying disclosures, as happens even with regulatory penalties in place.").

115. *Id.* at 215 ("[A]bsent agency problems, managers will choose investment and financing decisions in conjunction with the accounting and reporting policies in an optimal manner to maximize firm value. Thus, a rigid accounting or reporting policy change imposed by the standard setter is likely to increase deadweight costs of compliance . . . .").

116. *Id.*

By focusing on the stock market's reaction to the introduction of accounting standards and their effect on the value of traded companies affected by the new standards,[117] the overall value contribution of the generic disclosures they create can be estimated. If the benefit resulting from standardized disclosure outweighs the additional costs it brings about, the value of affected companies should go up with the release of additional standards. However, after examining the market's effect on 138 standards issued by the FASB from 1973 to 2009,[118] the study concludes by finding no support for "shareholder value creation by FASB standards."[119]

B. The Opportunistic Angle of Non-GAAP Disclosures

The decision whether and how to adjust GAAP measures and disclose additional non-GAAP metrics is left to managerial discretion.[120] In troubled times, managers might selectively disclose metrics that exclude negative events from income, and thereby inflate investors' expectations of future profitability.[121]

Returning to Papa John's non-GAAP reporting, as the company was facing troubling times,[122] not only did Papa John's exclude more than $19 million of waived royalties (mentioned above) from its 2019 non-GAAP metrics, but they also excluded $27.5 million in marketing investments, arguing they were not part of the company's "incremental marketing fund investments."[123]All-in-all, Papa John's converted a GAAP loss of more than $7 million into a non-GAAP net income of more than $37 million.[124] Nevertheless,

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117. Accordingly, if companies choose accounting practices that maximize firm value, imposing constraints on their choices will lead to declines in firm values. However, if market participants expect the standards to produce decision-relevant information that is deemed to be cost-beneficial, then standards will increase the value of firms affected. Khan et al., *supra* note 112; Eli Amir & Amir Ziv, *Economic Consequences of Alternative Adoption Rules for New Accounting Standards*, 14 CONTEMP. ACCT. RSCH. 543, 543 (1997) (predicting "that firms with 'favorable' information recognize the impact of the new standard earlier than the mandatory adoption date," hence, a positive market reaction is anticipated to early-adoption decisions).

118. Khan et al., *supra* note 112, at 218.

119. *Id.* at 242 ("While our evidence does not support equity shareholder value creation by FASB standards, we acknowledge that other stakeholders might benefit."); *see also*, Hadar Y. Jabotinsky & Barak Yarkoni, *The Network Effects of International Financial Regulation* 8–10 (Hebrew Univ. of Jerusalem Legal Stud. Research Paper, Series No. 19-04, 2018) (reviewing the debate on reaching an international regulatory standard).

120. *See, e.g.*, Ironworkers Local 580—Joint Funds v. Linn Energy, LLC, 29 F. Supp. 3d 400 (showing that non-GAAP metrics have no uniform definition).

121. *See, e.g.*, Arena, Catuogno & Moscariello, *supra* note 25, at 656 ("[A]s the decision to adjust GAAP measures is largely down to managerial discretion, managers might mislead investors by opportunistically excluding some negative events from income in order to artificially inflate investor expectations of future profitability.").

122. *See* Duster, *supra* note 92 (describing decline of Papa John's shares); Brian Sozzi, *Yahoo Finance Domino's Sees a Vulnerable Papa John's—but Here's How the Pizza Giant's Fighting Back*, YAHOO! FIN. (Dec. 31, 2019), https://finance.yahoo.com/news/dominos-ceo-sees-papa-johns-as-vulnerable-but-heres-how-the-pizza-giants-fighting-back-183215515.html [https://perma.cc/Z8TX-4W3V] (reporting that "[s]ome of Papa John's franchisees have closed stores as a result of the profit pressure, in turn hurting the parent company's financial statements.").

123. Letter from Steve Coke, VP, Inv. Relations & Strategy (Interim Principal Fin. & Acct. Officer), Papa John's Int'l, Inc., to Blaise Rhodes & Rufus Decker, Div. of Corp. Fin., Off. of Trade & Servs., SEC (April 13, 2020), https://www.sec.gov/Archives/edgar/data/0000901491/000115752320000500/filename1.htm [https://perma.cc/84KP-C9CS].

124. Papa John's Int'l, Inc., *supra* note 93, at 40.

following the SEC criticism mentioned above,[125] a few months after reporting, the company affirmed that it "will no longer present adjusted (non-GAAP) financial results excluding the marketing fund investments made by the Company. . . [or] add revenues [we] did not receive due to royalty relief."[126]

The concern that companies may use non-GAAPs to manipulate investors has caused researchers to question whether the disclosure of non-GAAPs reflects an "honest" attempt to provide better information regarding a company's core performance or, alternatively, are being used "opportunistically" by managers in order to cast performance in a better light, as compared to the picture emerging from the generic metrics, thus misleading investors[127] (in part, owing to investors' lack of appreciation of the lower cash flow implications of the adjustments).[128]

A recently published study, reviewing 85 articles published in leading accounting and financial journals on the use and effect of non-GAAPs, covering a time span of more than fifteen years of research, concluded that:

> The disclosure of pro forma indicators [non-GAAPs] has been extensively debated in the academic and professional arenas and has attracted the attention of scholars, regulators, and standard setters. Managers and other advocates of pro forma reporting argue that these disclosures supplement GAAP financial presentations, providing a clearer picture of companies' core earnings. On the other hand, regulators, policymakers and the financial press often allege that pro forma earnings are opportunistic attempts to mislead investors. Empirical evidence suggests that while many non-GAAP disclosures are informative, some may represent managers' attempts to portray an overly optimistic financial performance.[129]

The study further points to the opportunistic use of non-GAAPs and that "[e]mpirical evidence shows that managers disclose pro forma earnings to conceal losses, report positive earnings growth, meet or beat analysts' expectations, and increase investor perceptions of earning credibility."[130]

One way managers can use non-GAAP reporting to meet or beat analysts' expectations is by shifting expenses from core items[131]—e.g., cost of goods sold—to "special items."[132] Since special items are characterized as non-recurring, they are usually

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125. *See supra* note 94, at ¶ 1 (commenting on Papa John's disclosure filings).

126. Coke, *supra* note 97, at ¶ 1.

127. Arena, Catuogno & Moscariello, *supra* note 25, at 658.

128. *Id.* at 667; *see generally* Jan Bouwens, Ties de Kok & Arnt Verriest, *The Prevalence and Validity of EBITDA As a Performance Measure*, 25 COMPTABILITÉ-CONTRÔLE-AUDIT 55 (2019) (reporting that smaller, leveraged, capital intensive, less profitable firms and those with longer operating cycles opportunistically use EBITDA disclosures to paint a rosy picture of profitability and cash-generating ability).

129. Arena, Catuogno & Moscariello, *supra* note 25, at 678–79.

130. *Id.* at 658.

131. *See, e.g.*, Michael Baumker et al., *The Disclosure of Non-GAAP Earnings Following Regulation G: An Analysis of Transitory Gains*, 28 ACCT. HORIZONS 77, 77 (2014). Managers tend to report the existence of transitory gains but are less prone to adopt a non-GAAP metric that excludes them. The tendency is instead to exclude only transitory losses to improve performance and present a positive image of the firm, even in the post-Regulation G era. *Id.*

132. Arena, Catuogno & Moscariello, *supra* note 25, at 667. *Compare* Ervin L. Black et al., *Has the*

excluded from analysts' earnings definitions.[133]

One of the most common exclusions in pro-forma reporting (non-GAAPs) is stock-based compensation; nevertheless, when the informative contribution of the exclusion of stock-based compensation was empirically examined, studies found that "opportunism is the primary explanation for exclusion of the expense from pro forma earnings,"[134] and that "earnings that includes . . . stock-based compensation expense [have] significantly greater predictive ability for future earnings for firms whose pro forma earnings excludes . . . the expense . . . ."[135]

Moreover, in response to the introduction of clawback constraints on executive compensation,[136] "opportunistically motivated managers shift their focus from GAAP to non-GAAP earnings by increasing non-GAAP earnings disclosure frequency and decreasing the quality of non-GAAP exclusion."[137] It was also found that the tendency to disclose non-GAAP earnings in earnings announcements is strong in instances when CEOs sell holdings after the earnings announcement.[138]

C. Investors' Overall Low Attention to Annual Reports

The diminishing usefulness of the generic disclosure and the disturbing indications that accompanied non-GAAPs are joined by an overall low attention on the part of investors to company annual reports, as observed by the EDGAR system's log files.

Regulation of Non-GAAP Disclosures Influenced Managers' Use of Aggressive Earnings Exclusions?, 32 J. ACCT., AUDITING & FIN. 209 (discussing that, although the introduction of SOX and Regulation G achieved their intended purpose, a number of firms still appear to endorse aggressive non-GAAP exclusions) *with* David Bond et al., *Market Reaction to Non-GAAP Earnings Around SEC Regulation*, 13 J. CONTEMP. ACCT. & ECO. 193 (arguing that the use of non-GAAP reporting after Regulation G shows that non-GAAP exclusions are more transitory and therefore of higher quality); *see also* Dirk E. Black et al., *Non-GAAP Reporting: Evidence from Academia and Current Practice*, J. BUS. FIN. & ACCT. 259, 260 (indicating, *inter-alia*, that in calculating non-GAAP metrics managers have become increasingly likely to exclude "recurring" items).

133. *See generally* Sarah Elizabeth McVay, *Earnings Management Using Classification Shifting: An Examination of Core Earnings and Special Items*, 81 ACCT. REV. 501 (2006) (discussing that managers use the classification of items within the income statement to meet the analyst forecast earnings benchmark, as special items tend to be excluded from both pro forma and analyst earnings definitions); Arena, Catuogno & Moscariello, *supra* note 25, at 667.

134. Barth, Gow & Taylor, *supra* note 98, at 528.

135. *Id.* at 529.

136. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat.778 ("If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer . . . the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for . . . any bonus . . . received by that person from the issuer during the 12-month period following . . . filing . . . of the financial document embodying such financial reporting requirement . . . .").

137. Arena, Catuogno & Moscariello, *supra* note 25, at 674; *see generally* Hangsoo Kyung, Haykin Lee & Carol Marquadt, *The Effect of Voluntary Clawback Adoption on Non-GAAP Reporting*, 67 J. ACCT. & ECON. 175 (2019) (reporting that non-GAAP earnings disclosure frequency increases and non-GAAP exclusion quality decreases after clawback adoption, consistent with more opportunistic use of non-GAAP reporting).

138. Shiah-Hou Shin-Rong & Teng Yi-Yun, *The Informativeness of Non-GAAP Earnings After Regulation G?*, 18 FIN. RSCH. LETTERS 184, 185 (2016) (explaining that CEOs who sell their holdings after the earnings announcement are more likely to disclose non-GAAP earnings to gain personal benefit). *See also* Jessie M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 454, 458–60 (2008) (discussing managers' ability to choose when to sell incentives manipulation of the stock price before selling in order to maximize managers' gains at substantial cost to other shareholders).

U.S. public companies must electronically file their reports with the SEC through the Electronic Data Gathering and Retrieval system—known as the "EDGAR."[139] Investors and other stakeholders can access the EDGAR and download the reports. The system logs all internet search traffic, including each user's IP address and the company about which the user is requesting information.[140]

In order to "provide insight into the usage of publicly accessible EDGAR company filings,"[141] the SEC made some of EDGAR's log file datasets publicly available,[142] thus allowing research to measure investor attention to the reporting as reflected in the number of downloads per report.

A number of studies utilized the EDGAR log files (currently available for the period of February 2003 through June 2017) to report a surprisingly low number of downloads of U.S. annual reports from the EDGAR system.[143] The rosiest average number of downloads for a company's annual report is lower than 30 downloads per day in the days surrounding the release.[144]

The reported low level of public attention to companies' annual reports should not be surprising considering the diminishing usefulness of generic reporting. To wit, although companies enjoyed a booming economy in recent years, nearly half of all U.S. public companies reported losses in their generic statements. [145]

IV. ALTERNATIVE DISCLOSURES

Private parties overcome deficiencies and inadequacies in the generic financial disclosure by negotiating *ad-hoc* contractual provisions that better serve their contractual

139. *See Important Information About EDGAR*, SEC, https://www.sec.gov/edgar/searchedgar/aboutedgar.htm [https://perma.cc/9DBK-5ETR] (citing submission types of EDGAR filing system).

140. *Id.*

141. *EDGAR Log File Data Set*, SEC, https://www.sec.gov/dera/data/edgar-log-file-data-set.html [https://perma.cc/44PK-2BS4].

142. *Id.* (covering the SEC's Division of Economic and Risk Analysis (DERA) which has assembled information on internet search traffic for EDGAR filings through SEC.gov generally covering the period of February 14, 2003, through June 30, 2017).

143. *See* Zhen Caoa, Osman Kilic & Xuewu Wang, *Investor Attention, Divergence of Opinions, and Stock Returns*, 22 J. BEHAV. FIN. 265, 271 (2021) (reporting that "the number of downloads by human beings in a month averages around 574, 410, and 469, respectively, based on 3 different robot-screening approaches"); Xuechen Gao, Xuewu (Wesley) Wang & Zhipeng Yan, *Attention: Implied Volatility Spreads and Stock Returns*, 21 J. BEHAV. FIN. 385, 390 (2020) (noting "that the number of downloads by human beings in a month averages around 813, 580, and 664, respectively, based on the three robot-screening approaches"); Ruihai Li et al., *Sophisticated Investor Attention and Market Reaction to Earnings Announcements: Evidence From the SEC's EDGAR Log Files*, 20 J. BEHAV. FIN. 490, 490–503, 495 tbl.1 (2019) (reporting that "the number of downloads by human beings averages 16–23 per day"); Tim Loughran & Bill McDonald, *The Use of EDGAR Filings by Investors*, 18 J. BEHAV. FIN. 231, 232 (2017) (reporting that the average publicly traded firm has their annual report requested only 28.4 total times by investors immediately after the 10-K filing).

144. Loughran & McDonald, *supra* note 143.

145. Feng Gu, Baruch Lev & Chenqi Zhu, All Losses Are Not Alike: Real Versus Accounting-Driven Reported Losses 1 (Nov. 2021) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3847359 [https://perma.cc/BV47-SWQK] ("Nearly half of all U.S. public firms reported annual losses in 2019, and among innovative firms (high tech, science-based, and healthcare) the loss percentage was a staggering 70% . . . a very surprising and puzzling phenomenon in a decade-long booming economy.").

needs. Investors in public companies would benefit from having a similar option to affect and adjust disclosed financial metrics so that the disclosure better caters to their information needs and interests.

Before positing the proposed regime—allowing companies to adjust their reporting to better cater to investors' needs—this section briefly discusses some prominent examples of such alterations of the generic disclosure. Under certain circumstances discussed below, investors are expected to prefer them over the generic metrics currently provided.

A. Self-Generated Intangibles and R&D

As discussed above, one of the flaws researchers point to in the generic disclosure is the missing financial metric reflecting companies' self-generated intangibles, such as internal R&D breakthroughs, a distinguished workforce, trademarks, and patents.[146]

According to existing GAAP rules,[147] companies are required to expense spending on intangibles, such as R&D activities, as incurred, even if spending is expected to create income for the company in later periods.[148] Therefore, all monetary funds and other corporate resources invested in training employees, searching for new technologies, registration of patents, or promotion of a company's brand and products, are all expensed when they occur and are not capitalized as items expected to produce prospective benefits—i.e., they are not recorded as assets.

The immediate expensing of all spending on self-generated intangibles is said to discourage managers from direct spending on self-generating intangibles,[149] whereas it incentivizes indirect purchasing of intangibles through mergers and acquisitions (M&A) of other companies, whose self-generated intangibles then become recognized as assets due to the accounting treatment of M&A transactions by the purchasing company. To wit, the recently announced $12 billion Intuit-Mailchimp deal is questioned by many, seeing Intuit as purely a financial software company and Mailchimp as an email marketing firm and nothing more.[150] Nevertheless, from a financial reporting perspective, the transaction will result in Intuit, the purchaser, recognizing all of Mailchimp's self-generated intangibles as assets, thus stepping-up the value and financial recognition of Mailchimp's long-time investments in R&D, branding, client lists, etc.—all of which are self-generated intangibles

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146. *See* Lev, *supra* note 105 (describing the flaws in the generic financial disclosures).

147. *See* Gary Buesser, *Internally Generated Intangible Assets*, FIN. ACCT. STANDARD BD., https://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176173166185 [https://perma.cc/GQY4-2C4U] (stating that accounting standard setters have not required internally generated intangibles be reported on the balance sheet, believing the information would not be useful for investors and would be very costly for companies to prepare).

148. One exception is internally developed software. *See* Internal-Use Software, ACCT. STANDARDS CODIFICATION § 350–40 (FIN. ACCT. STANDARDS BD. 2018) (stating that in general, planning, design, and implementation costs, for internal-use software are capitalizable while ongoing maintenance costs are not).

149. *See* Lev, *supra* note 105, at 715 (discussing the adverse consequences of the accounting rules for intangibles); *see generally* Mirit Eyal-Cohen & Ana Santos Rutschman, *Promoting Vaccine Innovation*, 83 OHIO STATE L.J. 1004 (2022) (arguing that the current design of tax incentives drives research away from a vaccine and towards more profitable mainstream discoveries).

150. *See* Alex Wilhelm, *Intuit Confirms $12B Deal to Buy Mailchimp*, TECHCRUNCH (Sept. 13, 2021), https://techcrunch.com/2021/09/13/intuit-confirms-12b-deal-to-buy-mailchimp [https://perma.cc/VL4D-X8M6] (reporting that Intuit's motivation for acquiring Mailchimp was to advance their goal of becoming "the center of small business growth, and to disrupt the small business midmarket").

that were fully expensed in Mailchimp's past reports and will now be recognized as intangible assets of the merged company.

Overall, investors in companies that provide inadequate information due to non-reporting of self-generated intangibles—e.g., investors in pharmaceuticals engaged in innovative research on new drugs and breakthrough vaccinations[151]—or investors who want to remove any reporting-based obstacles for expanding internally generated research and investments in R&D, etc., or remove any reporting-based incentives for managers to prefer an expensive acquisition over investing in research,[152] would all be expected to advocate for the adoption of alternative metrics that will account for internally generated intangibles differently than the existing expensing under the generic disclosure.

Specifically, in regard to self-generated R&D achievements, investors are faced with a number of alternatives that allow for better information and incentives than provided by the generic disclosure. Investors could select relatively conservative alternatives that result in the capitalization of past spending as assets, as provided by the International Financial Reporting Standards (IFRS) R&D model or the Internal Revenue Code (IRC) § 174 model, or they can opt for a more progressive model that recognizes intangibles according to the fair value of the intangible—i.e., the price a third-party would theoretically be willing to pay in exchange for the intangible asset.

B. The IFRS Model for R&D

With respect to investing in internal research and development of new technologies and products, a ready alternative to GAAP-based disclosure is the IFRS model for R&D, currently implemented by European traded companies and those in other jurisdictions that adopted the IFRS.[153] According to the IFRS model, a company is required to distinguish between: (a) spending on research,[154] that is, spending made at a phase in which the company is searching for additional knowledge; thus, the phase may result in gaining new and useable scientific knowledge for the company or in not discovering any findings; and (b) spending made in the course of development,[155] that is, the application of research findings to the production of a new or substantially improved product before the start of commercial production.

Following the principal distinction between *research* and *development*, a company following the IFRS capitalizes development costs (but not research costs) once it can demonstrate technical feasibility of completing an intangible asset, the intention to use or

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151. *See* Paul M Healy, Stewart C. Meyers & Christopher D. Howe, *R&D Accounting and the Tradeoff Between Relevance and Objectivity*, 40 J. ACCT. RSCH. 677, 677 (2002) (arguing that a simple capitalization rule, similar to the successful-efforts method of capitalizing oil and gas exploration costs, provides a stronger relationship between accounting information and economic value than immediate expensing of R&D outlays or capitalizing the full cost of outlays).

152. *See also* Lev, *supra* note 105, at 729 ("[T]he expensing of intangibles seriously distorts widely used profitability indicators, like ROE and ROA, due to the absence of the intangibles' capital from their denominators.").

153. IFRS standards, promulgated by the International Accounting Standard Board, constitute the GAAP norms used by European companies and those of more than 100 jurisdictions around the world.

154. INTANGIBLE ASSETS, Int'l Fin. Reporting Standard no. 38, § 8 (INT'L ACCT. STANDARDS BD. 2016); *see also IFRS vs. US GAAP: R&D Costs*, KPMG, https://advisory.kpmg.us/articles/2017/ifrs-vs-us-gaap-rd-costs.html [https://perma.cc/L68C-RCFX] (comparing IFRS to U.S. GAAP).

155. INTANGIBLE ASSETS, Int'l Fin. Reporting Standard no. 38, § 8 (INT'L ACCT. STANDARDS BD. 2016).

sell the intangible asset with probable future economic benefits, and the ability to do so.[156]

C. IRC § 174 Model

While U.S. investors might advocate for the IFRS model and have U.S. companies capitalize all spending on development, similar to European companies, investors have another alternative present in the U.S. tax code. The IRC § 174 model allows a broader capitalization of spending than the IFRS model, while also subjecting it to higher scrutiny,[157] as the resulting report is also used in the company's U.S. tax return.

As a way to prevent over-deducting and reduced taxable income, the IRC model is conservative with respect to expensing taxpayers' spending on R&D (and intangibles, in general) and inclined toward capitalization of expenses (that is, recording the expenses as assets).[158] Thus, while the IFRS model requires a demonstration of probable future economic benefit in order to start capitalization, the IRC model requires capitalization (by denying any expensing) once uncertainty concerning "the development or improvement of a product" is eliminated.[159] Thus, capitalization begins even before an ability to use or sell the findings can be demonstrated or the probable generation of future economic benefits.

Thus, under the IRC § 174 model, once uncertainty regarding a positive outcome of a laboratory process is achieved, companies can stop expensing and start capitalizing R&D expenditures. So, for example, once a pharmaceutical discovers a new drug and starts preliminary safety tests (Phase 1), it can start capitalizing even though the drug has not yet arrived at a stage where marketability is probable.

Electing the IRC § 174 model would be especially appealing to investors who would like reported financial metrics to reflect some value for internally generated intangibles but are nevertheless concerned with managers' manipulation of reporting. The adoption of a tax model for the purpose of financial reporting subjects the reporting to increased monitoring. This increased monitoring thus reduces the ability of managers to manipulate the conditions to stop expensing and start capitalizing.[160]

D. Reporting at Fair Value

While the IFRS and the IRC § 174 models allow for a "conservative" capitalization of spending, investors can opt for a more "progressive" fair-value accounting method, such

156. *Id.* at § 57 (stipulating the conditions for the recognition of an intangible asset arising from the development phase of an internal project).

157. *See generally* Israel Klein, *Contemptuous Tax Reporting*, 2019 WIS. L. REV. 1161 (2019) (proposing measures for minimizing contemptuous tax reporting with respect to inflated or intentionally miscategorized R&D expenditures).

158. I.R.C. § 174 (2018); 26 C.F.R. § 1.174-2(a)(1) (2023) (allowing a taxpayer to "treat research or experimental expenditures which are paid or incurred by him during the taxable year . . . as expenses which are not chargeable to capital account" as long as "the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product"); Klein, *supra* note 157, at 1204.

159. 26 C.F.R. § 1.174-2(a)(1) (2023).

160. *See* Klein, *supra* note 157, at 1161 (proposing to link managers' interpretations used in tax reporting to reports for investors, thereby enhancing scrutiny over managers' contemptuous interpretations); Israel Klein, Contemptuous Positions 20–30 (Sept. 10, 2020), (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3688906 [https://perma.cc/GM6P-D26C] (discussing managers' reporting of tax positions that do not correspond to the tax code).

as the GAAP's acquisition method, originally implemented in the reporting of M&A's financial outcomes, which thus reports internally-generated intangibles at their fair value.[161]

When an enterprise obtains control of another enterprise ("target"),[162] generally through an M&A transaction, the transaction's outcomes are accounted using an "acquisition method."[163] An essential part of the acquisition method is the recognition of all assets acquired and liabilities assumed, including any of the target's internally-generated intangibles being acquired by the enterprise.[164] Specifically, GAAP requires the acquiring enterprise to recognize every intangible item expected to contribute benefit to the entity as long as the item (a) arises from contractual or other legal rights;[165] or (b) is capable of being separated or divided from the acquired business and sold, transferred, licensed, rented, or exchanged.[166]

Although not all benefiting intangibles meet either of the two criteria—e.g., a business's relationship with unidentifiable "walk-up" customers do not arise from a contractual right and cannot be separated from the acquired business[167]—all other intangibles which fulfill one of the two conditions are recognized as assets. Examples of such assets include: relationships with repeat customers; customer lists; patented technology as well as unpatented processes related to trademarks; internet domain names; noncompetition agreements; and many other internally-generated intangibles that were denied recognition by GAAP for the generating entity itself but are recognized by the acquiring enterprise.[168]

With limited exceptions, all acquired assets and assumed liabilities are measured at fair value under the acquisition method. Moreover, following the M&A transaction, if the target enterprise continues to report separately—i.e., continues to report its 10-K/10-Q—it can opt for a "pushdown accounting" treatment,[169] under which it continues to report on

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161. *See also* S. Taylor Hood, *Fair-Value Accounting: Maintain, Reform, or Eradicate*, 38 CAP. U. L. REV. 857, 858 (2010) (examining the legal doctrine and application of fair-value accounting).

162. *See* Acct. Standards Codification § 805-10-25-1 (FIN. ACCT. STANDARDS BD. 2018) ("[a]n entity shall determine whether a transaction or other event is a business combination by applying the definition in this Subtopic, which requires that the assets acquired and liabilities assumed constitute a business.").

163. JOANNE M. FLOOD, WILEY GAAP 2020: INTERPRETATION AND APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES Ch. 48 (2020) (providing interpretive guidance on transactions accounted for under the acquisition method).

164. *Id.* ("The acquisition method requires that the actual cost of the acquisition be recognized, including any excess over the amounts allocable to the fair value of identifiable net assets, commonly known as goodwill.")

165. Acct. Standards Codification § 805-20-55-2 (FIN. ACCT. STANDARDS BD. 2018).

166. Acct. Standards Codification § 805-20-55-5 (FIN. ACCT. STANDARDS BD. 2018).

167. *See, e.g.*, *Intangible Assets: Identifiable Criteria (Business Combinations)*, PWC, (Sept. 30, 2020) https://viewpoint.pwc.com/dt/us/en/pwc/accounting_guides/business_combination/business_combination__28_US/chapter_4_intangible_US/42_intangible_assets_US.html#pwc-topic.dita_1358041804212839-tOp-S [https://perma.cc/9CKJ-EWQ9] (discussing certain relationships that would fail to meet either of the two criteria).

168. *See, e.g.*, *Types of Identifiable Intangible Assets*, PWC, (Sept. 30, 2020) https://viewpoint.pwc.com/dt/us/en/pwc/accounting_guides/business_combination/business_combination__28_US/chapter_4_intangible_US/43_types_of_identifi_US.html#pwc-topic.dita_1302041904212840-tOp-S [https://perma.cc/3LWE-HKHB] (discussing certain relationships that would fail to meet either of the two criteria).

169. *See, e.g.*, *Pushdown Accounting*, PWC, (Sept. 30, 2020), https://viewpoint.pwc.com/dt/us/en/pwc/accounting_guides/business_combination/business_combination__28_US/chapter_10_other_bus.html [https://perma.cc/SX9M-J95E].

its own, but the assets and their value are now reported based on their assessed values for the purpose of reporting the M&A transaction's outcomes under the acquisition method.

Thus, investors that are interested in having the fair value of their company's self-generated intangibles reported should not be required to passively wait until a change in control occurs and the new enterprise elects push-down accounting for the company. Rather, investors should actively advocate for the reporting of the company's intangibles as if the company were acquired and implemented pushdown accounting.

V. VOTING ON REPORTING

There is little need for shareholder adjustments to the financial metrics reported by companies if the generic disclosure does a good job of providing the information they require or of promoting their interests.[170] However, as discussed above, there is substantial evidence that the generic disclosure does a poor job of catering to investors' needs.

Therefore, this Article proposes that companies should be permitted to provide investors with alternative financial metrics to those provided under the generic disclosure. The alternative metrics would be proposed by either the management or the shareholders and, if approved by a majority of shareholders in a vote at the general meeting, they would apply to prospective reporting.

A. Management's Proposals

As discussed above, the existing SEC interpretation of Regulation G prohibits management from reporting alternative metrics, such as expenses that exclude developing expenditures following the IFRS/IRC § 174 models, even as non-GAAPs. The SEC argues that these alternative metrics would substitute generic metrics and would thus be misleading. Presumably, if the SEC's interpretation is repealed, managers could provide non-GAAPs which will better cater to investors' needs and interests—e.g., report internally-generated intangibles at fair value.

However, as previously mentioned, when providing alternative information through non-GAAPs, managers might have different intentions—e.g., beating analysts' expectations; as such, management might misuse the removal of constraints over the reporting of non-GAAPs to the extent that it misleads investors. More importantly, non-GAAPs are reported outside of the financial statements (including in press releases) and, hence, are not audited by the company's independent auditor. If managers were allowed to report alternative metrics as non-GAAP, the metrics would not be subject to any *a priori* external scrutiny.

Thus, instead of repealing existing Regulation G's limitations on non-GAAPs, this Article suggests that companies report the alternative metrics within the audited statements and do so by substituting generic metrics.

At the same time, a new shareholder vote would be inaugurated—"Voting on Reporting"—in which shareholders will be asked to approve proposed changes to reported metrics. As such, the voting will subject managerial discretion in providing alternative

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170. *See also* Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1339–41 (1999) (partaking in the 1990s debate over mandatory disclosure versus issuer choice).

metrics to shareholder approval and, at the same time, constitute a "safe harbor" for those changes and not be considered misleading.

Changes approved by shareholder vote would be implemented in the company's prospective reporting, would substitute generic metrics reported within the statements rather than being reported as unaudited non-GAAPs, and, as such, would be subject to an audit by the company's independent auditor.

Furthermore, once companies can report new metrics within the statements, the opportunistic use of non-GAAP is expected to decline or become more apparent to financial statement users. Companies will no longer find justifications for *ad-hoc* disclosures of non-GAAPs when audited, in-statement metrics can be adapted—after gaining the consent of shareholders—and thus provide investors with the information they need, including data to better estimate the company's future performance.

B. Shareholder Proposals

Along with proposals initiated by management, independent shareholder proposals are crucial to making annual reports popular and useful again.[171] Accordingly, when voting on reporting, shareholders would also be asked to vote on changes proposed by shareholders.

Nevertheless, sometimes management decisions regarding metrics provided, though they may initially seem less informative, are such that benefit the company in the long run.[172] For example, before Apple Watch went on sale, Apple announced that it would not be disclosing Apple Watch revenue (or unit sales); rather, it would report Apple Watch financials together with a variety of other products including iPod, Beats, Apple TV, and other accessories.[173] The reasoning, according to Apple management, was that the lack of disclosure regarding the product's performance will make it difficult for the company's competitors to assess Apple Watch demand and market trends, and thus serve the company's interest in keeping its competitors in the dark.[174] Apple's decision to withhold information on Apple Watch sales is still a controversial one, and a decision that is not

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171. *See also* Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2004) (noting that shareholders' power to replace directors is insufficient to secure the adoption of value-increasing governance arrangements that management disfavors); Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006) (advocating for further shareholder power to make rules-of-the-game changes); Lisa M. Fairfax, *Shareholder Democracy on Trial: International Perspective on the Effectiveness of Increased Shareholder Power*, 3 VA. L. & BUS. REV. 1, 21–32 (2008) (discussing shareholder democracy through the lens of international experiences).

172. *See also*, Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554, 1615–19 (2015) (describing the factors affecting whether managers serving long-term shareholders will generate more or less long-term economic value than managers serving short-term shareholders); Bebchuk, *The Case for Increasing Shareholder Power*, *supra* note 171, at 892–93.

173. *Apple Inc. Q4 2014 Results Earnings Conference Call Transcript*, SEEKING ALPHA (Oct. 20, 2014), https://seekingalpha.com/article/2576865-apples-aapl-ceo-tim-cook-on-q4-2014-results-earnings-call-transcript [https://perma.cc/34N4-H44R] ("[In addition,] we [Apple] will begin to include iPod sales in the other products category and we will also reflect sales of Apple Watch in this line item once it begins shipping in early calendar 2015.").

174. *Id.* ("I [Tim Cook] am not very anxious in reporting a lot of numbers on Apple Watch because of the—and giving a lot of detail on it because our competitors are looking for it and so aggregating it is helpful from that point of view as well."); *see, e.g.*, Apple Inc., Quarterly Report (Form 10-Q) (July 22, 2015) (lacking clear indications and reporting on the Apple Watch product line or any relative successes and shortcomings).

foolproof.[175] By following shipment information for Apple Watch units, analysts are nevertheless able to estimate that Apple Watch consistently dominates the smart watch market and in the fourth quarter of 2020, accounted for 40% of smart watch shipments (while its next closest competitor accounted for only 10% of the market).[176]

Subjecting a shareholder proposal to a vote at a general meeting might not preclude proposals with potentially damaging disclosures. For example, some active investors focused on short-term returns might advocate disclosure with immediate benefits at an even higher expense to the company's long-term interests. Furthermore, hedge funds holding a short position on the company's stocks and expecting to benefit from a decline in the company's share prices may actively advocate and vote for a proposal that results in damaging reporting while benefitting their own interests.

Hence, in order to assure a shareholder proposal does not harm the company's interests—and therefore, shareholders at large—this Article suggests that, before inclusion in the designated shareholder vote on reporting, the proposal be regulated just as all other shareholder proposals are—i.e., according to Rule 14a-8 (discussed below). As such, before being brought to a vote, a shareholder proposal will be scrutinized by management that will also have the power to exclude a proposal, all in accordance with the conditions and procedures set in Rule 14a-8.

C. Rule 14a-8

Rule 14a-8 of the Securities Exchange Act of 1934[177] provides an opportunity for a shareholder owning a certain amount of a company's securities to submit a proposal for inclusion in the company's proxy materials.[178]

Although the rule cannot provide for a shareholder seeking financial disclosure that substitutes for the generic disclosure, it can be useful for interest groups seeking additional information about environmental and political issues. For example, over the last few years activist shareholder groups advocating gender and racial pay equity—e.g., Arjuna Capital, LLC—have been submitting proposals for the disclosure of pay gap data.[179] Such

175. *See, e.g.*, Shara Tibken, *What Apple isn't Telling us Anymore*, CNET (Oct. 21, 2014), https://www.cnet.com/tech/mobile/what-apple-isnt-telling-us-anymore [https://perma.cc/MFQ6-NQXU]; Neil Cybart, *It's Time for Apple to Disclose Apple Watch Sales*, ABOVE AVALON (Nov. 14, 2017), https://www.aboveavalon.com/notes/2017/11/14/its-time-for-apple-to-disclose-apple-watch-sales [https://perma.cc/5KUH-PZWC].

176. Sujeong Lim, *Global Smartwatch Shipments Rise 1.5% in 2020; Price Trends Going Premium*, COUNTERPOINT (Mar. 5, 2021), https://www.counterpointresearch.com/global-smartwatch-shipments-rise-1-5-2020-price-trends-going-premium [https://perma.cc/26TV-KMLC].

177. *See also* Virginia Harper Ho, *From Public Policy to Materiality: Non-Financial Reporting, Shareholder Engagement, and Rule 14a-8's Ordinary Business Exception*, 76 WASH. & LEE L. REV. 1231, 1245–52 (2019) (reviewing the legislative history of the rule).

178. *See also* Jill E. Fisch, *Purpose Proposals*, 1 U. CHI. BUS. L. REV. 113 (2022) (discussing Rule 14a-8 as a mechanism for shareholder debate over corporate purpose); Adi Libson, *Taking Shareholders' Social Preferences Seriously: Confronting a New Agency Problem*, 9 U.C. IRVINE L. REV. 699, 714–18 (2019) (describing shareholder proposals as a mechanism for enabling stockholders to voice their social preferences).

179. *See* John Ellerman et al., *The Current Landscape in Executive Compensation As Reflected in the 2022 Proxy Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 24, 2022), https://corpgov.law.harvard.edu/2022/10/24/the-current-landscape-in-executive-compensation-as-reflected-in-the-2022-proxy-

proposals usually focus on having the company disclose the mean pay gap figures, representing the average delta between what female and male employees earn, and global unadjusted median pay gap metrics for both women and minorities.[180]

However, before a shareholder proposal can be included in the proxy materials and brought to a vote, it must comply with certain procedural requirements[181] and may not fall within one of the substantive bases that allow its exclusion by management.[182] Among the bases for exclusion are, the proposal is contrary to any of the SEC's proxy rules;[183] relates to a personal claim or grievance against the company or any other person;[184] relates to operations which account for less than five percent of the company's total assets, net earnings or gross sales;[185] relates to director nominations or dividends distribution;[186] or deals with the company's ordinary business operations.[187]

At present, although Rule 14a-8 is used by shareholders seeking additional disclosure, in light of Regulation G prohibitions discussed above, a proposal submitted under the Rule cannot overcome the deficiencies and inadequacies in the generic financial disclosure since any shareholder proposal for altering financial metrics would be excluded on the basis of "violation of law":[188] a proposal for reporting a metric that would replace a generic metric and, if implemented, would cause the company to violate Regulation G.

However, once companies are allowed to provide investors with financial metrics that are an alternative to those provided under the generic disclosure, any such shareholder proposal for adjusting financial metrics would be examined by company management and be excluded only if it falls within one of the substantive bases—e.g., the proposal deals with the company's ordinary business operations. So, for example, were a shareholder to have proposed to Apple that it disclose Apple Watch metrics, in opposition to management's belief that opacity is required and is part of the company's operational strategy, management would exclude the proposal.

Nevertheless, it should be mentioned that under Rule 14a-8, once management decides to exclude a shareholder proposal, it must file its reasons with the SEC[189] and the

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season/#:~:text=These%20proposals%20generally%20have%20called%20for%20increased%20disclosure,audits%204%20Report%20on%20diversity%2C%20equity%2C%20and%20inclusion [https://perma.cc/9U9W-BN6M] (discussing the recent trends in proxy battles, including those debates over pay gap concerns).

180. *See, e.g.*, Mike Delikat, Jessica R. L. James & Alex Mitchell, *An Update on Pay Gap Shareholder Proposals*, ORRICK HERRINGTON & SUTCLIFFE LLP (July 29, 2019), https://blogs.orrick.com/equalpaypulse/2019/07/29/an-update-on-pay-gap-shareholder-proposals [https://perma.cc/4SLF-ZTVV] (updating on pay gap proposals).

181. *See* C.F.R 17 § 240.14a-8 (2023) (explaining the procedural requirements in order to have a shareholder proposal included on a company's proxy card).

182. C.F.R 17 § 240.14a-8(i) (2023) (discussing bases a company may rely on to exclude a proposal).

183. C.F.R 17 § 240.14a-8(i)(3) (2023).

184. C.F.R 17 § 240.14a-8(i)(4) (2023).

185. C.F.R 17 § 240.14a-8(i)(5) (2023).

186. C.F.R 17 § 240.14a-8(i)(8) (2023); *see also* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 676, 707–09 (2007) (arguing that exclusions should not be understood as permitting the exclusion of "rules-of-the-game" provisions).

187. C.F.R 17 § 240.14a-8(i)(7) (2023); *see also* Libson, *supra* note 178178, at 716–18 (discussing uncertainty generated by the ordinary business criterion).

188. C.F.R 17 § 240.14a-8(i)(2) (2023) ("If the proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject.").

189. C.F.R 17 § 240.14a-8(j) (2023) ("If the company intends to exclude a proposal from its proxy materials, it must file its reasons with the Commission . . . .").

shareholder has the right to comment and object to the exclusion.[190] The SEC may object to the exclusion and compel the company to include the proposal in the voting.

Overall, the ability of management to exclude shareholder proposals under the Rule's exclusion bases, taken together with SEC oversight, is expected to meet the need for checks and balances of metrics changes initiated by shareholder proposals.

D. Proxy Materials & Notes

Information about proposals made by management or by shareholders (as long as it is not excluded under Rule 14a-8) would be circulated by the company to all shareholders as part of all other proxy materials sent to shareholders before the annual meeting.

In order for shareholders to have a thorough understanding of the proposed change, this Article suggests that every proposed change be accompanied by a detailed explanation of the proposal including a pro forma calculation demonstrating how the change would have affected last year's reporting had it been implemented at that time.

Once approved, the same explanation provided to shareholders before voting will also be reported in the notes to the financial statements (the notes). One of the main objectives of the notes is to inform users of the detailed assumptions made by the management when preparing the company financial statement. As such, the notes are essential for understanding the statements and the information disclosed by their metrics. Accordingly, detailed changes to reported metrics must be disclosed in the notes. Thus, for every change in metrics approved, the notes to the statements will include a detailed explanation similar to the ones included in the original proposal, thus also allowing future statement users to better understand the reported metrics.

VI. COMPARABILITY[191]

While allowing companies to provide investors with alternative financial metrics to those in the generic disclosure is expected to increase the usefulness of the annual reports and financial statements as well as better cater to investors' information needs and interests, it, arguably, has one prominent drawback: it limits the ability to compare one company's metrics to those of others.[192]

For example, if Pfizer starts reporting its Covid-19 vaccine's patents using fair value assessment while its main competitor, Moderna, keeps expensing all its vaccine-related expenditures, the two pharmaceuticals' financial metrics will not be comparable and thus will not serve investors' interests in understanding the relative performance of each company, and we're back to square one.

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190. C.F.R 17 § 240.14a-8(k) (2023) (deciding that a shareholder may submit a response to a proposal to the SEC).

191. *See* QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION, Statement of Fin. Acct. Concepts No. 8, ¶ QC21 (FIN. ACCT. STANDARDS BD. 2010) ("Comparability is the qualitative characteristic that enables users to identify similarities in, and differences among, items. Unlike the other qualitative characteristics, comparability does not relate to a single item. A comparison requires at least two items.").

192. *See, e.g.*, *id.* at ¶ QC25 ("Although a single economic phenomenon can be faithfully represented in multiple ways, permitting alternative accounting methods for the same economic phenomenon diminishes comparability."); *see also* Jabotinsky & Yarkoni, *supra* note 119, at 10 (highlighting the benefits of a global financial regulatory standard).

The importance of comparability and the role it fills in financial discourse should not be taken lightly. Since the inception of the modern accounting framework and the standards established by the FASB, comparison, together with other important foundations (postulates) of financial accounting,[193] has been emphasized as the objective that should guide the development of accounting standards used to report financial information.[194]

Ideally, the costs associated with facilitating comparability should rest on those who benefit from it. In this respect, comparability's merits are trifold: it benefits a company's current investors who compare company metrics with those of other companies, thus gaining a better understanding of the company's relative performance; it benefits investors other than those investing in the company—e.g., those invested in other companies, including the company's competitors—who compare the company's reports with those of other companies they are invested in; and lastly, it benefits the capital market as a whole, when *inter alia* potential investors can compare different investment alternatives and thus allocate capital between firms based on their relative financial performance.

Presumably, allowing companies to use alternative reporting limits the ability to compare one company's metrics to those of others. Nevertheless, as explained below, subjecting the change in financial metrics to shareholder approval as well as allowing shareholders (and managers) to initiate changes in reported metrics, overcome most of the potential harm that may result from reduced comparability. Moreover, in cases where alternative disclosure better serve company shareholders, the proposed regime shifts the burden and costs associated with facilitating comparability from the company's shareholders to those other stakeholders who benefit from it.

A. Benefits to Company Investors

The ability to compare metrics reported by one company to other companies' reports serves those who gain a better understanding of the company's financial status—i.e., the company's current investors. Arguably, if the company's disclosed metrics are changed, then company investors will lose this ability or, at the least, will face higher analysis costs when assessing the company's performance relative to other companies.

However, subjecting proposed changes to shareholder approval results in the company's investors having control over the application of changes. As such, those whom comparability serves are the ones who possess the power to decide whether to maintain comparability or exchange it for the purpose of gaining other financial insights. Legitimately, they might find information provided by alternative metrics more valuable than that gained by the ability to compare generic metrics among companies.

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193. *See* QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION, *supra* note 191, at ¶ QC4–18 (discussing the qualitative characteristics of useful financial information).

194. *See* AM. INST. CERTIFIED PUB. ACCTS., OBJECTIVES OF FINANCIAL STATEMENTS: REPORT OF THE STUDY GROUP ON THE OBJECTIVES OF FINANCIAL STATEMENTS 57–60 (1973) (listing six qualitative characteristics, in addition to comparability, that should be included in financial statements and reports); Letter from Richard M. Cyert et al., Study Group Members, to LeRoy Layton, President, AM. INST. CERTIFIED PUB. ACCTS. (Oct. 1973), https://files.eric.ed.gov/fulltext/ED089583.pdf [https://perma.cc/HH7K-JAAR] ("[T]he Study Group does express the desire that the FASB will view these report findings as a major effort in the establishment of objectives, to be used as guidelines in judging and testing proposed accounting standards.").

B. Benefits to Other Investors

In addition to the company's investors, comparability also serves those interested in the company's financials as a benchmark for evaluating other companies (other investors). Among other things, investors in the company's competitors may use the company's metrics to evaluate the performance of companies in which they are invested. Arguably, by allowing a company's shareholders to report alternative metrics, the ability of other investors to compare various companies is harmed.

However, under the proposed regime, investors in other companies can act similarly and change their companies' reporting to fit the updated metrics until a reasonable symmetry is reached.

In this respect, a prominent change brought about by the proposed regime is in the interest of the party that bears the costs of facilitating the ability to compare reports. Under the existing disclosure regime, where only reporting of generic metrics is allowed, constituting comparability is always at the expense of company investors. Even if company investors are in need of information other than that provided by the generic metrics, they must maintain the generic metrics and pay the price associated with having suboptimal financial disclosure that does not provide for their needs, or bear the costs of additional alternative analysis or additional disclosures of company performance (if such is possible).[195]

In contrast, under the proposed regime, once company investors can exchange generic metrics for alternative metrics, gaining comparability is at the expense of the benefiting party: If company investors benefit more from comparability, they can decide to maintain it and bear the costs of the presumably suboptimal disclosure of generic metrics. In the event they decide on an alternative disclosure and exchange comparability for the reporting of alternative metrics, then those other investors (in other companies) who seek to benefit from comparability become those now required to bear the cost of regaining the ability to compare reports—by changing their companies' metrics.

The same arguments apply to potential investors. Since potential investors lack the ability to directly affect the reporting of companies and to facilitate comparability, allowing companies to use alternate metrics will compel those interested in comparing companies in which they are not yet invested but are expected to benefit from additional information generated by the comparison to invest in additional analysis of the companies, *inter alia*, by using the explanations provided by those companies in their notes to the financial statements. Thus, if existing investors are better served by alternative metrics than generic ones and accordingly change their companies' metrics, potential investors will then be required to bear the costs associated with facilitating comparison between companies that opt for alternative reports that better serve their existing investors.

C. A Bottom-Up Contribution to Accounting Standards-Setting

As a last remark, another contribution to the reporting environment that would be made by the new regime is worth mentioning. In addition to the reconstitution of the costs associated with facilitating comparability upon those who benefit from it the most (or seek it), allowing companies to adjust their reporting is expected, at least with reference to some

195. *See supra* Part II.D (discussing Regulation G).

metrics such as those associated with the reporting of R&D, to result in a chain reaction where one company alters its metrics to better meet its investors needs and then other companies from the same sector follow. This, then, creates a bottom-up process that affects GAAP as implemented *de facto* by reporting entities. Under the current financial disclosure regime, accounting standards (the GAAP) are established by the FASB with SEC oversight.[196] Overall, the current accounting standards-setting process is a top-down process where professional boards decide on standards that market firms apply.

Although companies can comment on FASB standards, provide proposals for changes, and lobby,[197] at the end of the day, they must comply with the standards decided for them by the accounting standards-setter (the FASB).

Nevertheless, allowing companies to amend their financial disclosures and provide novel metrics that are then followed by other companies breaks the top-down exclusivity and allows a parallel bottom-up setting of accounting standards, which is expected to improve the overall accounting standards-setting process.

VII. Conclusion

The existing financial disclosure regime, as established in the Securities Acts and SEC regulation, limits companies to the reporting of generic metrics. These metrics are estimated according to accounting standards (GAAP) promulgated by the FASB for the purpose of creating a homogenous—one size fits all—reporting by market firms. Although a company's management can decide to disclose additional non-GAAP metrics that exclude non-recurring events, etc., these metrics are not audited by the company's CPA and are, by regulation, prohibited from substituting individually tailored revenue recognition and measurement methods for those of the generic GAAP metrics.

Overall, the existing regime provides investors with generic GAAP metrics promulgated by the FASB and limited non-GAAPs decided on by managers. Meanwhile, investors cannot cater to the disclosed metrics for their company-specific information needs—in fact, they are unable to affect the metrics at all—and they remain exposed to the opportunistic use of non-GAAP reporting by management.

Recent litigation draws attention to these deficiencies and how private parties overcome them by negotiating *ad-hoc* alternative novel financial metrics that are then implemented in the parties' contractual arrangement. Executives of publicly traded firms act alike: when negotiating their pay packages, they use tailor-made financial indicators in compensation schemes.[198]

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196. *See* Klein, *supra* note 41, at 600–01 (discussing how the AICPA contributes to the process of accounting standards-setting by assisting the FASB directly and by promulgating guides covering contemporary or niche issues not included in the official FASB or SEC releases).

197. *Cf.* Ross Watts & Jerold Zimmerman, *Towards a Positive Theory of the Determination of Accounting Standards*, 53 ACCT. REV. 112, 112 (1978) (exploring factors that affect corporate lobbying on accounting standards).

198. *See, e.g.*, Asher Curtis, Valerie Li & Paige H. Patrick, *The Use of Adjusted Earnings in Performance Evaluation*, 26 REV. ACCT. STUD. 1290 (2021) (documenting widespread adoption of adjustments to earnings for performance evaluation; 84% of the study's sample of S&P 1500 firms used adjusted earnings for bonus compensation); Michael Rapoport, *Some Companies Alter the Bonus Playbook: More U.S. Firms Use Nonstandard Accounting Measures to Figure Executive Payouts*, Wall St. J. (Feb. 26, 2014),

In contrast, investors in publicly traded companies do not enjoy similar privileges: they cannot negotiate their financial disclosure and remain bound to a flawed, generic financial disclosure regime.

Unsurprisingly, the usefulness of public companies' annual reports and financial measures disclosed within has been consistently deteriorating. In the past, generic metrics, such as a company's book value or operating income, provided a strong explanation for stock prices and allowed for an efficient market-based allocation of capital among traded firms. Disclosed metrics no longer provide a strong correlation with stock prices.

In an effort to make annual reports and regulated financial statements relevant again, this Article proposes allowing companies to adjust their reporting to better cater to investor needs. Specifically, it suggests that companies should be allowed to use novel alternative financial metrics that are based on tailored revenue recognition and measurement methods that will substitute for those of the generic disclosure (and the GAAP).

Nevertheless, reporting using new financial metrics would be subject to a new shareholder vote—"Voting on Reporting"—in which shareholders would be asked to approve proposed changes to reported metrics. This would ensure that changes benefit investors and do not serve managers' self-interests—e.g., achieving target metrics in executive bonus schemes—or be used to offset unflattering generic numbers and mislead investors.

Some might argue that the new regime harms reporting comparability. However, rather than eliminating comparability, the proposed regime suggests a change in the identity of the party that bears the costs of facilitating the ability to compare reports. Under the existing disclosure regime, where only reporting of generic metrics is allowed, investors in the reporting company bear the costs of comparability. Even if they are in need of other information than what is provided by the generic metrics, they must maintain the generic metrics and bear the costs associated with having suboptimal financial disclosure. By allowing investors to vote on changes to the reporting, they can opt for altered metrics that serve them better than the ability to compare generic metrics among companies.

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https://www.wsj.com/articles/no-headline-available-1393364796 [https://perma.cc/4X93-6E2F] (reporting that 542 companies used metrics that differ from U.S. accounting standards to determine executive compensation in 2013, more than double the 249 companies that did so in 2009); Melissa Burek & Michael Bonner, *Annual Incentive Plans – Payouts and Performance Alignment*, COMP. ADVISORY PARTNERS (Dec. 3, 2020), https://www.capartners.com/cap-thinking/annual-incentive-plans-payouts-and-performance-alignment-2020 [https://perma.cc/ND5J-L9ED] (reporting on the use of operating income metrics, including EBIT, EBITDA, and Pre-tax Income, as well as other strategic and nonfinancial metrics that incentivize behaviors that contribute to long-term success not captured by short-term financial performance); MERIDIAN, 2020 EXECUTIVE COMPENSATION TRENDS AND DEVELOPMENTS SURVEY 21 (2021) (reporting EBIT/EBITDA to be the most common annual incentive financial performance metrics, based on the responses from 108 companies) https://www.meridiancp.com/wp-content/uploads/Meridian-2020-Trends-and-Developments-Survey-Final.pdf [https://perma.cc/V7KZ-FGGZ]; *see also* Hangsoo Kyung, Jeff Ng & Yong George Yang, *Does the Use of Non-GAAP Earnings in Compensation Contracts Lead to Excessive CEO Compensation? Efficient Contracting Versus Managerial Power*, 48 J. BUS. FIN. & ACCT. 841 (2020) (suggesting that, on average, the use of non-GAAP performance metrics in executive compensation contracts reflects boards' efforts to retain talented CEOs and mitigate agency problems); James Potepa, *The Treatment of Special Items in Determining CEO Cash Compensation*, 25 REV. ACCT. STUD. 558 (2020) (discussing why compensation committees are more likely to include a component of income that can predict future earnings in their CEO bonus performance measures); Boris Groysberg et al., *Compensation Packages That Actually Drive Performance*, HARV. BUS. REV. (Jan.–Feb. 2021), https://hbr.org/2021/01/compensation-packages-that-actually-drive-performance [https://perma.cc/JCK6-KA4E] (describing how firms approach executive compensation).

Meanwhile, others who benefit from comparing their investments to the company's financial results now have to bear the cost of facilitating comparability (either by additional analysis or by advocating similar changes to those made by the company in their investments).

Moreover, beyond the immediate improvement in the usefulness of the regulated and audited financial information disclosed by companies, the proposed regime also facilitates a bottom-up process of accounting standards setting led by market firms that parallels the existing FASB's top-down process. As such, the new regime proposed in this Article is not only expected to make financial reporting more useful, but it is also expected to improve the process of setting accounting standards.