Non-GAAP Reporting following Debt Covenant Violations

Theodore E. Christensen (Brigham Young University)

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We examine the influence of creditor and investor scrutiny on firms' voluntary disclosure of non-GAAP earnings. We find that the likelihood of non-GAAP reporting declines sharply following a debt covenant violation. If, however, managers elect to provide a non-GAAP earnings disclosure following a covenant violation, we find that they report the non-GAAP figure less aggressively. Specifically, when firms disclose non-GAAP earnings in the quarter following a covenant violation, (1) they place it less prominently within the press release, (2) it is less likely to meet or beat analysts' forecasts when the GAAP number falls short, and (3) it is marginally less likely to exclude items that are incremental to what analysts exclude. Furthermore, the significant association between non-GAAP exclusions and future GAAP earnings disappears following the covenant violation, indicating improvement in exclusion quality. Finally, market participants react differently to non-GAAP earnings following creditor intervention. Specifically, analysts (investors) react more to non-GAAP (GAAP) information following a covenant violation, suggesting that analysts (investors) are more (less) willing to trust manager-adjusted earnings metrics in the presence of creditor scrutiny. Overall, our results are consistent with creditor intervention (accompanied by investor scrutiny) playing an important role and mitigating opportunism in managers' discretionary disclosures.