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Litigation reform, accounting discretion, and the cost of equity

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ABSTRACT

In this paper, we isolate a context – the 1995 Public Securities Litigation Reform Act – where information risk (accruals quality) is likely to change, and investigate whether the increase in accounting discretion associated with litigation reform is viewed by investors as basically opportunistic (i.e., as distorting reported earnings) or as improving the ability of reported earnings to reflect economic value. We measure accounting discretion using both positive (i.e., income-increasing) as well as absolute performance-adjusted abnormal accruals. Our analysis focuses on a constant sample of firms over a 10-year (1992–2001) period, and is structured in two stages. In the first-stage, we utilize an instrumental variable technique that isolates the increase in accounting discretion associated with the 1995 Act. In the second-stage, we relate the predicted increase in accounting discretion associated with litigation reform – obtained from the first-stage regression – to the ex ante equity risk premium for Big N audit clients. Our results suggest that the increase in accounting discretion associated with the 1995 Act was viewed by investors as basically opportunistic. Further, the exogenous nature of the 1995 Act suggests that the observed increase (and pricing) of accounting discretion is related to litigation reform rather than some omitted firm-specific operating characteristic. Overall, our findings suggest that litigation reform affects firm value through managers' exercise of accounting discretion and cost of equity capital channels.

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1. Introduction

In this study, we isolate a context – the 1995 Private Securities Litigation Reform Act – where information risk (accruals quality) is likely to change. Specifically, the 1995 Act sought to amend what was perceived to be an excessively litigious environment, by increasing restrictions on private litigation for securities frauds.[1] Other things being equal, a decline in legal exposure (following litigation reform) may be expected to create a more conducive environment for managers to exercise accounting discretion. Consistent with this argument, Lee and Mande (2003) document an increase in accounting discretion by Big N audit clients in the three years subsequent to the 1995 Act.[2]

To our knowledge, there is little or no prior research on whether the accounting discretion implications of the 1995 Act are reflected in the cost of equity capital. In this paper, we use estimates of the ex ante cost of equity capital to investigate

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[1] Throughout the paper, to vary the exposition, we refer to the 1995 legislation as the 1995 Litigation Reform Act, the 1995 Act, or simply as the Act.

[2] We use the term "Big N" to refer to the large international accounting firms which over the years have changed from the Big 8 to the extant Big 4. Note that Arthur Andersen was an auditor during the entire 1992–2001 period covered by our study.

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whether the 1995 Act-related increase in accounting discretion is priced by investors. Such a finding would indicate that litigation reform can influence firm value through managers' use of accounting discretion and cost of equity capital channels.[3]

In their study, Lee and Mande (2003) implicitly assume that accounting discretion reflects managers' opportunistic behavior ("earnings management"), is intended to mislead investors, and that it implies lower earnings quality. However, consistent with Dechow and Skinner (2000) and Subramanyam (1996), and Tucker and Zarowin (2006), one could argue that discretion (judgment) is essential to the practice of accrual accounting, and that "earnings management" may merely reflect the exercise of accounting discretion intended to enhance the informativeness of reported earnings by communicating private information. Moreover, to the extent that the manager's decision to limit accounting discretion is dominated by concerns about legal liability, the drop in the incentive to curtail accounting discretion (following the 1995 Act) may actually enhance the manager's ability to utilize accounting reports to communicate effectively with investors. In any event, it is an empirical question whether investors view the increase in accounting discretion associated with the 1995 Act as basically opportunistic (i.e., intended to distort earnings) or as improving the ability of reported earnings to reflect economic value.

Prior research on the stock price consequences of the 1995 Act has largely focused on investor reactions at the time of various legislative events *leading up to* the Act, with mixed results.[4] For example, Spiess and Tkac (1997) and Johnson et al. (2000) report that the stock price reaction to the various legislative event-days *preceding* the 1995 Act was favorable, indicating that the anticipated positive effects of the Act (reduced frivolous litigation) outweighed the anticipated negative effects (potential inability to bring meritorious lawsuits or increased susceptibility to earnings manipulations). However, Ali and Kallapur (2001) report that shareholders in four high litigation risk industries reacted negatively to the various event-days leading up to the Act.

By contrast, our study goes beyond the short event windows preceding the passage of the 1995 Litigation Reform Act, by examining a constant sample of Big N audit clients over a longer time frame (1992–2001) that incorporates years both before and after the Act, and focuses directly on the ex ante equity risk premium as our research metric.[5] As suggested by Francis et al. (2004), the firm-specific ex ante cost of equity capital represents a summary indicator of investors' resource allocation decisions. Consistent with Gebhardt et al. (2001) and Dhaliwal et al. (2006), we utilize the ex ante equity risk premium, i.e., the excess of the firm-specific ex ante cost of equity capital over the risk free interest rate, as our research metric to capture investor pricing.

Consistent with Bhattacharya et al. (2003), several assumptions are implicit in our study. First, we assume that although investors in an efficient market can rationally anticipate the exercise of accounting discretion, they cannot "see through" it in the sense that they cannot undo the effects of earnings management to arrive at what Bhattacharya et al. (2003) refer to as the "unobservable economic earnings" number. Second, we assume that the information asymmetry created by the opportunistic use of accounting discretion is not completely resolved through other communication mechanisms such as disclosures. Third, we assume that the information risk caused by the opportunistic exercise of accounting discretion is an important factor relative to other factors that affect the equity markets, and is therefore priced.[6] Finally, we assume that the exercise of accounting discretion that enhances the informativeness of reported earnings by communicating private information is also priced. As noted by Bhattacharya et al. (2003), none of these assumptions may hold.

Specifically, Core et al. (2008) point out that there is no well-accepted theory to suggest that accounting information quality is not diversifiable, and question whether information risk (accruals quality) is a priced risk factor. Still, they (pp. 20–21) go on to suggest that the notion that information quality matters for the capital markets is intuitively appealing, and that (consistent with Lambert et al. 2007) the consequences of information quality may be manifested in other risk factors (such as beta) even if itself is not a distinct (separate) risk factor. Thus, whether or not the increase in accounting discretion associated with the 1995 Act is priced by investors remains an open empirical question.

Bhattacharya et al. (2003, p. 650) indicate that a limitation of extant studies on earnings attributes and investor pricing is that *expected* earnings management is basically unobservable. In our study, we utilize the Lee and Mande (2003) model to estimate the expected level of accounting discretion. Specifically, we utilize an instrumental variable technique similar to Ittner et al. (2003) to estimate the increase in accounting discretion associated with the 1995 Act. Essentially, in our first-stage ("preparer perspective") regression model, we parse out actual accounting discretion into three components attributable to the firm-specific control variables in the model, the 1995 Act itself (an exogenous event), and statistical noise. Then, in a second-stage ("investor perspective") regression model, we relate the predicted increase in accounting discretion attributable to the 1995 Act (obtained from the first-stage regression) to the ex ante equity risk premium to test whether investors

[3] Other things being equal, a higher (lower) ex ante equity risk premium implies a lower (higher) share price and firm value. This intuition parallels the standard notion that an increase in the yield of a bond lowers its price.

[4] For completeness, we note that prior research has examined the ex post impact of the 1995 Act on management and analyst earnings forecasts. Specifically, Johnson et al. (2001) indicate that the quantity of discretionary management earnings forecasts increased after the Act. Also, Leung and Srinidhi (2006) examine the impact of the Act on analyst forecast properties, and suggest that the Act resulted in additional high quality disclosures for large firms which face higher litigation risk and tighter scrutiny from investors. However, neither study examines directly the impact of the Act on the stock price of firms subsequent to litigation reform.

[5] We stop at 2001 to avoid the confounding effects of heightened regulator (and investor) scrutiny of earnings management in the months leading to the passage of the Sarbanes–Oxley Act in July 2002. Separately, we examine only Big N audit clients since Lee and Mande (2003) document an increase in earnings management by Big N (but not non-Big N) audit clients in the three years subsequent to the 1995 Act. Also, by focusing on Big N audit clients, we avoid potential confounding issues related to differences in audit quality between Big N and non-Big N auditors.

[6] Bhattacharya et al. (2003, p. 642) define information risk as the risk that investors face as a result of possessing inadequate or imprecise firm-specific information on which to base their investment decisions.

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