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Managerial reporting, overoptimism, and litigation risk

Volker Laux [a], Phillip C. Stocken [b,*]

[a] University of Texas at Austin, United States
[b] Dartmouth College, United States

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ABSTRACT

We examine how the threat of litigation affects an entrepreneur's reporting behavior when the entrepreneur (i) can misrepresent his privately observed information, (ii) pays legal damages out of his own pocket, and (iii) is optimistic about the firm's prospects relative to investors. We find higher expected legal penalties imposed on the culpable entrepreneur do not always cause the entrepreneur to be more cautious but instead can increase misreporting. We highlight how this relation depends crucially on the extent of entrepreneurial overoptimism, legal frictions, and the internal control environment.

1. Introduction

A fundamental feature of the financial reporting landscape is that investors want a firm's management to diligently and faithfully report on its firm's affairs. In the event of fraudulent material misstatement or omission of information, the federal securities laws provide investors with the right to take legal action. The efficacy of securities litigation at deterring fraudulent management and compensating aggrieved shareholders has been vigorously debated. Within this debate, a commonly held view is that securities actions can serve an important deterrence role only if legal damages are borne by the culpable managers and not by the corporation and its insurance firm (e.g., Alexander, 1996; Arlen and Carney, 1992; Coffee, 2006; Langevoort, 2007).

This paper examines this argument by analyzing the relation between the magnitude of potential legal penalties imposed on culpable entrepreneurs and financial reporting behavior. We study a model featuring an entrepreneur and a representative investor in a primary market setting. The entrepreneur is endowed with a project and issues a report to raise equity capital from the investor to finance it. If the entrepreneur reports fraudulently and the project is financed but fails, the investor can sue the entrepreneur for damages. We assume that any damages are paid by the entrepreneur out of his own pocket and not by the corporation and its insurance firm. The investor anticipates the possibility of legal damages when determining the cost of equity capital.

Our model views entrepreneurs as being more optimistic than investors about the chances that their business ideas will succeed. Within such an environment, we show that even when an entrepreneur bears damages out of his own pocket, an increase in expected legal penalties does not necessarily lead to more truthful reporting, but in fact can lead to more

* Corresponding author. Tel.: +1 603 646 2843.
E-mail address: phillip.c.stocken@tuck.dartmouth.edu (P.C. Stocken).

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misreporting. Assuming investors' beliefs about the project's prospects are correctly calibrated, misreporting leads to overinvestment in the project and reduces investment efficiency.

The threat of legal damages has two opposing effects on the entrepreneur's reporting behavior. On one hand, potential legal penalties for fraudulent reporting directly reduce incentives for manipulation. We call this the *punishment effect*. On the other hand, the anticipation of legal damages raises the investor's expected payoff, which lowers the equity stake the investor demands if she finances the project. This reduction in the cost of capital, in turn, increases the entrepreneur's residual interest and makes implementing the project more attractive. Given that the project is only financed when a favorable report is released, legal damages increase the entrepreneur's incentive to manipulate unfavorable signals in an attempt to obtain financing. We label this the *compensation effect*. Clearly, an increase in potential legal damages will strengthen both the punishment effect as well as the compensation effect. The question, however, is which effect will dominate?

Coupling the punishment and compensation effects, we emphasize three relations. First, we show that when the entrepreneur is more optimistic than investors, an increase in legal damages can have a stronger impact on the compensation effect than on the punishment effect. In this case, an increase in legal damages does not mitigate but rather accentuates the entrepreneur's incentives to misreport. The broad intuition for this result is that an optimistic entrepreneur, believing the probability of failure is relatively small, is not particularly anxious about the threat of being punished but is strongly motivated by the prospect of receiving a large residual payoff if the project is financed and is successful.

Second, we establish that the effects of heightened legal damages on reporting behavior depends on the way those damages are shared between the investor and her attorney. When the legal environment is characterized by large frictions that allow the plaintiff's attorney to capture a substantial portion of the damages, the compensation effect is weak. Importantly, in this case, any further increase in damages only weakly increases the compensation effect, but the increase in the penalty effect remains strong. Thus, the relation between legal penalties and misreporting is negative, as conventional wisdom suggests. In contrast, when legal frictions are small, the compensation effect is strong and the link between the expected damages and misreporting can be positive. This finding suggests that penalties collected by the SEC that punish the entrepreneur but do not directly compensate investors might more effectively discourage manipulation than damages awarded to investors under the securities laws. Accordingly, our analysis offers a rationale for the recent trend in legislation (e.g., Sarbanes Oxley Act of 2002 and Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010) to extend the authority of the SEC to impose fines and sanctions on fraudulent management.

Third, we explore how the effectiveness of the internal control environment, which was substantially altered following the implementation of the Sarbanes Oxley Act, affects the relation between legal damages and entrepreneurial misreporting. We show that raising the penalties for violation of the securities laws in a weak internal control environment, paradoxically, might weaken the quality of a firm's financial reporting. Thus, corporate governance systems and legal penalties are not necessarily substitutes for disciplining management behavior.

Our paper contributes to the theoretical literature examining the link between litigation and reporting behavior. Trueman (1997) considers a setting in which damages are imposed on the manager whereas Evans and Sridhar (2002), Spindler (2010), and Caskey (2010) consider environments in which damages are paid by the firm and its insurer. While the antecedent literature comes to different conclusions regarding the deterrence effectiveness of litigation, none of these studies raise the concern that an increase in litigation risk can enhance financial misreporting.

The salience of a positive relation between heightened legal damages and managerial misreporting depends on the pervasiveness of entrepreneurial optimism. Entrepreneurial optimism is widely documented in survey and empirical work, including Cooper et al. (1988), Bankman (1994), Arabsheibani et al. (2000), Pinfold (2001), Malmendier and Tate (2005), and Landier and Thesmar (2009).[1] It is important to note, however, that in our model optimism results in the entrepreneur earning fewer rents and destroying welfare. Accordingly, optimistic entrepreneurs might not survive, which mitigates the concern that an increase in legal damages leads to more misreporting.

Our paper tackles issues that might guide policy-makers and regulators as they consider the effect of the litigation environment on firms' reporting behavior. Our paper highlights that the relation between potential legal damages and firm reporting behavior is subtle and depends crucially on the particular features of the institutional environment such as entrepreneurial optimism, legal frictions, and the strength of the internal control system. It has been well argued that director indemnification for security law liabilities and payouts from the deep-pockets of auditors, insurance companies, and investment banks subvert the deterrence effect of the securities laws. However, even when a corporate executive is held responsible for paying damages, we continue to find that securities laws that compensate investors for their damages might not deter fraudulent misreporting. Accordingly, when policy-makers debate reforming the federal anti-fraud mechanisms, we propose a rationale in favor of extending the authority of the SEC to collect fines from culpable managers.

The paper proceeds as follows: Section 2 provides a review of the legal environment; Section 3 describes the model; Section 4 characterizes the unique equilibrium; Section 5 analyzes how the relation between legal damages and misreporting depends on entrepreneurial overoptimism, legal frictions, and the efficiency of the internal control environment; and, Section 6 concludes. All proofs are in Appendix A.

[1] Van den Steen (2010) offers a survey of the rapidly growing literature that models players as having different prior beliefs. He notes that this assumption is not the same as endowing players with private information that cannot be communicated, an assumption often made in the extant disclosure literature.