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# Earnings management, stock issues, and shareholder lawsuits☆

Larry L. DuCharme, Paul H. Malatesta, Stephan E. Sefcik*

*University of Washington School of Business Box 353200, Seattle, WA 98195, USA*

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**Abstract**

Abnormal accounting accruals are unusually high around stock offers, especially high for firms whose offers subsequently attract lawsuits. Accruals tend to reverse after stock offers and are negatively related to post-offer stock returns. Reversals are more pronounced and stock returns are lower for sued firms than for those that are not sued. The incidence of lawsuits involving stock offers and settlement amounts are significantly positively related to abnormal accruals around the offer and significantly negatively related to post-offer stock returns. Our results support the view that some firms opportunistically manipulate earnings upward before stock issues rendering themselves vulnerable to litigation.


*JEL classification:* G14; G24; G32; K22; M41

*Keywords:* Earnings management; Stock offers; Shareholder lawsuits; IPOs; SEOs

## 1. Introduction

Earnings are one of the most frequently cited firm performance statistics. It is well known that accounting earnings convey information about firm values to investors. Ball and Brown (1968), Beaver (1968), and Rendleman et al. (1982) were among the

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*Corresponding author.
*E-mail address:* sefcik@u.washington.edu (S.E. Sefcik).

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first to show that earnings surprises are positively related to contemporaneous stock returns. More recently, Bernard and Thomas (1990) also report a positive relation between earnings surprises and stock returns, though they emphasize that investors apparently under react to the information contained in earnings. Nevertheless, investors do react and there is little doubt that earnings disclosures move stock prices.

Managers exercise some discretion in computing earnings without violating generally accepted accounting principles. For example, firms can affect reported earnings by accelerating revenue recognition and deferring expense recognition. This effectively shifts earnings to the current period from a subsequent period. Alternatively, firms can affect earnings by changing methods of inventory accounting, revising estimated quantities such as bad debt expense, or a variety of other techniques.

It is possible that firms use discretionary accounting choices to manage earnings disclosures around the time of certain types of corporate events. Jones (1991), for example, argues that firms manage earnings strategically to influence the outcomes of import relief investigations. Similarly, DeFond and Jiambalvo (1994) find evidence consistent with earnings manipulation by firms that violate debt covenants. In light of the well-established link between earnings and stock prices, earnings management activity seems particularly plausible around the time of new stock issues. That is because a firm's recently reported earnings are likely to influence its issue proceeds and, therefore, its cost of capital.

There are two competing views about earnings management and stock issues. One view holds that some firms opportunistically manipulate earnings upward before stock issues. According to this opportunism hypothesis, investors are deceived and led to form overly optimistic expectations regarding future post-issue earnings. Thus, offering firms would obtain a higher price for their stock issue than they otherwise would, but subsequent earnings would tend to be disappointing. This view stresses the incentives that entrepreneurs, venture capitalists, and managers have to maximize issue proceeds, given the number of shares offered.

The second, competing view stresses instead the penalties arising from false earnings signals. These include explicit legal remedies that are available to investors who are damaged by defective accounting disclosures and implicit costs stemming from reputation effects. A poor reputation can adversely affect a firm's ability to raise additional capital. Entrepreneurs and venture capitalists must also consider the possible negative effects of false signaling on their ability to take other firms public in the future. In conjunction, these penalties tend to impel firms to signal validly. In this view, firms can manage earnings to achieve a fair value for stock issues, not an excessive one. This implies that investors are informed, not deceived, by discretionary accounting choices made by firms.[1]

[1] Dechow et al. (1996) also discuss possible adverse consequences of earnings management. They study a sample of firms that are alleged to have engaged in earnings management and that are subjected to enforcement action by the US Securities and Exchange Commission. They show that these firms tend to be cash poor and subsequently to issue stock.