



Insider trading before accounting scandals



Anup Agrawal*, Tommy Cooper

University of Alabama, Culverhouse College of Business, Tuscaloosa, AL 35487-0224, United States

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ABSTRACT

We examine insider trading in a sample of more than 500 firms involved in accounting scandals revealed by earnings-decreasing restatements, and in a control sample of non-restating firms. Managers who sell stock while earnings are misstated potentially commit two crimes, earnings manipulation and insider trading, and their selling increases investor scrutiny and the likelihood of the manipulation being revealed. We examine the purchases, sales and net sales of five groups of corporate insiders during the misstated period and a pre-misstated period, using a difference-in-differences approach. Using several measures of the level of insider trading, we estimate cross-sectional regressions that control for other determinants of the level of insider trading. For the full sample of restating firms, we find weak evidence that top managers of misstating firms sell more stock during the misstated period than during the pre-misstated period, relative to the control sample. But in a number of subsamples where insiders had greater incentives to sell before the revelation of accounting problems, we find strong evidence that top managers of restating firms sell substantially more stock during the misstated period. These findings suggest that managers' desire to sell their stockholdings at inflated prices is a motive for earnings manipulation. Our finding that insiders brazenly trade on a crime for which they are potentially culpable suggests that insider trading is more widespread in the market than has been found in the prior literature.

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1. Introduction

Accounting scandals during the early 2000s at prominent companies such as Enron, HealthSouth, Tyco and Worldcom shook investor confidence. The rapid succession of high-profile scandals was soon followed by numerous other companies also disclosing accounting problems. The resulting investor concern about accounting problems is an often cited cause of the stock market slump that ensued (see, e.g., [Browning and Weil, 2002](#)). Accounting scandals are often accompanied by large stock-price declines, SEC investigations, top-management turnover, and bankruptcy filings (see, e.g., [Agrawal and Chadha, 2005](#); [Agrawal and Cooper, 2013](#); [Desai et al., 2006a](#); [Palmrose et al., 2004](#)). Many misreporting companies and their top executives face lawsuits from regulators and investors (see, e.g., [Palmrose and Scholz, 2004](#)).

An issue in the lawsuits against these executives is whether they traded corporate securities before accounting problems were revealed.¹ For example, in the trial of former Enron CEO Jeffrey Skilling, the U.S. government contended that Skilling grossed nearly \$63 million from Enron stock sales in 2000 and 2001, while holding material, non-public information about the company's fraud (see [Emshwiller, 2006](#)). Skilling was not the only Enron executive whose selling seems well-timed. In all, 29 Enron executives and

* Corresponding author. Tel: +1 205 348 8970.

E-mail address: aagrwal@cba.ua.edu (A. Agrawal).

¹ Throughout the paper, we use the terms financial misstatement, accounting manipulation, accounting problem and accounting scandal interchangeably. As discussed in [Section 4.1](#), we examine only restatements prompted by misstatements, i.e., material violations of generally accepted accounting principles (GAAP). Given the wide latitude that companies have in reporting earnings under GAAP, GAAP-violations represent serious accounting problems.

directors sold \$1.1 billion in Enron stock from 1999 to mid-2001, while gross financial misreporting supported a soaring stock price (see Wayne, 2002). Similarly, during a period of massive accounting fraud at HealthSouth, then-CEO Richard Scrushy sold his stockholdings for several hundred million dollars (see Freudenheim and Romero, 2003). Another example is Qwest Communications, where then-CEO Joseph Nacchio sold over \$100 million in stock while the company overstated earnings (see Young, 2005).

Spectacular cases of abuse such as the Enron and HealthSouth scandals led to public and media outcry about insider trading before the revelation of accounting problems (see, e.g., Countryman, 2004). This paper provides systematic evidence on whether insider trading before accounting scandals is the norm or the exception. This issue is important for at least four reasons. First, stock market participants want to know if insider trading is widespread because it affects investors' willingness to trade, and consequently affects the liquidity of the stock. Second, gauging the extent of insider trading is of interest to policy makers and regulators concerned about the effectiveness of existing insider trading regulations. Third, insiders are less likely to trade before accounting scandals than before other major corporate events such as takeovers, bankruptcies, stock buybacks, or equity issues. Managers who sell stock while earnings are misstated potentially commit two crimes: earnings manipulation and trading on material, non-public information. Furthermore, by selling stock, they attract investor scrutiny which increases the risk of the manipulation being revealed. A finding that insiders openly trade on a crime for which they are likely to be blamed² would suggest that insider trading is more widespread in the market than has been found in the previous literature. Fourth, the prevalence of insider trading also has implications for the design of optimal incentive compensation schemes, which assume that greater managerial stockholdings align managers' interests with those of stockholders. Given that short sales by managers are prohibited, greater managerial stockholdings have the unintended consequence of increasing managers' ability to profit (i.e., to avoid losses) from advance knowledge of bad corporate news by selling stock.

We analyze insider trading activity in a sample of 518 publicly traded U.S. companies that announced earnings-decreasing restatements during the period January 1997 – June 2002 to correct misstated financial statements, and in an industry-size matched sample of non-restating companies. We focus on restatements announced before the July 2002 adoption of the Sarbanes–Oxley Act (SOX) for three reasons. First, post-SOX, a large number of companies restated to 'clean house'; consequently, these cases tend to be less serious and have negligible average stock price reactions to their announcements (see, e.g., Agrawal and Cooper, 2013), reducing insiders' incentives to trade on them. Second, SOX section 304(a) requires a company's CEO and CFO to return any profits realized from the sale of company securities during the 12-month period following the first public issue or SEC filing of financial statements that are later restated due to a GAAP violation. This rule further reduces insiders' incentives to trade on financial misstatement post-SOX. Third, as Brochet (2010) argues, SOX and greater scrutiny from investors, media and regulators in the wake of the prominent accounting scandals that preceded SOX reduce the incentive of insiders to sell before disclosing bad news even more than their incentive to buy before disclosing good news. This argument is consistent with insider sales being more exposed to litigation and prosecution than insider purchases (see also Sale, 2002; Skinner, 1994).

Our sample includes restatements by prominent companies such as Adelphia, Best Buy, Enron, JDS Uniphase, K-Mart, Lucent Technologies, Rite-Aid, Worldcom, and Xerox. We focus on open-market stock transactions of five insider groups, all of whom are required to report all of their trades to the SEC on Forms 3, 4 and 5. These insider groups are top management, top financial officers, all corporate officers, board members, and blockholders. We examine their purchases, sales and net sales during the misstated period and a pre-misstated period using a difference-in-differences (DID) approach. We analyze five parametric and two non-parametric measures of the level of insider trading. Our analysis employs univariate tests and cross-sectional regressions that control for other potential determinants of the level of insider trading.

Prior studies find that stocks sold by insiders underperform stocks bought by them (see, e.g., Jaffe, 1974; Rozeff and Zaman, 1988; Seyhun, 1986). Seyhun (1988) finds that aggregate insider trading even predicts stock market movements. However, the extensive literature on insider trading before major corporate events presents somewhat mixed findings. Insiders appear to trade profitably before Chapter 11 bankruptcy filings, stock repurchases, seasoned equity offerings, earnings announcements, and dividend initiations (see, e.g., John and Lang, 1991; Karpoff and Lee, 1991; Lee et al., 1992; Penman, 1985; Seyhun and Bradley, 1997, respectively). But insiders appear to refrain from profitable active trading before other major events such as mergers (see Seyhun, 1990 for acquiring firms, and Agrawal and Jaffe, 1995; Agrawal and Nasser, 2012 for target firms).

Our study contributes to the literature on insider trading during earnings manipulation. Prior studies have examined insider trading during periods of earnings management and insider trading before SEC Accounting and Auditing Enforcement Releases (AAERs). As discussed in Section 3 below, the collective evidence from these studies points to abnormal insider selling during periods of earnings management, but the evidence on insider trading before SEC AAERs is mixed. To our knowledge, no prior empirical study provides a detailed examination of insider stock trades prior to the announcement of restatements to correct misstated earnings. This paper aims to fill this gap in the literature.

As discussed by Agrawal and Chadha (2005), earnings misstatements lie somewhere between earnings management and SEC enforcement actions in terms of the seriousness of the earnings manipulation. Earnings misstatements differ from typical earnings management in at least two respects. First, while earnings management appears to be practiced routinely at most public firms, a restatement is a rare event in the life of a company,³ with serious consequences as discussed in the first paragraph in this section.

² This is akin to the possibility, investigated by the SEC, that terrorists traded stock or options before September 11, 2001 in industries directly affected by the attack such as insurance and airlines (see, e.g., Eisinger, 2001). Potesman (2006) finds some evidence of unusual trading before 9/11 in stock options on the two airlines targeted in the attacks.

³ As we discuss in Section 4.1 below, there were a total of 919 restatements by U.S. public companies during a 5.5-year period beginning in January 1997. Based on a total of about 7000 public companies on Compustat per year, the annual probability of restatement by a public company works out to about 0.0239 (= 919 / (7000 * 5.5)).

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