Advances in Accounting, incorporating Advances in International Accounting 29 (2013) 12–26

Contents lists available at SciVerse ScienceDirect

Advances in Accounting, incorporating Advances in International Accounting

journal homepage: www.elsevier.com/locate/adiac

Insider trading in loss firms☆

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ARTICLE INFO

Keywords:
Insider trading
Loss firms
Earnings announcements
Asymmetric litigation risk

ABSTRACT

This study investigates whether insiders in loss firms trade their company stock differentially around new loss and loss reversal earnings announcements. Research suggests that the likelihood of litigation influences managers' stock trading decisions prior to material events. I hypothesize and find that insiders reduce their net stock sales in a monotonic manner before a new loss announcement presumably to avoid improper trading allegations before bad news. This decrease is more pronounced if the new loss is the start of a multiple loss sequence. In contrast, there is no significant change in net trading patterns in the quarters prior to a loss reversal announcement irrespective of whether the loss reversal is the start of a single profit or multiple profit sequence indicating that insiders seem less concerned about legal implications when trading before good news. The results suggest that insiders in loss firms perceive asymmetric litigation risks to trading stock in the quarters before bad news relative to good news and act accordingly.

1. Introduction

Insiders can decide not to sell or buy shares in the periods leading up to material information events like earnings announcements and avoid allegations of wrongful conduct. However, insider trading based on nonpublic earnings information is not uncommon as evidenced by recent actions by the US Securities and Exchange Commission (SEC) against the chief executives of Qwest Communications and Countrywide Financial Corp.[1] This study examines whether insiders in loss firms trade their company stock differentially around new loss and loss reversal earnings announcements based on perceived litigation risks.[2] Specifically, I look at insider stock purchases and sales in a series of quarters leading up to a new loss (NL) and a loss reversal (LR) to determine how insiders trade before these two different information events.[3] I also investigate insider trading behavior prior to new losses leading up to single vs. multiple loss quarters and prior to loss reversals leading up to single vs. multiple profit quarters.

The prospect of insider trading opportunities has long irked regulators in their zeal to ensure a level playing field for all capital market participants. SEC regulations and company restrictions on managerial stock trading have some mitigating effects on insiders' ability to earn abnormal profits using private information about future earnings performance. Insiders seem to respond to regulatory constraints by identifying appropriate "safe window" periods to time their trades and avoid detection. Moreover, from a litigation risk perspective, there is evidence to suggest that there is an asymmetric response from shareholders and regulators to insider stock sales before bad news when compared to insider stock purchases before good news.

Research on securities class action litigation suggests that most investor lawsuits follow unexpected declines in stock prices (Grundfest & Perino, 1997; Johnson, Nelson, & Pritchard, 2007). The insider trading cases pursued by the SEC also depict a pattern. Of the 376 insider trading based litigation releases and administrative proceedings I hand-collected between 1996 and 2003, there are only 12 incidences related to insider buying prior to positive earnings announcements. The disproportionately low occurrence of legal and regulatory proceedings prior to good earnings news may motivate insiders to consider trades before positive earnings surprises as less risky compared to trades prior to negative earnings surprises. In this context, loss firms provide a unique setting to examine insider trade decisions around both bad news (i.e. new loss) and good news (i.e. loss reversal) announcements.

Unlike other earnings surprises, NL and LR announcements are critical thresholds in a firm's reported earnings sequence. A loss announcement generates considerable ambiguity about the nature of loss and the firm's subsequent return to profitability. Research on loss firms suggests that the reasons and implications of loss announcements

☆ I am grateful to my dissertation committee — Jim Ohlson (chair), Mike Mikhail and Jim Boatsman for their guidance and valuable discussions. I also thank Phil Reckers (Editor) and the workshop participants at Arizona State University, Drexel University, George Mason University, Indiana University, Texas A&M University, University of Illinois-Chicago and University of Utah for their helpful comments and suggestions.

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[1] The former CEO of Qwest has been found guilty of fraudulent reporting and selling stock before an earnings downturn while no formal charges have been filed as yet against the CEO of Countrywide for allegedly increasing stock sales in a 105b-1trading plan before the company's financial problems became public.

[2] For this study, I use the term "loss firms" to represent companies that have reported a loss in at least one quarter during the sample period — earnings before extraordinary items and discontinued operations (Compustat data item # 8) is less than zero in at least one quarter between 1986 and 2003.

[3] A new loss (NL) refers to a quarterly earnings announcement with a loss after a string of one or more profit quarters while a loss reversal (LR) refers to a quarterly earnings announcement with a profit after a string of one or more loss quarters.

0882-6110/$ – see front matter
http://dx.doi.org/10.1016/j.adiac.2012.12.002

are systematically different from other earnings changes and therefore merit a separate inquiry (Hayn, 1995; Joos & Plesko, 2005; Pinnuck & Lillis, 2007). The market reaction to earnings announcements by loss firms provides some support to these assertions. Abnormal returns surrounding NL and LR announcements are significantly different from those surrounding other quarterly loss or profit announcements. Mean 32 day cumulative abnormal returns of −2.59% and 4.68% prior to new loss and loss reversal earnings announcements respectively indicates that there are potential economic gains to having private information about forthcoming new losses and loss reversals.

I posit that insiders will trade their company stock strategically before NL and LR quarters based on perceived litigation risks. Insiders are likely to be more diligent when trading ahead of new loss announcements to avoid assertions of unfair trades around bad news. Conversely, insiders are unlikely to exhibit undue caution when trading before loss reversal announcements since they may expect limited scrutiny of their stock transactions around good earnings news. To capture insider foreknowledge and trading strategies before NLs and LRs, I separately examine insider trades in a series of quarters prior to NL and LR earnings announcements. For the new loss event, I compare insider trades in new loss quarters and profit quarters leading up to new loss quarters to average insider trades during other loss quarters. Similarly, for the loss reversal event, I contrast insider trades in loss reversal quarters and loss quarters leading up to loss reversal quarters to average insider trades during other profit quarters.

The results show that insiders trade actively in a manner that suggests prior knowledge of forthcoming new losses and loss reversals. In the four quarters preceding a new loss announcement, insiders monotonically reduce their net stock sales presumably to avoid potential litigation risk for trading on private information. However, unlike the new loss sample, insiders do not change their stock trading pattern in the quarters immediately before a loss reversal. Insiders do not seem concerned about trading related legal risks when the firm is about to announce a good news earnings event.

Losses differ in their cause, severity and duration. The 32 day abnormal return before a multiple loss sequence is −4.07% compared to −1.29% prior to a single loss sequence. As such, insider selling prior to a multiple loss sequence is more likely to attract investor and regulatory scrutiny than a one-time loss. Consistent with expectations, the results show that the monotonic reduction in net selling ahead of NL announcements is more pronounced in the quarters preceding a multiple loss sequence when compared to quarters prior to a single loss sequence.

In contrast, there are no significant differences in insider trading patterns preceding a multiple profit sequence relative to a single profit sequence. This is despite the fact that the mean 32 day abnormal return prior to a multiple profit sequence (5.18%) is significantly higher when compared to a single profit sequence (3.39%). As such, one would expect insiders to behave differentially if the return to profitability is persistent relative to one-time since more scrutiny is likely around large stock price changes. These results provide additional support to the assertion that insiders expect minimal legal problems when trading before good earnings news.

This study contributes to two streams of literature relating to insider trading and loss firms. First, the results of this study should be of interest to researchers who investigate insider trading around material events like earnings announcements. It is not easy to disentangle information motivated trades in short trading windows between earnings announcements. By focusing on extreme earnings thresholds like new losses and loss reversals, this study uses a long event window methodology to capture insider trading strategies. Insiders seem apprehensive about legal ramifications when they trade ahead of bad earnings news but do not seem concerned when trading ahead of good earnings news. Stock trading decisions by managers based on perceived asymmetric litigation risk would imply an unintended consequence of the existing regulatory environment.

Second, this paper suggests that loss firms face a high information asymmetry environment that encourages systematic trades by insiders. I find that insiders are aware of a forthcoming transition to negative earnings and subsequent reversal in advance and trade accordingly. The study provides additional support to proponents of the superior knowledge perspective of insider trading who argue that insiders exploit non-public information for personal gains. Followers of insider trades should also note that the nature of loss has a significant influence on insider trading behavior. The findings in this paper suggest that insider trades may be useful indicators of the timing and characteristics of NLs and LRs — when a new loss or loss reversal is likely to be announced and whether the announcement is the start of a single or multiple loss/profit sequence.

The remainder of the paper is organized as follows. I review related literature and develop hypotheses in Section 2. In Section 3, I discuss the sample data. Section 4 elaborates on the model specifications. Section 5 presents the descriptive statistics and empirical results. Section 6 discusses sensitivity analyses and I conclude in Section 7.

2. Literature and hypotheses development

2.1. Related literature

Recent research highlights the growing incidence of losses in the last 35 years (Darrough & Ye, 2006; Givoly & Hayn, 2000; Hayn, 1995; Joos & Plesko, 2005; Klein & Marquardt, 2006). Losses have grown from about 10% of Compustat firm quarters in the early 1970s to almost 40% in 2003. Prior research suggests that increasing accounting conservatism, macroeconomic cycles and a growing number of high technology and R&D intensive companies have contributed to the frequency of loss announcements by firms. Investors find analyzing loss firms particularly problematic since current earnings may not be a reliable indicator of future cash flows. The prevailing ambiguity in loss firms provides managers with an opportunity to earn abnormal profits from foreknowledge of their firm's future performance.[4]

Insider trades are prominently tracked by the business press since analysts and investors expect insider actions to reflect firms' future prospects.[5] This belief is not unreasonable given insiders' involvement in ongoing business plans and activities. Managers are presumably better aware of how their products are selling, whether inventories are piling up or costs are rising, planned capital expenditures or recent R&D innovations. Hence, insiders are well positioned to exploit any private information on future earnings for personal gains.

To discourage insiders from trading on non-public information, regulatory authorities have enacted a number of laws to curb improper insider trades.[6] Recently, the Sarbanes-Oxley Act accelerated the reporting requirements of insider trades to two business days after they have occurred. Many firms also impose restrictions on employees and allow managerial stock transactions only in the days following earnings announcements (Bettis, Coles, & Lemmon, 2000; Roulstone, 2003). Garfinkel (1997) documents that the passage of the Insider Trading and Securities Fraud Enforcement Act in 1988 curbed abnormal insider trades in the month before quarterly earnings announcements. Despite existing regulations, shareholders and investors argue that the

[4] An expectation of loss reversal is a critical premise in the valuation of loss firms; absence of which raises concerns about loss firms' going concern assumptions in the preparation of financial statements (Hayn, 1995; Joos & Plesko, 2005).

[5] For instance, the Wall Street Journal presents a weekly report on insider trades. Also, popular business information websites like CNBC.com, Yahoo finance and CNNMoney.com provide information on insider stock transactions.

[6] The antifraud provisions and reporting requirements of the Securities and Exchange Act, 1934, the Insider Trading Sanctions Act (ITSA), 1984 and the Insider Trading and Securities Fraud Enforcement Act (ITSFEA), 1988 are the main regulatory deterrents. Insiders face civil and criminal penalties for unlawful trades and are not allowed to short sell their firms' shares. They must also unload any short swing profits i.e. profits earned from any matching sale and purchase trades within a six month period.