



Management earnings forecasts, insider trading, and information asymmetry



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ABSTRACT

We investigate whether senior officers use accrual-based earnings management to meet voluntary earnings disclosure (i.e., management earnings forecasts) before selling or buying their own shares when they have private information. This study is the first to use the differences in timing of trades by senior officers and other insiders (e.g., directors or large shareholders) to infer information asymmetry. We hypothesize that the timing of senior officers' trades with no other insiders' trades at the same time indicates opportunistic trades and asymmetric information between senior officers and other insiders. Our results show that senior officers' exclusive sales are negatively associated with future returns, indicating that they tend to use insider information. Moreover, senior officers are more likely to meet their earnings forecasts when they plan to sell stocks.

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1. Introduction

In this study, we investigate whether senior officers (i.e., CEOs, CFOs, and COOs) are more likely to meet their earnings forecasts through accrual-based earnings management before they sell or buy their own stocks to profit from their potential private information. We are the first to use the differences in timing of trades by senior officers and other insiders (e.g., directors or large shareholders) to infer opportunistic trades of the former. This paper sheds more light on the relationship between insider information and earnings management by showing that senior officers are more likely to meet management earnings forecasts before subsequent sales when they have private information.

We distinguish between senior officers' trades (i.e., sales and purchases) and other insiders' trades for two reasons. First, prior research shows no evidence for strategic actions (e.g., timing insider trades or voluntary disclosures, meeting analysts' forecasts) of non-managers/other insiders (Cheng and Lo, 2006; Ke et al., 2003; McVay et al., 2006). Second, we want to shed more light on the information asymmetry between senior officers and other insiders by analyzing the relation between their insider trades and stock returns (i.e., backward- vs. forward-looking trading behavior). Compared to other insiders, senior officers usually have more information about the firm and have more ability to influence financial numbers and stock prices (e.g., through earnings management or voluntary disclosures). Insider trading comprises routine (e.g., liquidity and diversification incentives) and opportunistic trades (e.g., exploitation of private information to maximize trading profits). Having private information about the firm, senior officers can strategically time selling or buying their own stocks.

We hypothesize that periods with only senior officers' trades with no other insiders' trades (i.e., exclusive trades) indicate opportunistic trading behavior, reflecting their superior information over other insiders. For periods with trades of both groups

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(i.e., simultaneous trades), we hypothesize that senior officers do not have information advantage. Our econometric model, which allows us to test the potential information asymmetry, shows that managers' exclusive sales are negatively associated with future returns. This implies that senior officers anticipate future lower returns before their exclusive sales, showing their forward-looking behavior. By contrast, we find evidence for backward-looking behavior on the part of other insiders when analyzing the exclusive sample. Investigating the simultaneous sample, we find that senior officers have no information advantage over other insiders, as expected.

We use logistic regressions to test whether higher discretionary accruals, which are used as a proxy for earnings management, increase the probability of meeting management earnings forecasts. While analyzing different samples (i.e., exclusive and simultaneous samples, and their combined sample) and insider groups (i.e., senior officers and other insiders), we find a significant positive association between discretionary accruals and meeting management earnings forecasts. These findings indicate that higher discretionary accruals increase the probability of meeting earnings targets. The marginal effect of discretionary accruals on the probability of meeting management earnings forecasts increases by 6% when exclusive managers' sales increase from zero to the sample mean. This indicates that senior officers are more likely to engage in accrual-based earnings management to meet their earnings targets before they sell shares, supporting the results of [McVay et al. \(2006\)](#).

Our results also show that senior officers are involved in opportunistic behavior only when they have private information. The analysis of the exclusive sample shows a positive and significant relationship between meeting management earnings forecasts and subsequent managers' sales. Contrary to sales, senior officers' purchases do not appear to have an effect on the probability of meeting management earnings forecasts in the exclusive sample. Moreover, senior officers' sales and purchases have no significant effect when we analyze the simultaneous sample. These findings suggest that senior officers do not engage in earnings management when they do not have an information advantage over other insiders. Furthermore, our results show no significant relationship between other insiders' trading activity and meeting earnings targets for the two samples. This suggests that since other insiders do not have the ability to influence the market through voluntary disclosures or meeting earnings forecasts and/or financial reporting through earnings management, their trading behavior does not affect the probability of meeting management earnings targets.¹ The results are robust using different measures of insider trades.

The paper contributes to the literature on insider trading, the accuracy of management earnings forecasts, and the relationship between equity incentives and earnings management (e.g., [Aboody and Kasznik, 2000](#); [Cheng and Warfield, 2005](#); [McNichols, 1989](#); [Rogers and Stocken, 2005](#)). Our paper is relevant to regulators and board members who deal with issues of information asymmetry and managers' stock-based compensations. It should also be of interest to investors who react to meeting or beating the management earnings forecasts. They should be aware that executives tend to be driven by equity incentives when they meet management earnings forecasts.

The remainder of this study is organized as follows. In the next section, we review prior research and develop our hypotheses. In [Section 3](#), we describe the sample and our research design. In [Section 4](#), we present empirical results of our analyses. [Section 5](#) concludes.

2. Literature review and hypothesis development

2.1. Related literature

There is a large literature base that deals with earnings management and voluntary disclosures including management earnings forecasts (e.g., literature summary in [Habib and Hansen, 2008](#); [Healy and Palepu, 2001](#); [Hirst et al., 2008](#)). Previous studies show that management earnings forecasts represent important information for investors ([Anilowski et al., 2007](#); [Das et al., 2011](#)). Their disclosure is voluntary and can be influenced by managers' incentives. Several studies investigate the incentives of voluntary disclosures such as the reduction in information asymmetry (e.g., [Coller and Yohn, 1997](#); [Verrecchia, 2001](#)), reduction in litigation costs ([Bartov et al., 2002](#); [Skinner, 1994](#)), and equity compensation incentives (e.g., [Aboody and Kasznik, 2000](#); [Noe, 1999](#)). Prior research tends to focus on the frequency of firms engaging in accrual-based management to avoid negative earnings surprises (e.g., [Brown, 1998](#); [Burgstahler and Eames, 2006](#); [Degeorge et al., 1999](#); [Matsumoto, 2002](#)).

Previous research shows that the incentive to maximize profits of insider trades is driven by insiders' superior information about prospective development of a firm. For instance, [Aboody and Lev \(2000\)](#) and [Huddart and Ke \(2007\)](#) show that insider trading is related to information asymmetry. There is evidence that insiders trade based on their superior knowledge about price-relevant events or information advantages over other market participants ([Beneish, 1999](#); [Ke et al., 2003](#)). Several studies report abnormal stock returns following insider trading (e.g., [Hillier and Marshall, 2002](#); [Jaffe, 1974](#); [Lakonishok and Lee, 2001](#); [Rozeff and Zaman, 1988](#); [Seyhun, 1986](#)). [Noe \(1999\)](#) shows that insiders sell more shares after good news than after bad news and buy more shares after bad news than after good news. [Aboody and Kasznik \(2000\)](#), [Cheng and Lo \(2006\)](#), and [Rogers and Stocken \(2005\)](#) find evidence for managers' incentives to release bad news opportunistically so they can take advantage of lower stock prices before insider trading. [Cheng and Lo \(2006\)](#) find that insiders increase the number of bad disclosures before purchasing shares. However, they find no change in disclosure activity before selling shares, relating this finding to the litigation costs that would result from an acceleration of good news or withdrawal of bad news that could be disclosed before a sale of

¹ However, the results appear to be sensitive to the extent of management earnings forecast errors. When we combine the two samples and restrict the forecast errors to be less than 10 or 15 cents, subsequent senior officers' purchases reduce the probability of meeting management earnings forecasts. Furthermore, other insiders' exclusive sales are significant and increase the probability of meeting earnings targets.

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