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What insiders know about future earnings and how they use it: Evidence from insider trades☆

Bin Ke[a], Steven Huddart[a,*], Kathy Petroni[b]

[a] Smeal College of Business Administration, Pennsylvania State University, University Park, PA 16802-1912, USA

[b] Eli Broad Graduate School of Management, Michigan State University, East Lansing, MI 48824-1121, USA

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Abstract

This paper provides evidence that insiders possess, and trade upon, knowledge of specific and economically significant forthcoming accounting disclosures as long as 2 years prior to the disclosure. Stock sales by insiders increase three to nine quarters prior to a break in a string of consecutive increases in quarterly earnings. Insider stock sales are greater for growth firms, before a longer period of declining earnings, and when the earnings decline at the break is greater. Consistent with avoiding an established legal jeopardy, there is little abnormal selling in the two quarters immediately prior to the break.

JEL classification: G18; M41; K22

Keywords: Insider trading; Securities regulation

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*Corresponding author. Tel.: +1-814-865-3271; fax: +1-814-863-8393.
E-mail address: huddart@psu.edu (S. Huddart).

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1. Introduction

A robust result of the literature on insider trading is that insiders subject to the filing requirements of section 16 of the U.S. Securities and Exchange Act of 1934 earn abnormal stock returns on their trades.[1] The fact that abnormal stock returns follow insider trades indicates that insiders possess private information that is not impounded in stock price at the time they trade, but does not identify the nature of insiders' informational advantage. There is relatively little evidence linking these trades to particular types of private information. In this study, we test whether insiders' trades are consistent with foreknowledge of future earnings by examining insiders' trading over a period of consecutive earnings increases.

Define a sequence of consecutive quarters in which quarterly earnings are increasing as a "string." Earnings increases and decreases are measured relative to the same quarter of the previous year. Thus, a string ends when earnings in the current quarter are less than earnings for the same quarter of the previous year. We refer to the event that ends a string as a "break". Barth et al. (1999) and DeAngelo et al. (1996) show that breaks are associated with economically and statistically significant stock price drops. Insiders therefore have an incentive to sell stock in advance of breaks. Prior research suggests that the stock price drop associated with a break is greater for growth firms, when the break follows a longer string, and when the earnings decline at the break is greater. In turn, this suggests insiders' incentives to sell stock before a break are higher in such cases. Further, if insiders can distinguish among breaks according to the length of the period of declining earnings that follows (which we call the length of the break), then there may be more selling prior to longer breaks. Therefore, we investigate the trading behavior of insiders in the quarters preceding a break and how this behavior varies according to whether the firm is growth or value, the length of the string, the magnitude of the earnings decline, and the length of the break.

We find an increase in the frequency of net insider sales in the ninth through third quarters before the break for our sample firms. This selling pattern is stronger for firm-quarters drawn from growth firms that precede a longer break or a greater earnings decline at the break. Remarkably, we find little evidence of a higher frequency of insider sales in the two quarters immediately preceding the announcement of a break. Not trading immediately before the break may reflect insiders' desire to avoid the appearance of exploiting inside information and the associated costs stemming from adverse publicity or litigation.

[1] Insiders routinely trade in the stock of the company with which they are affiliated. While some insider trades are due to insiders' liquidity needs and portfolio rebalancing objectives, a component of insider trades is driven by insiders' informational advantage over other market participants. This advantage has been demonstrated in several studies that find significant abnormal stock returns following insider trades. For example, see Jaffe (1974), Finnerty (1976), Seyhun (1986), Rozeff and Zaman (1988), Lin and Howe (1990), and Lakonishok and Lee (2001). The evidence is consistent with insiders selling stock when it is overvalued and buying stock when it is undervalued. Seyhun (1992) presents compelling evidence that such trades are legal, widespread, increasing in volume, and yield abnormal returns.