

The Great Escape: The Unaddressed Ethical Issue of Investor Responsibility for Corporate Malfeasance

Curtis L. Wesley II
Indiana University

Hermann Achidi Ndofor
Texas A&M University

ABSTRACT: Corporate governance scholarship focuses on executive malfeasance, specifically its antecedents and consequences. Academic efforts primarily focus on prevention while practitioners are often left to hold firms and executives (including directors) accountable through a variety of sanctions. Even so, executive malfeasance still occurs even in the face of the vast resources used to monitor, control, and penalize firms and executives. In this paper, we posit equity markets do not adequately penalize firms for inaccurate earnings reports. Using a sample of 129 firms identified by the U.S. General Accounting Office for reporting fraudulent earnings in 10K filings, we found support for our assertion. Consequently, the one party who may benefit but escape accountability is firm shareholders. Moreover, we find little empirical evidence that the subset of firms sanctioned by the SEC is penalized more heavily than the full sample by markets at the time they report and correct their 10K filings. Our results raise serious questions whether such managerial opportunism can be eradicated given the apparent lack of consequences in equity markets for investors. We also question whether the SEC is able to discern between fraud and error in financial reporting and its implications.

KEY WORDS: corporate governance, shareholder responsibility, earnings misstatements, earnings management, executive crime, fraud

WHILE CORPORATE GOVERNANCE SCHOLARS ARGUE that interest alignment and monitoring of management is paramount in minimizing bad acts by executives, fraudulent behavior continues. This prompts the question whether there is another more fundamental influence that could deter executives from malfeasant behavior, especially given that in some cases internal (boards) and external (regulators and analysts) monitoring mechanisms and incentive alignment are extensively used. Thus, we call for corporate governance scholarship to take a step back and address more rudimentary questions concerning who benefits from executive malfeasance and how benefits are extracted to provide probable answers as to why such conduct continues.

This paper investigates this query by inquiring whether there is a net financial benefit to firms and shareholders after the fraud has been identified and reported. Simply put, is cheating worth the consequences in the face of governance measures? Governance scholarship provides examples of executives who report inaccurate financial information to support the firm's share price so that they may benefit from the sale of equity or exercise of equity options (O'Connor, Priem, Coombs, & Gilley, 2006). Business ethics addresses the normative issues with respect to managerial opportunism often holding executives accountable for their malfeasant activities (Di Lorenzo, 2007). However, an unaddressed issue remains; executives are not the sole, primary beneficiaries of such malfeasance. Increasing (or supporting) equity values benefits shareholders as well. Critics of this commentary will raise the very real issue of a decrease in firm value when malfeasant activity is uncovered. To address this tension, this paper provides mathematical and empirical evidence that there may be a net benefit to the firm's market valuation and leverages business ethics literature to address the normative issues that arise from principals benefiting from unethical actions of their agents.

Specifically, this paper tests our assertions using event study methods to measure the cumulative abnormal return (CAR) of fraudulent reporting ex-post discovery of fraud. We develop an empirical model based on earnings response coefficients (ERC) around the filing dates of 10Ks and amended 10Ks to test our hypothesis that, indeed, there is financial benefit to reporting inaccurate information as equity markets insufficiently penalize firms. Using a sample of 129 firms from 2002–2006 identified by the Government Accountability Office (GAO) (United States Government Accountability Office, 2007) for overstating their annual earnings (10K filings), we find markets do not sufficiently penalize financial restatements. Simply put, sans other financial, criminal, and social sanctions, we show the shares of the focal firm in which the inaccurate reporting occurred may be more valuable after accurate information is provided than they would have been if the accurate information had been provided in the first place. Our empirical model also serves as a test of market efficiency (or inefficiency, as we propose), since one would expect an efficient equity market to not only correctly evaluate new, accurate information and return the value of the firm to its rightful valuation, but also penalize the firm as less trustworthy in providing accurate information in future filings. We do not find this in our sample.

Our results also reveal there is no statistical difference between firms sanctioned by the SEC ex-post of the restatements and those that were not. This raises the question of whether capital markets and regulators can discern between fraud and error in financial reporting. If markets and regulatory officials cannot discriminate between willful fraudulent and unintentional inaccurate reporting, the appropriate sanctions cannot be met out to the rightful offenders.

We draw two conclusions from our results. First, those responsible to establish monitoring and control mechanisms, firm shareholders, do not adequately bear the agency cost of their executives. Our results suggest little incentive exists for those charged to protect their own interests to ferret out careless or malfeasant managers if they benefit from the errors and bad acts. Second, firms that engage in fraudulent

criminal activity cannot be discerned from firms that simply provide unintentional erroneous information.

We draw attention to the often forgotten benefactor of the executive malfeasance that influences stock prices and firm value, the shareholders of the firm. In this paper, we address the feasibility of investor apathy to monitor and control their agents, provide empirical evidence of the benefits of such apathy, and provide possible normative solutions that incentivize shareholders to properly engage in oversight of their firm's managers. We also address the inability of markets to discern between intentional cheating and erroneous reporting providing normatively solutions to such dilemmas as well.

This paper proceeds as follows. First, we provide an overview of corporate governance and business ethics literature with special attention being paid to the role of ownership and arguments about their primacy in the corporation. We explore the normative aspects of accountability for shareholders in the context of the sanctions of management and directors. Second, we draw from signal theory to explain why managers may violate their fiduciary responsibility to provide accurate information to markets. Afterward, we present our methodology, develop and test our empirical model, and report our results. Finally, we discuss our findings and provide ethically grounded research implications for our results.

BACKGROUND

Earnings Management and Restatements

Despite the presence of various governance mechanisms to ensure the reliability of announced earnings, substantial incentives exist for firms to manage their earnings. Over the past three decades, our economy has witnessed an increased shift from tangible and manufacturing assets to intangible, information and service-based assets (Landsman & Maydew, 2002). The information asymmetry between managers of firms competing primarily based on intangible resources such as knowledge and external stakeholders is inherently greater. Not only is the value of the resources invisible to external parties, their existence, quality and quantity are equally difficult to ascertain. This increased information asymmetry provides increased opportunity for executives to manage firm earnings leading to increased incidents of earnings restatements (Ndofof, Wesley, & Priem, in press).

The purpose of this paper is to not review all previously explored antecedents to earnings restatements (for a review of the influence of compensation incentives see Burns & Kedia, 2006, 2008; Desai, Hogan, & Wilkins, 2006; Efendi, Srivastava, & Swanson, 2007; Harris & Bromiley, 2007; Matsumura & Shin, 2005; and Zhang, Bartol, Smith, Pfarrer, & Khanin, 2008; for director oversight, see Agrawal & Chadha, 2005; Ndofof et al., in press; Vera-Munoz, 2005). Nevertheless, most governance studies conclude internal governance prescriptions used to motivate value creation for executives also have the unintentional consequence of increasing the propensity of management to engage in aggressive accounting leading to earnings restatements (for incentive alignment discussions see Miller & Leiblein, 1996; Sanders, 2001; Zhang et al., 2008; and for a behavioral theory perspective,

see Harris & Bromiley, 2007; Weisbach, 1988). The common theme in all literature on misrepresenting firm performance is that information and its dissemination is in control of the manager, and may be intentionally inaccurate so that it positively influences the equity value so that management can meet their variable compensation hurdles. Previous research assumes that such risks are taken because benefits outweigh costs of discovery.

However our main point of contention is twofold. First, the costs are not adequately punitive so they are not truly effective deterrents; second, such efforts are also ineffective due to the lack of sufficient monitoring and control of executives by firm investors. The increase in the prevalence of financial reporting fraud this past decade (from 3.7 percent of SEC reporting firms in 2002 to 6.8 percent in 2005), as evidenced in the substantial number of firms that restate their earnings either due to fraud or error, has greatly undermined the reliability and credibility of financial disclosures (United States Government Accountability Office, 2007). While academic and practitioner focus has almost exclusively been on executive malfeasance, little attention has been given to the culpability and accountability of firm shareholders for firm governance.

THEORY DEVELOPMENT

The Rewards and Responsibility of Ownership

A basic tenet of corporate governance is the role of shareholders as the primary beneficiaries of the economic organization (see Boatright, 1996, for a complete review of the theories of the firm with respect to business ethics) and the shareholder relationship to the firm is central to any discussion of governance (Ryan & Buchholtz, 2001). They provide the financial capital to acquire the resources necessary for the firm to operate in a profitable manner. Investors possess claims to the residual rents of the firm in exchange for their financial capital. Additionally, the law provides shareholder rights to those rents in exchange for limited liability protection from legal and civil sanctions directed at the firm. As a consequence, shareholders are only at risk for the capital they provide to the firm regardless of the sanctions imposed on the firm.

While we do not minimize this risk as many investors have a majority of their net worth tied into equity ownership, we do point out these risks are likely to be more distal than other internal stakeholders (Ghoshal, 2005; Stout, 2012; see Maitland, 1994, for a contrary opinion). Sanctions on the firm impact firm executives as they are held to a fiduciary responsibility by law and firm charter; between possible criminal and civil sanctions, employment risk, and internal control mechanisms such as claw back provisions, executives are squarely in the cross-hairs of systematic sanctions if they do not protect the interests of the firm and its stakeholders (Marens & Wicks, 1999). Shareholders are protected more so than employees when firms bear negative financial consequences as the latter are subject to employment-at-will, can be laid off, and bear immediate personal financial costs of poor management practices (Maitland, 2001). Moreover, due to limited liability laws, creditors bear such financial costs more immediately than shareholders as firms with poor financial results are

less likely to pay their debts; shareholders are not responsible for making creditors whole (Maitland, 2001). Even board members, often accountable in more intangible terms (i.e., reputation and status), can be held to account via civil penalties.

Given the more direct potential implications to other internal stakeholders, investors appear to escape similar accountability. This is ironic when one considers shareholder wealth maximization serves as the overarching purpose of managers for those who espouse traditional theories of the firm, even to the detriment of other stakeholders (Coase, 2007; Jensen & Meckling, 1976; Williamson, 1991). Forcing harmful externalities onto other parties is considered appropriate when attempting to maximize shareholder value. In fact, in a perverse manner, the mantra of shareholder wealth maximization may hurt shareholders themselves as shareholders are not a homogenous group but have varying degrees of investment interests (Stout, 2012).

The fact that shareholders and option holders can often be made better off at the expense of creditors and employees and others with firm-specific investments at risk in the corporation means that, neither in theory nor in practice, is it true that maximizing the value of equity shares is the equivalent of maximizing the overall value created by the firm. (Blair, 2003: 6)

Nevertheless, common belief manifested in current governance practices is that shareholder supremacy supersedes claims of other stakeholders (Boatright, 1994; Goodpaster, 1991; Goodpaster & Halloran, 1994) and operating in this governance structure maximizes the common economic good of all stakeholders.

Consequently, given the benefits of ownership, do shareholders have any responsibilities other than providing capital in exchange for residual rents of the firm? Goodstein and Wicks (2007) suggests there are, stating there are mutual responsibilities among all stakeholders to each other when operating as an economic entity. While in the specific context of moral and ethical behavior, Goodstein and Wicks (2007) make the point that interdependency between stakeholders requires reciprocity and accountability between all parties to maximize the efficient operation of the firm. Each stakeholder, including shareholders, is responsible to others to provide an environment whereby the firm can maximize its opportunity to be successful. Consequently, shareholders, as owners of the firm, possess the unique ability among firm stakeholders to enact governance measures that minimizes agency costs and presumably increases the profitability of the firm. Shareholders provide governance that other stakeholders may not be able to provide, and thus fulfill their responsibility to other stakeholders.

While shareholder responsibility to other stakeholders appears obvious, the implications of such responsibilities are more nuanced and less apparent. After all, should shareholders have a moral obligation to provide diligent governance since effective control could mean increased agency costs for which they bear on behalf of other stakeholders (Fassin, 2012; Heath, 2006, Rodin, 2005; Spurgin, 2001)?

This brings Goodstein and Wicks's (2007) arguments that firm stakeholders are mutually responsible to each other into a much narrower focus. Most shareholders are not subject to employment risk or criminal and civil sanctions via ownership as true with other stakeholders. Instead, they are accountable through changes in the

value of the firm. Only in the sale of equities and the liquidation of the firm through bankruptcy do the investors bear any penalties for bad management of their ongoing economic concern. Many scholars would suggest the most efficient manner in which to manage the interests of firm stakeholders is to focus on the shareholder's interest to own a valuable, appreciating asset given their investment in the firm. The financial implication of monetary loss provides the incentive for investors to remain engaged in the oversight of management especially as their ownership stakes increases.

We argue that these assumptions are unreasonable given the structural foundations of the investor market (see Boatright, 1994, for a full review of shareholder rights via agency contracting). Dispersion of ownership within a firm combined with investing diversification in equity markets facilitates dispersion of risk for the investor. Not only does a shareholder operating as a diversified investor have no incentives to monitor and control firm executives based on their ability to exit the small stake they have in a firm, they can free ride on the information of investors who have a more acute interest in monitoring and control of management. Even if the owner with a small equity stake in the firm desires more control over their managers, they may not have enough ownership in the firm to have a voice management would consider relevant. They are even less relevant considering the money they exchange for the ownership and claims to the residual rents does not flow to the firm. Spurgin (2001) comes to similar conclusions when highlighting the current state of investment practices, stating that indirect investment and small equity ownership stakes are the norm. Blockholders, such as institutional investors, have more of an interest in monitoring and control; yet, they too are hamstrung by the information asymmetry problem that exists between them and management. Given such owners are also invested in a wide array of firms, the level of importance to monitoring and control of a single firm may lessen the more firms that are in their ownership portfolio.

So what is an investor to do? Some may espouse the use of an ethical standard for investing. Ethical investing would be defined as foregoing profit from unethical business investments and providing accountability to firms through investing or divesting in firms based on their business practices (Hudson, 2005). This may also be ineffective as potential investors and current owners must ascertain the behavioral intent *ex-ante* to behavioral outcomes. Not only will you have an information asymmetry issue with respect to management revealing the true condition of the firm, you are not going to find an executive in their right mind who will reveal malfeasant intent. Thus, ethical investing decisions must be made *ex-post* such activities.

Hudson (2005) makes the argument that using non-financial normative criteria to make investment (or divestment) decisions under such conditions is highly likely to yield an underperforming portfolio and not likely to induce appropriate ethical behavior in firm executives as investors are unable to impose sanctions on management by selling or not owning such firms (see Dunfee, 1998; Rivoli, 2003; and Ryan & Buchholtz, 2001, for contrary viewpoints). His premise is risk based pricing of firm leads to higher value "ethical" firms and lower value "unethical" firms as ethical concerns associated with management are included in the firm's equity price (and firm value). Since we truly do not know management ethicality until there is a lapse

in ethical behavior, ethical investors will divest ex-post of such behavior driving down the value of the firm and capturing losses in that ownership stake (Hudson, 2005). Meanwhile, sanctions will be imposed to managers (and other internal stakeholders), ethical practices tighten in the firm, and as a consequence firm price will then appreciate (Hudson, 2005). So, in a perverse manner, ethical investors accomplish their goal yet lose money as they divest prior to firms implementing new ethics policies in response to sanctions due to unethical behavior.

It is those that care less about ethical outcomes for firms that benefit from the actions of ethical investing. It is also these shareholders who could avoid full sanction for the actions of their managers. Let us provide a simple mathematical example. Consider this notion using a simplified agency-based model whereby you have a single principal (shareholder) and a single agent (manager). The owner delegates the management of her firm to the manager and responsibility (and liability) to the firm. In exchange for the manager's time, the owner provides compensation and establishes a system of monitoring and control as they require a mechanism to align agent-principal interests. In exchange for the capital and the delegation of control to management, the owner has rights to residual rents and owns an appreciable asset.

Now let's say at time T_1 management reports earnings to move the stock price from \$10 to \$20. The value of the information provided is worth \$10 per share; however, this is incorrect information. Had correct information been provided, the market would move against the stock and decrease its value by \$5. At a future point in time, T_2 , the firm, whose stock price is now \$25, reports an amendment of T_1 earnings. The market could behave in the following ways. First, the market may not react at all, reflecting perfect market inefficiency. The price remains at \$25. Secondly, the market could react as it would have if given the proper information and value the equity at \$10 less to account for the market reaction at T_1 . This price of the equity falls to \$15. This reflects that markets are efficient to varying degree. However, these scenarios fail to account for the change in price that would have occurred as an initial market reaction, a decrease of \$5. Thus, investors avoid the sanction of \$5/share to account for the consequences of inaccurate information being provided in the first place. Moreover, the investor also laid claim to residual rents in the form of dividends from T_1 to T_2 .

While this example is rather simple, it bears out that full accountability over the governance of the firm has been avoided by the shareholder. If you now relax the requirement of a single shareholder in our example it will further highlight the ethical conundrum of ownership accountability. Let's assume you have three types of investors for this firm based on when they invested in the firm. The "happy" investor is one who owned a stake in the firm and divested her interests prior to time T_2 . They capture appreciation (or retain value in other scenarios) and sold to the next investor. This investor, "angry," unknowingly bought into the company at an artificially high price only to learn at T_2 his investment is based on inaccurate information. This shareholder succumbs to an information asymmetry penalty (\$10/share), is held to account for the malfeasance of their management, and, if an ethical investor, will divest their interest in the firm prior to the firm righting themselves. The investors that own firm equity through T_1 and T_2 , we shall coin them as "unhappy," are also

held accountable to a degree. However, they are shareholders at T_2 with the highest ability to have the most accurate information (for what it is worth) as they have owned the stock since (or before) T_1 . Along the way, they posture to hold management accountable for inaccuracy in reporting while possessing an ownership stake that is actually more valuable (\$5/share) than it would have been “truth be told.”

Management (and other stakeholders) suffers from the aforementioned sanctions to a varying degree. Some are severe; some are less so. Yet, every reporting cycle there continue to be firms that report inaccurate, and quite possibly fraudulent, financial statements even after observing the sanctions imposed upon their executive peers. Research suggests many answers for manager motivation to do so and many mechanisms to prevent malfeasant behavior and align principal-agent interests. Obviously, this may not be enough. Therefore, the current set of sanctions may not be sufficient to deter future opportunistic behavior. Considering increased shareholder activism and vigilance of the government, why do such concerns remain? As provided in the aforementioned mathematical model, we propose there isn't enough motivation on the part of investors to properly monitor and control management or support government sanctions because (1) enforcement costs are borne by both the firm and the executives that manage the firm, and (2) they derive economic benefit as the firm is more valuable in the short and long term. As owners of the firm, it is not in their economic interests to have the firm bear the cost of enforcement and it is in their interests to have a more valuable firm.

We suggest that value in the firm is preserved because the markets (specifically those that trade the firm's stock) are inefficient in interpreting the information provided in the annual reports due to the ability for less valuable firms to masquerade as more valuable firms and the inability of market participants and enforcement officials to discern between the two. The following section leverages signal theory (Spence, 1974) outline why this is so.

Earnings Announcements as Information

Financial disclosures, especially earnings announcements, are central to reducing the information asymmetry between managers of firms and external stakeholders. Because external stakeholders rely on earnings as a signal to direct resource allocation in capital markets (Lev, 1989), the reliability of earnings statements is crucial to the smooth functioning of capital markets (Banker, Huang, & Natarajan, 2009; Biddle, Bowen, & Wallace, 1997; Sloan, 1996). As a result, regulations (e.g., Sarbanes-Oxley), financial regulators (e.g., SEC), standard setting boards (e.g., Financial Accounting Standards Board), capital market intermediaries (e.g., analysts) and auditors all seek to enhance the credibility of announced earnings (Healy & Palepu, 2001).

Commonly referred to as ‘the bottom line,’ earnings are a key item in financial disclosures. The effectiveness of earnings to act as a signal of firm value lies in its capacity to convey information about the current performance of management and project the future performance of a firm given its resources. Signals are “activities or attributes of individuals in a market which by design or accident, alter the beliefs

of, or convey information to, other individuals in the market” (Spence, 1974: 1). Effective signals create a separating equilibrium, i.e., they convey information to external parties about the qualities of the sender (Spence, 1974). Reported earnings (and its many derivations) are essential to understanding the quality of a firm’s resource base and estimating its future value (Dechow, 1994). Earnings measures of performance have been argued to signal both the current and future value of the firm (Swaminathan & Weintrop, 1991; Banker et al., 2009). The usefulness and importance of earnings lies in both its value relevance and its information content.

Value relevance refers to the capacity of earnings to capture the contemporaneous information necessary to value a firm for a given period (Chandra & Ro, 2008). Within strategic management research, the value relevance of earnings is manifested in several ways. First, modern financial theory relies heavily on earnings to estimate the value of a firm (Dechow, 1994). The value of a firm comprises two components: assets in place and growth opportunities (Myers, 1977). The value of assets in place is evidenced through the cash flows that generate earnings for shareholders. Thus, the commonly used discounted cash model estimates firm value as the present value of future earnings (Datta & Dhillon, 1993).

In addition to firm valuation, earnings and its mathematical derivatives reveal information vital to other capital market contexts such as bankruptcy prediction, bond ratings, and estimation of a stock’s systemic risks (Campbell, Hilscher, & Szilagyi, 2008). The value relevance of earnings information extends beyond capital markets to contractual relationships with other stakeholders such as management, suppliers, and creditors (Dechow, 1994). Positivist agency theory, for example, argues that compensation contracts can be used to incentivize managers to act in the best interest of shareholders (Eisenhardt, 1989). In such performance-based compensation contracts, earnings are expected to provide accurate information on managerial effort (Bagnoli & Watts, 2005; Kwon, 2005).

The information content of earnings focuses on the capacity of this performance measure to convey new information about the firm (Chandra & Ro, 2008). New information is assessed by its capacity to change the perceptions of external parties such as stockholders, bondholders, and market analysts. Empirical research has confirmed earnings announcements to have substantial information content (Atiase, Li, Supattarakul, & Tse, 2005; Datta & Dhillon, 1993). Models that examine abnormal returns to earnings release, for example, capture the newness of information contained in earnings.

The value relevance and information content of earnings enable it to be a widely-used signal of firm value. Signals are important because of their information conveyance (Spence, 1974). They provide information about the quality of unobservable attributes to an uninformed investor. Earnings serve as a signal that conveys information about the unobservable firm attribute of firm performance, and thus, the estimation of firm valuations by analysts and investors. Effective signals are those signals that create a *separating equilibrium*. In a separating equilibrium, uninformed agents are able to use the signal (*ex post*) to ascertain the value of a firm. For example, a high-value firm takes an action (in this case earnings announcement) that reveals its performance level, and thus its value. This action is such that

a lower-value firm cannot or will not imitate, either because it is impossible for it to do so given the quality and level of its attributes or because the cost of doing so would be prohibitive (Ndofor & Levitas, 2004). After seeing the signal, investors then update their belief about the performance and value of the firm.

For a separating equilibrium to occur, the uninformed investor has to be able to separate higher-value firms from lower-value ones based on their reported earnings (the signal). When a separating equilibrium is not achieved, then we have a *pooling equilibrium*. The implications herein are twofold. First, a firm that provides inaccurate information to equity markets is a low value firm masquerading as a high value firm, thus acquiring a higher valuation than what is otherwise justified. When more accurate information is provided and a separating equilibrium is achieved, the market is now subject to discerning the veracity of the new, past information in conjunction with the past information from the time of the original earnings information and the restated earnings. Subsequently, markets must discern a separating equilibrium in the face of learning new information and assessing the past information used to pool the lower quality firm with the higher quality firm. We propose markets are unable to manage this process efficiently for individual firms. Thus, there *isn't any discernible difference in net market reaction to financial restatements*.

If firms overstate their earnings, then the accuracy of earnings to serve as a signal that separates higher-value firms from lower-value ones is greatly jeopardized. Given external stakeholders cannot discern between accurate and inaccurate signaling via earnings announcements, managers are able to present themselves as a higher-value firm regardless of whether there is intentionality in their misrepresentation. Equity markets value such firms more highly and firm value (stock price) increases.

As one may surmise, this misrepresentation may be with or without intent. Misrepresentation with intent is considered fraudulent and is subject to civil and criminal penalties. In these cases, managers offer to markets inaccurate information for their own benefit (e.g., increasing compensation, hiding poor performance, etc.). However, we must also account for error without intent. In such cases, managers provide inaccurate information without prejudice; their error may be from carelessness, incapacity, or neglect. In these instances, inaccurate reporting can only be considered erroneous unless one finds evidence of intent to mislead. Moving forward, we draw a distinction between the two types of misrepresentation and empirically test for differences between the two scenarios. References to fraud infer intentionally misrepresenting the condition of the firm while references to erroneous reporting suggest there is a lack of intent to deceive equity markets. Of course, in both cases, inaccurate information is offered to the marketplace and, whether immediately or over time, firm insiders are aware the market value of the firm diverges from underlying reality of true firm value (Blair, 2003).

When accurate information is eventually reported, the market corrects itself. However, the information concerning the company from the original earnings statement to the amended restatement is now incorporated into the new firm valuation. Even if the market corrects itself, the stock price afterward reflects information that is suspect as its authors are the executives that provided inaccurate information in the first place. And, such information is likely to be presented in the best light

such that it either positively impacts the stock price or decreases the depths of the stock values decline if given accurate information. Consequently, one would expect firms that inaccurately reported their earnings: (a) will not be penalized sufficiently to offset the ill-gotten gains from the initial market response, and (b) the correct market response for the true information (had it been offered at the time of original statement) is less than the original market response based on inaccurate (erroneous or fraudulent) financial information. More formally:

Hypothesis 1: With respect to financial restatements, equity markets do not sufficiently penalize firms for reporting inaccurate earnings information.

Second, with a pooling equilibrium, the uninformed investor cannot use the signal (*ex-post*) to ascertain the value of different firms and thus cannot distinguish between higher-value and lower-value firms (Bagnoli & Watts, 2005). Firms that report inaccurate earnings undermine the separating equilibrium for the uninformed investor. Likewise, executives that intentionally deceive investors induce a pooling equilibrium in order to masquerade as a higher-value firm, often because firm values are directly related to their employment risk, compensation, and perquisites. Given the motivation of executives to manage firm performance in the best light possible, earnings management has become an acceptable practice. This decreases the effectiveness of earnings announcements leading to *little discernible difference between erroneous filings and fraudulent filing of similarly pooled firms*. Thus, we offer the following hypothesis:

Hypothesis 2: With respect to financial restatements, equity markets do not penalize firms reporting fraudulent information more than firms that report erroneous earnings information.

METHODOLOGY

Sample

The sample for this study started with the 181 firms out of 987 firms identified from the GAO (2007) report to Congress concerning financial restatements. Each firm is identified as having overstated earnings due “to accounting irregularities” and has amended previous annual (10K) earnings announcements during the 2002 to 2006 time period. This sample provides the most conservative identification of restated firms as the GAO report strongly implies less culpability and more forthrightness for firms outside those selected herein. Thus, the sample reflects a strong but undetermined level of intentionality for the firms. Management could easily claim unintentional error when addressing the cause of their restatements; yet, the SEC categorizes these firms in a manner that suggests otherwise. Moreover, the use of annual reporting of earnings (10K) captures public, firm-specific information over a reasonable amount of time for review by markets and regulators. These selection criteria increase the validity of our results.

The sample was further screened by the following criteria: (1) the availability of analysts’ earnings expectations represented by consensus estimates available in the Institutional Brokers Estimate System (I/B/E/S) database, and (2) at least four years of SEC filings to obtain the previous three years of annual earnings announcements

(10K). This screening reduced the sample to 129 firms. Data was collected manually from the individual 10K and 10K/A statements, data from the Center for Research in Security Prices (CRSP), Eventus, and I/B/E/S databases.

Empirical Setting

The central purpose of this paper is to discern the impact of reporting inaccurate information on the net abnormal returns of the firm. We purposefully limited the scope of the paper to whether earnings are an effective signal of firm value because a basic premise of executive malfeasance is whether there is something to gain regardless of discovery, given such activity occurs in the face of heightened scrutiny. Moreover, we posit the gain in (or sustenance of) firm value makes it worthwhile for shareholders as it is higher than the enforcement costs they bear in conjunction with sanctions against management.

We have established that for earnings to be an effective signal, i.e., create a separating equilibrium, the capital market has to prohibitively punish firms that overstate their earnings such that lower-value firms have no incentive to overstate their earnings and masquerade as higher-value firms (Ndofor & Levitas, 2004). Therefore, we must calculate the net impact of earnings restatements for firms suspected of fraud. A positive net impact indicates an indirect reward to firms for misstating their earnings; a negative net impact indicates sufficient penalty by equity markets for misstatement of earnings. Of course, if the net impact is not significantly different from zero, the equity markets operate efficiently as the firm (and its executives and shareholders) are neither rewarded nor penalized for misstating their earnings. We expect since the firms are identified by the SEC as engaging in fraudulent activity (either by intentional reporting of fraudulent information or engaging in fraudulent activity that required reporting inaccurate financial statements), the equity markets would react more negatively than if the firm was simply identified as having originally reported unintentional erroneous information that required a subsequent financial restatement. Thus, a non-significant result can be interpreted that equity markets make no distinction between fraudulent reporting and other types of erroneous reporting.

Following prior literature, we measure the information content of earnings announcements using event-study analysis focusing on cumulative abnormal returns that occur do to unexpected earnings announcements (Collins, Li, & Xie, 2009). Accounting, finance, and management research have used abnormal returns to measure the information content, and thus the market response to unexpected earnings (Allen & Ramanan, 1995; Bushman, Engel, & Smith, 2006; Tang & Tikoo, 1999), insider trading (Coff & Lee, 2003), and other significant corporate events such as mergers and acquisitions (Barney, 1988; Pangarkar & Lie, 2004) and SEC rulings (Campbell, Campbell, Sirmon, Bierman, & Tuggle, 2012).

Given our hypothesis, three key variables are computed. First, we calculate the cumulative abnormal returns (CAR) to the original earnings announcement. For discussion convenience, we refer to this as original CAR or OCAR. Second, we compare the cumulative abnormal returns to the restated earnings. We refer to this

as amended CAR or ACAR. Last, using each firm's historical CARs for the prior three years of earnings announcements, we estimate what the cumulative abnormal returns would have been had the firm released the correct (i.e., restated) earnings at the original earnings release date. We refer to this as the estimated CAR, or ECAR. We used Eventus to calculate the CARs, with stock price information taken from CRSP. Event dates for the calculation of OCAR are the earnings announcement (10K filing) dates. Event dates for the calculation of ACAR include the first date of restatement announcement in the news and corroboration by 10K/A filing dates. We use stock prices during a 255-day window beginning forty-five days prior to the earnings (or amendment) announcement to compute the CARs. Again, this is a conservative measure to ensure relevant market information is captured in the returns before and after the announcements. To ensure robustness of our results, we calculated each of the CARs over six different event windows. The event windows begin one day prior to the announcement date (t) to one day after the announcement date and ending with one day prior to the announcement date to six days after the announcement date. The event windows used therefore were $(t-1, t+z)$ where z can be 1 to 6.

To estimate ECAR we used Eventus to calculate the CARs for each firm's earnings announcements for the three years prior to the (misstated) 10K filing year. Event dates for the calculation of each CAR was the earnings announcement date. Similar to OCAR and ACAR, we used stock prices during a 255-day window ending forty-five days prior to the earnings announcement to estimate the market response to ensure there is no contamination in the subsequent CAR calculations from leaked information. Prior research has established that ERCs vary across firms, thus we use a firm-specific estimation procedure (Teets & Wasley, 1996). Using CAR for historical earnings announcement enables us to calculate firm-specific market responses to unexpected earnings.¹

Using these CARs, we estimated the earnings response coefficient (ERC) for each firm. The earnings response coefficient is used to calculate what the cumulative abnormal return to correct earnings would have been had it been announced accurately. The earnings response coefficient captures the sensitivity of the market's response to unexpected earnings (Francis, Schipper, & Vincent, 2002). Additionally, past research has shown that ERCs serve as a signal concerning the private information of management about future firm value (Allen & Ramanan, 1995; Bagnoli & Watts, 2005; Collins et al., 2009) and serves as a proxy for earnings quality whereby noisier representation of future cash flows lead to smaller ERCs (Higgs & Skantz, 2006; Holthausen & Verrecchia, 1988). The markets belief of a firm's earnings persistence (Kormendi & Lipe, 1987) and earnings quality (Teoh & Wong, 1993) has also been shown to be reflected in its earnings coefficient. In strategic management, Tang and Tikoo (1999) show how geographic breadth and depth of internationalization of multinational corporations directly influence the magnitude of firm ERCs inferring more operational flexibility leads to more sustainable earnings and greater response coefficients.

More recently, ERCs have been used in conjunction with calculating estimates of abnormal returns in association with investor reaction to earnings surprises

(Keung, Lin, & Shih, 2010) and econometric modeling to show managerial reporting decisions impact information in earnings announcements (Bagnoli & Watts, 2005). Accounting research on insider trading (Allen & Ramanan, 1995) and firm diversification also leverage ERC calculations. Only more recently has the use of ERCs migrated to other disciplines. Lim and Lusch (2011) answer Kimbrough et al.'s (2009) call on use of ERC and CAR calculations in marketing research to link strategic marketing to firm value creation.

Mathematically, ERC is estimated from the regression equation below.

$$CAR_{i,t} = \alpha_i + \beta_i UE_{i,t} + \varepsilon_{i,t} \quad (1)$$

$CAR_{i,t}$ is regressed onto $UE_{i,t}$ for each event window supplying an ERC (β), normally distributed error term ($\varepsilon_{i,t}$), and an intercept term (α) for the firm specific data. $CAR_{i,t}$ is firm i 's abnormal return for the announcement period t , α is a constant term, $UE_{i,t}$ is firm i 's unexpected earnings for period t , $\varepsilon_{i,t}$ is the random error term (assumed normally distributed), and β is the earnings response coefficient (ERC). Both α_i and β_i are firm specific. Unexpected earnings are defined as the difference between reported earnings and the most recent consensus analyst forecasts (Collins et al., 2009) compiled from the I/B/E/S database. Unexpected earnings are measured as follows:

$$UE_{i,t} = (A_{i,t} - F_{i,t}) / P_{i,t} \quad (2)$$

where $A_{i,t}$ is the actual earnings for firm i in period t , $F_{i,t}$ is the expected earnings for firm i in period t , measured as the mean security analysts' annual earnings forecast, and $P_{i,t}$ is the stock price for firm i on the day of the firm i 's earnings announcement.

Using the estimated α and β , we compute what the CAR would have been had the restated earnings been announced originally (ECAR). To calculate ECAR, we first compute the revised unexpected earnings by substituting the amended earnings for the original (misstated) earnings in equation (2) above. The revised unexpected earnings, together with the estimates for α and β are inserted into equation (1) to compute ECAR. To summarize, cumulative abnormal returns are net market reactions tied to firm-specific events such as earnings announcements. CARs are calculated based on the earnings surprises, commonly defined as the difference between actual earnings and analyst forecasted estimates of earnings. Calculations for the cumulative abnormal returns of the original earnings announcement for each firm including the previous three years are used to calculate the beta coefficient of CAR. In short, each year's CAR is regressed onto each year's earnings surprise yielding the beta coefficient (the earnings response coefficient, ERC), an error term and a constant term. The ERC, error term, and constant from this regression are used to calculate what the CAR would have been had the earnings announcement been accurate. Thus, the earnings surprise used is the difference between the amended earnings (10K/A) and the analysts forecasted estimates of earnings for the 10K report.

To our knowledge, this study is the first to use the earnings response coefficient in calculations to derive estimates of market reactions given new information to past events. However, using CAR and ERC data to derive predictive calculations has occurred in recent accounting literature. Imhoff and Lobo (1992) use estimates of daily unexpected stock returns to estimate the cumulative unexpected stock returns in their

study linking ex-ante earnings uncertainty to the relationship between unexpected returns and unexpected earnings. They conclude larger ERCs imply less uncertainty in the future earnings announcements. More recently, Allen and Ramanan (1995) found that the earnings response coefficient was a predictor of future abnormal returns and that greater magnitudes and positive signs were associated with reportable insider trading (stock purchasing). Moreover, the study uses future information (insider trading) to assess the value relevance of past information (unexpected earnings, earnings response coefficient). Similarly, our study utilizes ex-post restated earnings to analyze the value relevance of both originally reported earnings and the cumulative abnormal returns from the originally reported earnings. Likewise, Kinney, Burgstahler, and Martin (2002) use ex-post earnings information and ex-ante ERC calculations to ascertain the probability of a significant market reaction to an earnings surprise. They find an S-shaped relationship suggesting equivalent orders of magnitude of earnings surprises may influence market reaction significantly by firm.

Finally, a most recent example by Koch and Sun (2004) uses future earnings in conjunction with ERCs (which use ex-ante point in time information) to discern whether changes in dividends are signals to investors of persistence of past earnings changes. They found investors use changes in dividends in comparison with past dividend policy to assess the persistence of future earnings. The broad theme of their empirical methodology is to use ex-post and ex-ante information to answer research questions of how future events influence past outcomes. This is consistent with the empirical setting in this paper. However, the difference between the two general empirical themes is that the final outcome in Koch and Sun's (2004) paper is a forward looking indicator while this paper attempts to determine likely outcomes of past events.

Empirical Results

Table 1 highlights the summary statistics of the cumulative abnormal returns for the original 10K announcement (OCAR), the amended 10K/A announcement (ACAR) and the estimated response had amended earnings been released originally (ECAR). In general, the original earnings announcement (OCAR) is positive while the amended announcement (ACAR) is negative across most event windows. In each case for OCAR and ACAR, the results are not statistically different from zero (0) suggesting support for the efficient market hypothesis. It appears the market reacts positively to the erroneous report and recaptures market gains when earnings announcements are corrected.

However, when reviewing the estimate for what the cumulative abnormal returns would have been had correct information been offered (ECAR), we find a statistically significant negative result across most event windows. This strongly suggests the true earnings report would have been greeted negatively by equity markets in support of our hypotheses. One can easily surmise this result is to be expected since managers are more likely to manage their fraudulently reported earnings upward (in the original 10K report) if they anticipate a negative response from equity markets. Figure 1 shows the relationship between original CAR (10K), amended CAR (10K/A), and the estimated CAR for the full sample.

Table 1: Summary Statistics (2 YR CAR & ERC Calculations)

| | Original CAR (10K earnings) | | | | Amended CAR (10K/A earnings) | | | | Estimated CAR (10K/A earnings – 10K analysts estimates) | | | |
|----------------------------|-----------------------------|-------------|--------------|--------------|------------------------------|--------------|--------------|--------------|---|---------------|--------------|--------------|
| | Full Sample | GAO | AAER | Difference | Full Sample | GAO | AAER | Difference | Full Sample | GAO | AAER | Difference |
| | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) |
| CAR Window (-/+ event day) | | | | | | | | | | | | |
| -1 day, +1 day | .006 (.016) | .003 (.007) | .015 (.015) | -.013 (.017) | .005 (.007) | .003 (.007) | .013 (.016) | -.010 (.016) | -.056* (.031) | -.062* (.038) | -.036 (.033) | -.026 (.079) |
| -1 day, +2 days | .009* (.005) | .008 (.006) | .012 (.010) | -.004 (.013) | -.000 (.006) | -.000 (.007) | -.002 (.015) | .001 (.015) | -.024* (.012) | -.020 (.018) | -.039 (.042) | .019 (.031) |
| -1 day, +3 days | .001 (.005) | .003 (.005) | -.004 (.009) | .007 (.011) | .007 (.007) | .010 (.008) | -.008 (.012) | .018 (.016) | -.029* (.015) | -.024* (.014) | -.044 (.051) | .020 (.040) |
| -1 day, +4 days | .007 (.006) | .005 (.007) | .013 (.014) | -.009 (.016) | -.003 (.008) | -.006 (.009) | .005 (.017) | -.012 (.020) | -.040* (.019) | -.037* (.017) | -.053 (.065) | .017 (.047) |
| -1 day, +5 days | .008† (.006) | .009 (.007) | -.001 (.013) | .011 (.015) | -.011* (.007) | -.010 (.008) | -.014 (.018) | .004 (.018) | -.039* (.017) | -.034* (.014) | -.059 (.061) | -.024 (.041) |
| -1 day, +6 days | -.002 (.006) | .001 (.006) | -.014 (.011) | -.015 (.014) | -.007 (.007) | -.005 (.008) | -.015 (.015) | .010 (.018) | -.038* (.021) | -.030* (.016) | -.070 (.087) | .040 (.054) |

Table 2: Comparison of Original 10K CAR, Restated 10K/A, and Estimated 10K (3YR CAR & ERC Calculations)

| | OCAR – ACAR > 0 | | | | OCAR – ECAR > 0 | | | | ACAR – ECAR > 0 | | | |
|----------------------------|-----------------|---------------|-------------|--------------|-----------------|----------------|-------------|--------------|-----------------|---------------|--------------|--------------|
| | Full Sample | GAO | AAER | Difference | Full Sample | GAO | AAER | Difference | Full Sample | GAO | AAER | Difference |
| | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) | Mean (s.e.) |
| CAR Window (-/+ event day) | | | | | | | | | | | | |
| -1 day, +1 day | .001 (.008) | .000 (.009) | .003 (.019) | -.002 (.020) | .062* (.034) | .064* (.042) | .053 (.036) | .011 (.055) | .060* (.033) | .064* (.041) | .046† (.033) | .017 (.052) |
| -1 day, +2 days | .010† (.006) | .008 (.007) | .014 (.014) | -.005 (.016) | -.033** (.014) | -.028** (.014) | .053 (.042) | -.025 (.044) | -.023* (.013) | -.020* (.014) | .037 (.039) | -.017 (.041) |
| -1 day, +3 days | -.005 (.006) | -.007 (.007) | .003 (.012) | -.010 (.016) | .030* (.016) | .028* (.016) | .040 (.052) | -.013 (.054) | .035* (.017) | .035* (.018) | .037 (.047) | -.002 (.051) |
| -1 day, +4 days | .010† (.008) | .011 (.009) | .008 (.017) | .003 (.020) | -.047** (.020) | -.042** (.019) | .068 (.064) | -.025 (.067) | -.037* (.021) | -.032* (.023) | .058 (.061) | -.026 (.065) |
| -1 day, +5 days | .018** (.007) | .020** (.008) | .012 (.012) | .007 (.016) | .046** (.017) | .043** (.017) | .059 (.053) | -.015 (.056) | .028* (.017) | .024* (.018) | .045 (.050) | -.022 (.053) |
| -1 day, +6 days | .005 (.006) | .006 (.007) | .001 (.009) | .005 (.015) | .036* (.021) | .031* (.018) | .055 (.079) | -.024 (.081) | -.031* (.021) | -.025† (.019) | .056 (.076) | -.031 (.079) |

**p<.01; *p<.05; †p<.10; all one-tailed tests. n = 126

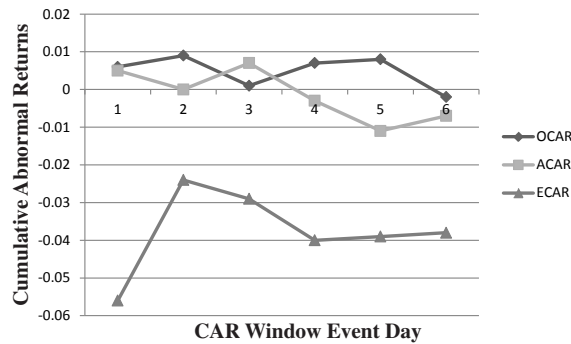


Figure 1: Full Sample Cumulative Abnormal Returns

We posit that a primary motivation for management to overstate earnings is to avoid a more severe negative reaction from the market due to the failure of earnings to meet market expectations (Harris & Bromiley, 2007; Weisbach, 1988). The net impact of restatement is calculated as the difference between the returns of the original earnings announcement (OCAR) and the returns of the subsequent restatement had accurate financial statements been offered originally (ECAR). Consequently, we compare the estimated response if the amended earnings information had been released in the original earnings announcement (ECAR) to the original 10K (OCAR) earnings announcement. This captures the financial benefits that occur from presenting fraudulent information initially then restating more accurate earnings afterward.

A comparative analysis of cumulative abnormal returns (Table 2) reveal support for our underlying hypothesis that the net response to amended earnings announcements leaves the firm more valuable than it would have otherwise been had the true information been provided in a timely manner (in the original 10K instead of the revised 10K/A). While on its face a comparison of OCAR to ACAR further substantiates the efficient market hypothesis, a comparison of OCAR to ECAR reveals a market inefficiency being exploited. Across all windows, the sample firms are more valuable (0.030–0.062) having provided erroneous information then revealing true information in subsequent filings. Moreover, timing the provision of true information appears to be a value sustaining action as a comparison of ACAR to ECAR reveals a net gain (0.023–0.060); revealing true information later is less painful than providing true information at the appropriate time. Without exception, it appears that the net gain from reporting erroneous earnings is positive when adding the market responses of original 10K and amended 10K/A at the times they were published. In other words, the firm investors avoid a more severe negative market reaction when management initially overstates their earnings than if they provided accurate information in a timely manner. The firm's shareholders are actually left with a more valuable firm than if the original report was accurate.

We also take the opportunity to address another fundamental question previously raised herein. Does the market discern a difference between “unintentional” error and fraudulent reporting? To address this question empirically, we divide our sample into firms that have had SEC civil actions taken against them (fraudulent reporting) and those that have not (“unintentional” error or erroneous reporting). The former

category of firms is identified through the SEC's Accounting and Audit Enforcement Releases (AAER). AAER's have been used in recent governance literature (Cecchini, Aytug, Koehler, & Pathak, 2010) to definitively identify fraudulent activity as fraud requires intentionality. Following Cecchini et al. (2010), we discriminate in our analysis based on the SEC's assessment of intent based on Rule 17(a) from the Securities Exchange Act of 1933, and Rules 13(b)(5), 13b2-1, and 10b-5 from the Securities Exchange Act of 1934. Each instance of fraud can have multiple AAERs; our sample highlights whether the firm was subject to an AAER ex-post our sampling period. Any firm in the sample identified ex-post to the GAO report as having an enforcement action taken against them can reasonably and confidently be identified as providing fraudulent earnings reports. This discrimination within the sample reveals twenty-five firms on the AAER reports leaving 101 firms classified as unintentionally reporting erroneous earnings. We note that the identification of AAER firms in our sample is approximately 20 percent while Cecchini et al. (2010) finds that only 1 percent of firms that restate earnings have AAERs registered against them. In combination with the SEC's characterization of our sample firms as having "accounting irregularities," the relatively large number of AAER firms further highlights the conservative nature of our sample selected from the GAO report.

Previously identified results of the full sample are consistent across subsamples with respect to cumulative abnormal returns. It appears the market recaptures the gains of an original earnings announcement (10/K) when more accurate information in the amended earnings announcement (10K/A) is revealed. Moreover, the estimated CAR based on the earnings surprise of the amended earnings announcement in comparison to analyst expectations leads us to consistent negative CARs across all windows. Figures 2 through 6 show graphical representations of these results.

However, unexpected results are revealed when making comparisons across subsamples (GAO and AAER). In every empirical iteration across every time window, the AAER firms do not benefit from their earnings restatement activities; meanwhile, our previously mentioned results hold for the GAO report firms that do not have enforcement action taken against them. The markets appear unable to discern a fraudulent firm ex-ante of enforcement action. Thus, the caveat can be made that claiming unintentional error or possessing some level of "plausible deniability" in reporting erroneous earnings works to the advantage of the firm. Graphical representations in Figure 7, 8, and 9 reveal in the full sample and each subsample (GAO

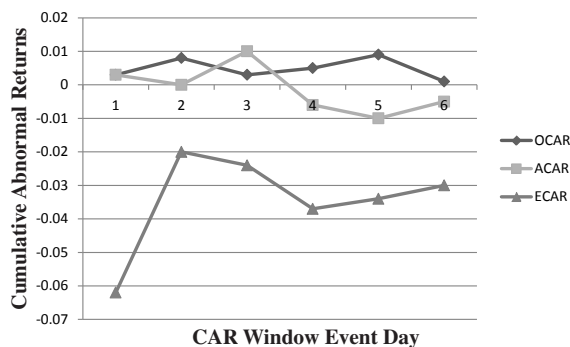


Figure 2: GAO Sample Cumulative Abnormal Return

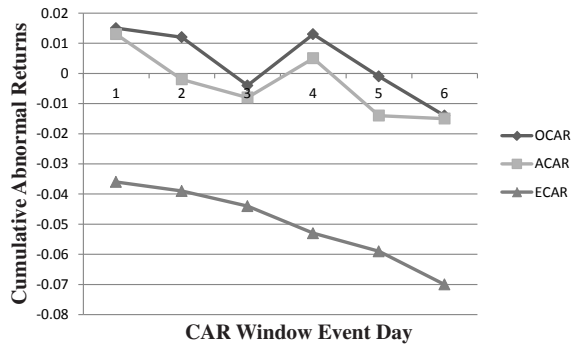


Figure 3: AAER Sample Cumulative Abnormal Returns

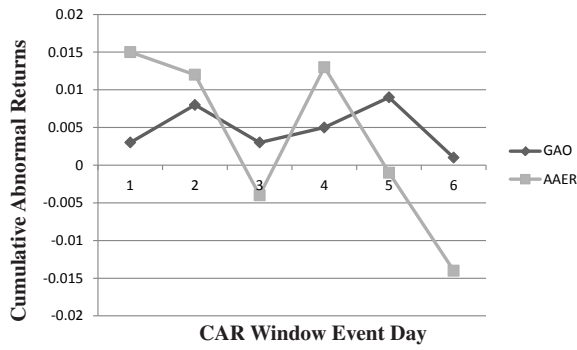


Figure 4: Original Cumulative Abnormal Returns (10K)

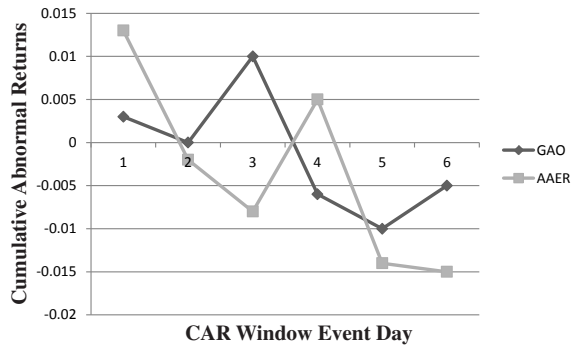


Figure 5: Amended Cumulative Abnormal Returns (10K/A)

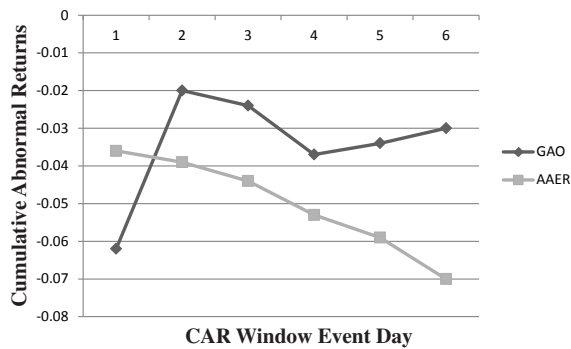


Figure 6: Estimated Cumulative Abnormal Returns (10K/A Earnings - 10 K Analyst Estimates)

and AAER) firms benefit from providing inaccurate information when comparing the estimated market reaction to accurate information in comparison to the original and amended reported earnings.

In the context of signal theory, lower-value firms are not penalized for masquerading as higher-value firms by overstating their earnings. Earnings, therefore, appear not to be an effective signal of firm quality as it does not provide a separating equilibrium. External stakeholders will have difficulty ascertaining the value of firms by their reported earnings. Consequently, managers may be able to leverage information asymmetry to behave opportunistically for personal gain. Shareholders are also beneficiaries as market-based sanctions may not be substantial enough to offset ill-gotten gains. However, in egregious cases that illicit regulatory sanction (AAER

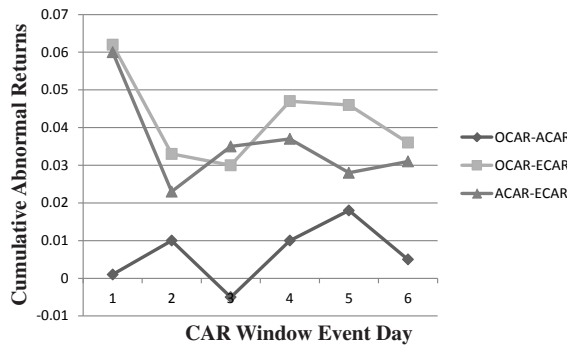


Figure 7: Full Sample Test of Market Efficiency (Benefit of Restating Earnings)

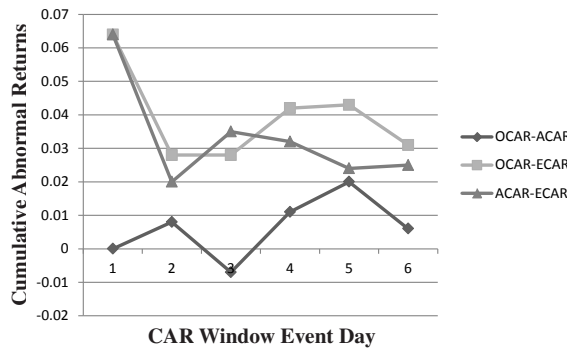


Figure 8: GAO Sample Test of Market Efficiency (Benefit of Restating Earnings)

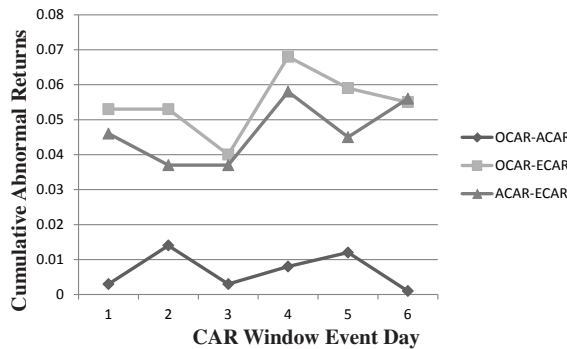


Figure 9: AAER Sample Test of Market Efficiency (Benefit of Restating Earnings)

reporting), this gain is negligible and undesirable for the firm owners. Nevertheless, shareholders benefit from “error” both when managers leverage information asymmetry to masquerade as firms that report accurately and when managers leverage the same asymmetry for “plausible deniability” when reporting corrected annual earnings statements.

Given these findings, what are the implications for owners and regulators in an equity market based system? The following section addresses this and discusses the ethical issues that are raised by these results.

DISCUSSION

Our paper, in the broadest sense, investigates why current measures in corporate governance to limit executive malfeasance and curb managerial opportunism are ineffective. We posit a very simple answer: it’s worth it. While Schwab (1996) queries “Do Ethics Always Make for Good Business?” or Paine (2000) asks “Does Ethics Pay?,” we investigate the counterargument, “can unethical behavior make for ‘good’ business” and “does unethicality pay?” We find unethical behavior may preserve firm value for shareholders as equity markets may insufficiently penalize firms (and its investors) for executive malfeasance. Specifically, there appears to be financial benefit for this behavior ex-ante and ex-post discovery of fraud; equity markets do not penalize transgressions sufficiently to deter future opportunistic behavior by executives predisposed to leverage moral hazard for personal gain. In effect, our results only heighten the tension addressed in Schwab (1996) and Paine (2000) yet highlights the theme each author espouses that ethical behavior and economic benefit are not necessarily (and need not be) aligned.

Specifically, we examined whether earnings and its derivative measures of performance are effective signals of firm value in the context of fraudulent financial reporting by firms to the SEC. We argued that the ability of earnings measures to act as a signal of firm value lies in their ability to convey information about the current and future performance of a firm’s resources. Building from signaling theory, we propose that for earnings to be an effective signal, the equity market has to prohibitively punish firms that overstate their earnings as a disincentive for other firms to overstate earnings in the future.

Our results, however, show that firms that overstate their earnings and are later forced to restate them are, on average, not penalized by the stock market sufficiently if earnings are an effective signal of firm performance. In other words, at least with respect to market valuation, firms with earnings below expectations are better off intentionally overstating those earnings, even if they will have to amend them later. Interestingly, this is consistent Harris and Bromiley’s (2007) findings with respect to accounting returns. An incentive therefore exists for firms with poor-quality earnings to masquerade as firms with higher-quality earnings by overstating their earnings. External stakeholders would find it difficult to differentiate worse-performing, lower-value firms from better-performing, higher-value firms based on their earnings.

The failure of equity markets (and the SEC) to ensure the effectiveness of earnings as a signal of firm value might be the result of the dual agency costs shareholders

face with managers who overstate earnings. First, the overstatement of earnings by managers, especially for compensation or employment risk reasons (e.g., Zhang et al., 2008) presents shareholders with agency costs. Attempts by the stock market to penalize firms that overstate their earnings pass this penalty through to shareholders in the form of lower share prices, thus producing a second agency cost for shareholders.² These agency costs may serve as a deterrent for the enforcement of accurate reporting as accuracy in reporting and enforcement of inaccurate reporting yields financial costs to long-term shareholders and reputation costs to the SEC.

However, a more nefarious scenario may also play out. Whether with intent or not, our empirical results suggest some shareholders benefit from inaccurate earnings reports. Those investors that divest equity stakes after the inaccurate report but prior to its amendment have the highest potential for monetary gain in the sale of firm equity; likewise, those that own firm equity ex-ante inaccurate reporting and ex-post amended reporting are likely to own a more valuable firm than had accurate information concerning firm performance been provided originally. The only certain “losers” are those that rely upon inaccurate information to purchase firm equity ex-ante the filing amendment and continue to own a stake ex-post the filing amendment.

The results of our study and its implication for managers and shareholders present a rather interesting dilemma. One should question whether the lack of effective monitoring and control is a consequence of shareholders simply not bearing enough accountability through agency cost to offset the benefit of the shared gain in malfeasant behavior of management. Recently, it appears Sandbu (2012) takes this claim further. He states that shareholders are “morally complicit in an action by delegating to a corporation the authority to” act on one’s behalf, and the lack of effective monitoring and control serve to enable their agents (Sandbu, 2012). In fact, given his commentary, Sandbu (2012) would view the results herein as making shareholders culpable for executive malfeasance as some benefit financially from the activity.

A critic of this position would rightly state few investors would even entertain such a posture especially given the monetary risk they bear. We submit this assessment is not in play for investors who are considering purchasing an ownership stake. However, ex-post investment, a rational person protecting their economic interests would withhold information on executive malfeasance until they had an opportunity to divest their interests. Why? Because it is not in their economic interest to take a loss (by revealing malfeasance prior to divestment) to protect the investment value of other owners. Given this, the ethical quandary occurs when considering whether to reveal malfeasance when it is known and not after one can harvest the value in the firm by divesting. The implication of this dilemma is present and remains unresolved even if the shareholders are ignorant of managerial opportunism; shareholders, as principals in the firm, remain responsible for the actions of their managers, as agents of the principal. This view is consistent with a prior exposition by John Hasnas (2007) whereby he aptly points out corporations are responsible for the malfeasant behavior of their employees. Legally, the corporation is the shareholders; thus, exacting sanctions on shareholders as owners of the corporation is consistent with legal precedent that corporations are accountable for employee activity (Hasnas, 2007).

LIMITATIONS

As with any empirical study, there are limits to the interpretation of the results. A primary consideration when drawing conclusions from this study is we are the first to use earnings response coefficients to estimate past market response to accurate information. While this methodology may be novel, as stated previously, it is not without precedent to estimate outcomes for analysis using cumulative abnormal returns and earnings response coefficients. Following Lipe, Bryant, and Widener (1998), we increase the validity of our empirical models by using firm-specific information as it has been found to possess the largest amount of explanatory power in the relationship between stock returns and earnings and utilizing our methodology in the narrow, limited context of earnings restatements. Furthermore, as Kimbrough et al. (2009) point out in their discussion of how to use event studies in marketing research, short-window studies are based on the notion that returns in excess of expected returns based on the firm's return-generating pattern can be attributed to the event of interest such as earnings restatements. Moreover, the measurement of abnormal returns is robust to alternative ways of calculating expected returns (Kimbrough et al., 2009). We acknowledge our use of CARs and ERCs to predict past events is novel, yet we also note it is not without precedent, and is limited in scope.

Additionally, our paper uses this empirical evidence to raise the specter of ethical issues arising from firm owners benefiting from opportunism because markets are inefficient. Our empirical findings support the theme of the paper by augmenting the theoretical development and simple mathematical example to show that not only can shareholders benefit from managerial opportunism but they may be doing so already. Thus, the empirical results herein serve to strengthen the underlying theme of how market inefficiency may provide an incentive for managers to report poor information and a disincentive to principals to monitor and control agents.

CONCLUSION

Given our findings, the key to curbing executive malfeasance may be beyond capacity of the current remedies as the primary stakeholder (shareholders) may not bear enough financial risk. Ownership has its rights (residual rents), privileges (limited liability and selection of board members), and responsibilities (agency costs such as monitoring and control) (Boatright, 1994). Thus, regulatory enforcement should strongly consider ways to ensure owners bear the appropriate amount of financial risk to incentivize more strenuous execution of their responsibilities to monitor and control their agents (Ryan, Buchholtz, & Kolb, 2010 provide an excellent overview of shareholder movement for more stringent manager and director accountability).

First, consideration must be given to impacting the rights of shareholders to claim residual rents. In order to do so, residual rents must be reduced, or the capacity for the firm to generate and deliver residual rents to owners must be negatively impacted. The former can be accomplished via clawback of paid dividends over the time period between original and amended filings. Given the state of technology in investment processes, targeted owners can be identified rather easily, the scream you hear from

investment fund firms and affected investors notwithstanding. The latter can also be accomplished via more significant regulatory fines with cooperation from offending firms lessening their penalties. This impacts the firms retained earnings, hampering the discretionary cash that can be used for dividend payments and manager incentive compensation and perks. This recommendation also impacts the privilege of limited owner liability. Since the only financial risk for owners is the value of the firm, fining a firm such that it significantly impacts retained earnings and cash flows negatively impacts firm value and hurts shareholders more significantly. Given the increased stakes reflected in possible losses due to malfeasant behavior of their agents, shareholders would be more interested in using a variety of monitoring and control mechanisms to ensure proper executive behavior or avail themselves of the option to sell their interests in the firm. In this manner, the governance structures would more tightly align ownership and control, forcing shareholders to hold accountable their agents for the "moral character of its activities" (Rodin, 2005: 178).

In addition, more stringent monitoring by boards of directors could serve as another non-capital market mechanism that penalizes managers who overstate earnings. Research by O'Connor et al. (2006), for example, provides preliminary evidence of the importance of board monitoring in reducing earnings management. Schwartz, Dunfee, and Kline (2005) propose a renewed focus on boards and suggest a specific codification of ethics to which each director adheres. Practically speaking, we suggest this only refocuses the marketplace on the status quo; we have evidence from Harris and Bromiley (2007) as well a holistic review of governance literature from Dalton, Hitt, Certo, and Dalton (2008) suggesting such efforts may have limited efficacy. This is especially odd given corporate law squarely puts the responsibility for shareholder value maximization on directors (Stout, 2012). A more impactful suggestion is allowing owners to exercise the right to sack the entire board of directors for ethical lapses of the top management team. This applies severe penalties (financial, reputational, social, etc.) for lack of oversight by the board and has implications for insider directors.

With respect to firms that the SEC deems as having "accounting irregularities," our results reveal that there is little discernment by equity markets between firms that intentionally and "unintentionally" report inaccurate earnings. Discerning between intentional fraud and unintentional error makes enforcement precarious; our results may exhibit a symptom of the issue, namely, firms that report fraudulent results are taking advantage of the pooling of themselves with firms that unintentionally report erroneous earnings. Thus, regulators must become timelier in their identification of "accounting irregularities" in financial reporting. Increased timeliness and transparency should lead to better protections for investors considering purchasing equity in the firm (i.e., the "angry" investors) and influences market reactions that decreases firm value as investors (ethical and otherwise) divest as the financial risk with the firm increases due to veracity issues in the firm's financial reporting. Moreover, such firms should be provided the proper incentives (through the board as they are the direct representatives of ownership) to cooperate with regulators to root out malfeasant executives. This not only imposes sanctions directly on such executives but also offers protection to owners of other firms for which opportunistic executives serve as directors. Furthermore, this allows regulators to more aptly discern

between error and opportunism as firm cooperation allows them to develop a better understanding of the processes that yield inaccurate financial reporting.

The aforementioned recommendations accomplish multiple objectives. First, it reestablishes the market framework for which executive malfeasance is addressed and sanctions are delivered. This establishes improper behavior is punished and ethical behavior is required of executives. Whether through intrinsic motivation or external mechanisms, proper behavior yields the possibility of rewards while improper behavior increases the probability of severe sanctions. Second, it puts the onus back on investors to monitor and control executive behavior by showing the benefit shareholders receive from the malfeasant activity of their executives. It also allows regulators to impact investors directly through clawback of previously paid dividends and indirectly through firm sanctions that decrease firm value, the sole financial risk shareholders' bear in the firm. The increase in enforcement costs for investors will heighten their sensitivity to executive opportunism and increase their level of accountability in the monitoring and control functionality of their directors.

In conclusion, we concur with Richard, Devinney, Yip, and Johnson (2009) and conclude that the lack of validity in earnings announcements and inefficient market valuation mechanisms create incentive for managers to behave opportunistically and leverage moral hazard for personal gain. We anticipate that future research will build on this paper by expressly including variables related to executive compensation that may be the antecedents to fraudulent reporting and to the market response of the amended results. Moreover, firm-level variables consistent with research on financial restatements and firm performance could offer additional insight into the antecedents and consequences of fraudulent reporting. From a practitioner viewpoint, we anticipate mechanisms and penalties to be further developed so that firms who fraudulently overstate earnings could be more appropriately penalized. The passage of the Sarbanes-Oxley Act, for example, represents a regulatory attempt to provide punitive disincentives to overstating earnings.

Ghoshal and Moran (1996) concluded that attempting to control opportunism of managers may be pointless as the effective implementation of one governance measure may only lead to other forms of opportunistic behavior. We offer a change in course and suggest regulators turn their sights onto shareholder influence on firm management as investors do not provide oversight significant enough to warrant a change in managerial behavior. Simply put, we suggest if you incentivize the investors to enforce ethical behavior of managers, malfeasant behavior will diminish. Incentives for increased shareholders engagement start with increased awareness of their accountability for firm outcomes and removing mechanisms that shield investors from further negative consequences of managerial opportunism and quite possibly (as shown empirically) the financial benefits of disengagement monitoring and control functions in the firm. The results of this study compel us to reflect upon the ethical responsibilities of ownership in our financial system. In closing, we offer the following as food for thought:

[The] responsibility for maximal moral obligations rests inalienably with the owners of business assets. (Rodin, 2005: 178)

NOTES

We thank Associate Editor Jerry Goodstein and his anonymous review team for offering constructive feedback and guiding the development of this paper. We thank Brian Connelly, Michael Holmes, Edward Levitas, Greg Martin, J. Mark Mayer, Richard Priem, and Justin Webb for their helpful comments and suggestions. We are grateful to Rachel Hills and Kirsty Schonegg for their support in the data collection efforts and to Sarah Pittman and Stacey Lynn Wessel for the clerical and editing support of this paper.

1. An alternative approach would be to use a pooled (cross-sectional) sample of the CARs for all the firms at the initial earnings announcement event and calculate a market ERC (i.e., the ERC will be the same for all the firms that period). We used both methods and the results did not substantially differ.

2. However, note that shareholders holding an ownership interest from the time of the original earnings statement to the earnings restatement possess a more valuable equity position than if the managers reported accurate earnings initially.

REFERENCES

- Agrawal, A., & Chadha, S. 2005. Corporate governance and accounting scandals. *Journal of Law & Economics*, 48(2): 371–406. <http://dx.doi.org/10.1086/430808>
- Allen, S., & Ramanan, R. 1995. Insider trading, earnings changes, and stock prices. *Management Science*, 41(4): 653–68. <http://dx.doi.org/10.1287/mnsc.41.4.653>
- Arthaud-Day, M. L., Certo, S. T., Dalton, C. M., & Dalton, D. R. 2006. A changing of the guard: Executive and director turnover following corporate financial restatements. *Academy of Management Journal*, 49(6): 1119–36. <http://dx.doi.org/10.5465/AMJ.2006.23478165>
- Atiase, R. K., Li, H. A., Supattarakul, S., & Tse, S. 2005. Market reaction to multiple contemporaneous earnings signals: Earnings announcements and future earnings guidance. *Review of Accounting Studies*, 10(4): 497–525. <http://dx.doi.org/10.1007/s11142-005-4211-8>
- Bagnoli, M., & Watts, S. G. 2005. Conservative accounting choices. *Management Science*, 51(5): 786–801. <http://dx.doi.org/10.1287/mnsc.1040.0351>
- Banker, R. D., Huang, R., & Natarajan, N. 2009. Incentive contracting and value relevance of earnings and cash flows. *Journal of Accounting Research*, 47(3): 647–78. <http://dx.doi.org/10.1111/j.1475-679X.2009.00335.x>
- Barney, J. B. 1988. Returns to bidding firms in mergers and acquisitions: Reconsidering the relatedness hypothesis. *Strategic Management Journal*, 9(S1): 71–78. <http://dx.doi.org/10.1002/smj.4250090708>
- Basu, S. 1977. Investment performance of common stocks in relation to their price-earnings ratios: A test of the efficient market hypothesis. *Journal of Finance*, 32(3): 663–82. <http://dx.doi.org/10.1111/j.1540-6261.1977.tb01979.x>
- Biddle, G. C., Bowen, R. M., & Wallace, J. S. 1997. Does EVA[®] beat earnings? Evidence on associations with stock returns and firm values. *Journal of Accounting & Economics*, 24(3): 301–36. [http://dx.doi.org/10.1016/S0165-4101\(98\)00010-X](http://dx.doi.org/10.1016/S0165-4101(98)00010-X)
- Bishara, N. D., & Schipani, C. A. 2009. Strengthening the ties that bind: Preventing corruption in the executive suite. *Journal of Business Ethics*, 88: 765–80. <http://dx.doi.org/10.1007/s10551-009-0325-4>
- Blair, M. M. 2003. Shareholder value, corporate governance and corporate performance: A post-Enron reassessment of the conventional wisdom. In P. K. Cornelius & B.

- Kogut (Eds.), *Corporate governance and capital flows in the global economy*: 53–82. London: Oxford University Press.
- Boatright, J. R. 1994. Fiduciary duties and the shareholder-management relation: Or, What's so special about shareholders? *Business Ethics Quarterly*, 4: 393–407. <http://dx.doi.org/10.2307/3857339>
- Boatright, J. R. 1996. Business ethics and the theory of the firm. *American Business Law Journal*, 34(2): 217–38. <http://dx.doi.org/10.1111/j.1744-1714.1996.tb00697.x>
- Bowman, E. H., Singh, H., & Thomas, H. 2002. The domain of strategic management: History and evolution. In A. Pettigrew, H. Thomas, & R. Whittington (Eds.), *Handbook of Strategy and Management*: 31–51. Sage: London.
- Boyd, B. K., Gove, S., & Hitt, M. A. 2005. Construct measurement in strategic management research: Illusion or reality? *Strategic Management Journal*, 26(3): 239–57. <http://dx.doi.org/10.1002/smj.444>
- Burns, N., & Kedia, S. 2006. The impact of performance-based compensation on misreporting. *Journal of Financial Economics*, 79(1): 35–67. <http://dx.doi.org/10.1016/j.jfineco.2004.12.003>
- . 2008. Executive option exercises and financial misreporting. *Journal of Banking & Finance*, 32(5): 845–57. <http://dx.doi.org/10.1016/j.jbankfin.2007.06.004>
- Bushman, R., Engel, E., & Smith, A. 2006. An analysis of the relation between the stewardship and valuation roles of earnings. *Journal of Accounting Research*, 44(1): 53–83. <http://dx.doi.org/10.1111/j.1475-679X.2006.00192.x>
- Campbell, J. T., Campbell, T. C., Sirmon, D. G., Bierman, L., & Tuggle, C. S. 2012. Shareholder influence over director nomination via proxy access: Implications for agency conflict and stakeholder value. *Strategic Management Journal*, 33(12): 1431–51. <http://dx.doi.org/10.1002/smj.1989>
- Campbell, J. Y., Hilscher, J., & Szilagyi, J. 2008. In search of distress risk. *The Journal of Finance*, 63(6): 2899–2939. <http://dx.doi.org/10.1111/j.1540-6261.2008.01416.x>
- Cecchini, M., Aytug, H., Koehler, G. J., & Pathak, P. 2010. Detecting management fraud in public companies. *Management Science*, 56(7): 1146–60. <http://dx.doi.org/10.1287/mnsc.1100.1174>
- Chandra, U., & Ro, B. T. 2008. The role of revenue in firm valuation. *Accounting Horizons*, 22(2): 199–222. <http://dx.doi.org/10.2308/acch.2008.22.2.199>
- Coase, R. H. 2007. The nature of the firm. *Economica*, 4(16): 386–405. <http://dx.doi.org/10.1111/j.1468-0335.1937.tb00002.x>
- Coff, R. W., & Lee, P. M. 2003. Insider trading as a vehicle to appropriate rent from r&d. *Strategic Management Journal*, 24(2): 183–90. <http://dx.doi.org/10.1002/smj.270>
- Collins D., Li, O., & Xie, H. 2009. What drives the increased informativeness of earnings announcements over time? *Review of Accounting Studies*, 14(1): 1–30. <http://dx.doi.org/10.1007/s11142-007-9055-y>
- Dalton, D. R., Hitt, M. A., Certo, S. T., & Dalton, C. M. 2008. The fundamental agency problem and its mitigation: Independence, equity, and the market for corporate control. In J. P. Walsh & A. P. Brief (Eds.), *Academy of Management Annals*, 1: 1–64. New York: Lawrence Erlbaum. <http://dx.doi.org/10.1080/078559806>

- Datta, S., & Dhillon, U. S. 1993. Bond and stock-market response to unexpected earnings announcements. *Journal of Financial and Quantitative Analysis*, 28(4): 565–77. <http://dx.doi.org/10.2307/2331166>
- Dechow, P. 1994. Accounting earnings and cash flows as measures of firm performance: The role of accounting accruals. *Journal of Accounting and Economics*, 18(1): 3–42. [http://dx.doi.org/10.1016/0165-4101\(94\)90016-7](http://dx.doi.org/10.1016/0165-4101(94)90016-7)
- Denis, D. J., Hanouna, P., & Sarin, A. 2006. Is there a dark side to incentive compensation? *Journal of Corporate Finance*, 12(3): 467–88. <http://dx.doi.org/10.1016/j.jcorpfin.2005.08.006>
- Desai H., Hogan, C. E., & Wilkins, M. S. 2006. The reputational penalty for aggressive accounting: Earnings restatements and management turnover. *Accounting Review*, 81(1): 83–112. <http://dx.doi.org/10.2308/accr.2006.81.1.83>
- Di Lorenzo, V. 2007. Business ethics: Law as a determinant of business conduct. *Journal of Business Ethics*, 71(3): 275–99. <http://dx.doi.org/10.1007/s10551-006-9139-9>
- Dunfee, T. W. 1998. The marketplace of morality: First steps toward a theory of moral choice. *Business Ethics Quarterly*, 8: 127–45. <http://dx.doi.org/10.2307/3857525>
- Efendi, J., Srivastava, A., & Swanson, E. P. 2007. Why do corporate managers misstate financial statements? The role of option compensation and other factors. *Journal of Financial Economics*, 85(3): 667–708. <http://dx.doi.org/10.1016/j.jfineco.2006.05.009>
- Eisenhardt, K. M. 1989. Agency theory: An assessment and review. *Academy of Management Review*, 14(1): 57–74.
- Elayan, F. A., Li, J. Y., & Meyer, T. O. 2008. Accounting irregularities, management compensation structure and information asymmetry. *Accounting and Finance*, 48(5): 741–60.
- Erickson, M., Hanlon, M., & Maydew, E. L. 2006. Is there a link between executive equity incentives and accounting fraud? *Journal of Accounting Research*, 44(1): 113–43. <http://dx.doi.org/10.1111/j.1475-679X.2006.00194.x>
- Fama, E. F. 1980. Agency problems and the theory of the firm. *Journal of Political Economy*, 88(2): 288–307. <http://dx.doi.org/10.1086/260866>
- Fama, E. F., & French, K. R. 1992. The cross-section of expected stock returns. *Journal of Finance*, 47(2): 427–87. <http://dx.doi.org/10.1111/j.1540-6261.1992.tb04398.x>
- _____. 1993. Common risk factors in the returns on stocks and bonds. *Journal of Financial Economics*, 33(1): 3–56. [http://dx.doi.org/10.1016/0304-405X\(93\)90023-5](http://dx.doi.org/10.1016/0304-405X(93)90023-5)
- Fassin, Y. 2012. Stakeholder management, reciprocity and stakeholder responsibility. *Journal of Business Ethics*, 109(1): 83–96. <http://dx.doi.org/10.1007/s10551-012-1381-8>
- Fischer, P. E., & Louis, H. 2008. Financial reporting and conflicting managerial incentives: The case of management buyouts. *Management Science*, 54(10): 1700–14. <http://dx.doi.org/10.1287/mnsc.1080.0895>
- Francis J., Schipper, K., & Vincent, L. 2002. Expanded disclosures and the increased usefulness of earnings announcements. *The Accounting Review*, 77: 515–46. <http://dx.doi.org/10.2308/accr.2002.77.3.515>

- Ghoshal, S. 2005. Bad management theories are destroying good management practices. *Academy of Management Learning & Education*, 4(1): 75–91. <http://dx.doi.org/10.5465/AMLE.2005.16132558>
- Ghoshal, S., & Moran, P. 1996. Bad for practice: A critique of the transaction cost theory. *Academy of Management Review*, 21(1): 13–47.
- Gomez-Mejia, L., & Wiseman, R. M. 1997. Reframing executive compensations: An assessment and outlook. *Journal of Management*, 23(3): 291–374.
- Goodpaster, K. E. 1991. Business ethics and stakeholder analysis. *Business Ethics Quarterly*, 1: 53–73. <http://dx.doi.org/10.2307/3857592>
- Goodpaster, K. E., & Holloran, T. E. 1994. In Defense of a Paradox. *Business Ethics Quarterly*, 4(4): 423–29. <http://dx.doi.org/10.2307/3857341>
- Goodstein, J. D., & Wicks, A. 2007. Corporate and stakeholder responsibility: Making business ethics a two-way conversation. *Business Ethics Quarterly*, 17(3): 375–98. <http://dx.doi.org/10.5840/beq200717346>
- Harris, J., & Bromiley, P. 2007. Incentives to cheat: The influence of executive compensation and firm performance on financial misrepresentation. *Organization Science*, 18(3): 350–67. <http://dx.doi.org/10.1287/orsc.1060.0241>
- Hasnas, J. 2007. Up from flatland: Business ethics in the age of divergence. *Business Ethics Quarterly*, 17(3): 399–426. <http://dx.doi.org/10.5840/beq200717339>
- Healy, P. M., & Palepu, K. G. 2001. Information asymmetry, corporate disclosure, and the capital markets: A review of the empirical disclosure literature. *Journal of Accounting & Economics*, 31: 405–40. [http://dx.doi.org/10.1016/S0165-4101\(01\)00018-0](http://dx.doi.org/10.1016/S0165-4101(01)00018-0)
- Heath, J. 2006. Business ethics without stakeholders. *Business Ethics Quarterly*, 16(4): 533–57. <http://dx.doi.org/10.5840/beq200616448>
- Higgs, J. L., & Skantz, T. R. 2006. Audit and nonaudit fees and the market's reaction to earnings announcements. *Auditing: A Journal of Practice & Theory*, 25(1): 1–26. <http://dx.doi.org/10.2308/aud.2006.25.1.1>
- Holthausen, R. W., & Verrecchia, R. E. 1988. The effect of sequential information releases on the variance of price changes in an intertemporal multi-asset market. *Journal of Accounting Research*, 82–106. <http://dx.doi.org/10.2307/2491114>
- Howton, S. D., Howton, S. W., & McWilliams, V.B. 2008. Ethical implications of ignoring shareholder directives to remove antitakeover provisions. *Business Ethics Quarterly*, 18(3): 321–46. <http://dx.doi.org/10.5840/beq200818326>
- Hudson, R. 2005. Ethical investing: Ethical investors and managers. *Business Ethics Quarterly*, 641–57. <http://dx.doi.org/10.5840/beq200515445>
- Humphery-Jenner, M. L. 2012. Internal and external discipline following securities class actions. *Journal of Financial Intermediation*, 21(1): 151–79. <http://dx.doi.org/10.1016/j.jfi.2011.09.001>
- Imhoff, E. A., & Lobo, G. J. 1992. The effect of ex ante earnings uncertainty on earnings response coefficients. *Accounting Review*, 67(2): 427–39.
- Jensen, M. C., & Meckling, W. H. 1976. Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, 3(4): 305–60. [http://dx.doi.org/10.1016/0304-405X\(76\)90026-X](http://dx.doi.org/10.1016/0304-405X(76)90026-X)

- Jones, T. M. 1995. Instrumental stakeholder theory: A synthesis of ethics and economics. *Academy of Management Review*, 20(2): 404–37.
- Kesavan, S., Gaur, V., & Raman, A. 2010. Do inventory and gross margin data improve sales forecasts for US public retailers? *Management Science*, 56(9): 1519–33. <http://dx.doi.org/10.1287/mnsc.1100.1209>
- Keung, E., Lin, Z. X., & Shih, M. 2010. Does the stock market see a zero or small positive earnings surprise as a red flag? *Journal of Accounting Research*, 48(1): 91–121. <http://dx.doi.org/10.1111/j.1475-679X.2009.00354.x>
- Kimbrough, M. D., Mcalister, L., Mizik, N., Jacobson, R., Garmaise, M. J., Srinivasan, S., & Hanssens, D. M. 2009. Commentaries and rejoinder to “Marketing and firm value: Metrics, methods, findings, and future directions.” *Journal of Marketing Research*, 46(3): 313–29. <http://dx.doi.org/10.1509/jmkr.46.3.313>
- Kinney, W. R., Burgstahler, D., & Martin, R. 2002. Earnings surprise “materiality” as measured by stock returns. *Journal of Accounting Research*, 40(5): 1297–1329. <http://dx.doi.org/10.1111/1475-679X.t01-1-00055>
- Kinney, W. R., Palmrose, Z. V., & Scholz, S. 2004. Auditor independence, non-audit services, and restatements: Was the US government right? *Journal of Accounting Research*, 42(3): 561–88. <http://dx.doi.org/10.1111/j.1475-679X.2004.t01-1-00141.x>
- Koch, A. S., & Sun, A. X. 2004. Dividend changes and the persistence of past earnings changes. *Journal of Finance*, 59(5): 2093–2116. <http://dx.doi.org/10.1111/j.1540-6261.2004.00693.x>
- Kormendi, R., & Lipe R. 1987. Earnings innovations, earnings persistence, and stock returns. *Journal of Business*, 60(3): 323–45. <http://dx.doi.org/10.1086/296400>
- Kwon, Y. K. 2005. Accounting conservatism and managerial incentives. *Management Science*, 51(11): 1626–32. <http://dx.doi.org/10.1287/mnsc.1050.0417>
- Landsman, W. R., & Maydew, E. L. 2002. Has the information content of quarterly earnings announcements declined in the past three decades? *Journal of Accounting Research*, 40(3): 797–808. <http://dx.doi.org/10.1111/1475-679X.00071>
- Letza, S., Sun, X. P., & Kirkbride, J. 2004. Shareholding versus stakeholding: A critical review of corporate governance. *Corporate Governance: An International Review*, 12(3): 242–62. <http://dx.doi.org/10.1111/j.1467-8683.2004.00367.x>
- Lev, B. 1989. On the usefulness of earnings and earnings research—lessons and directions from two decades of empirical research. *Journal of Accounting Research*, 27: 153–92. <http://dx.doi.org/10.2307/2491070>
- Lim, S. C., & Lusch, R. F. 2011. Sales margin and margin capitalization rates: Linking marketing activities to shareholder value. *Journal of the Academy of Marketing Science*, 39(5): 647–63. <http://dx.doi.org/10.1007/s11747-010-0226-1>
- Lipe, R. C., Bryant, L., & Widener, S. K. 1998. Do nonlinearity, firm-specific coefficients, and losses represent distinct factors in the relation between stock returns and accounting earnings? *Journal of Accounting and Economics*, 25(2): 195–214. [http://dx.doi.org/10.1016/S0165-4101\(98\)00022-6](http://dx.doi.org/10.1016/S0165-4101(98)00022-6)
- Maitland, I. 1994. The morality of the corporation: An empirical or normative disagreement? *Business Ethics Quarterly*, 4: 445–58. <http://dx.doi.org/10.2307/3857343>

- Maitland, I. 2001. Distributive justice in firms: do the rules of corporate governance matter? *Business Ethics Quarterly*, 11: 129–43. <http://dx.doi.org/10.2307/3857873>
- March, J. G., & Sutton, R. I. 1997. Organizational performance as a dependent variable. *Organization Science*, 8(6): 698–706. <http://dx.doi.org/10.1287/orsc.8.6.698>
- Marens, R., & Wicks, A. 1999. Getting real: stakeholder theory, managerial practice, and the general irrelevance of fiduciary duties owed to shareholders. *Business Ethics Quarterly*, 9: 273–93. <http://dx.doi.org/10.2307/3857475>
- Matejka, M., Merchant, K. A., & Van der Stede, W. A. 2009. Employment horizon and the choice of performance measures: Empirical evidence from annual bonus plans of loss-making entities. *Management Science*, 55(6): 890–905. <http://dx.doi.org/10.1287/mnsc.1090.0999>
- Matsumura, E. M., & Shin, J. Y. 2005. Corporate governance reform and CEO compensation: Intended and unintended consequences. *Journal of Business Ethics*, 62(2): 101–13. <http://dx.doi.org/10.1007/s10551-005-0175-7>
- Miller, K. D., & Leiblein, M. J. 1996. Corporate risk-return relations: Returns variability versus downside risk. *Academy of Management Journal*, 39(1): 91–122. <http://dx.doi.org/10.2307/256632>
- Myers, S. C. 1977. Determinants of corporate borrowing. *Journal of Financial Economics*, 5(2): 147–75. [http://dx.doi.org/10.1016/0304-405X\(77\)90015-0](http://dx.doi.org/10.1016/0304-405X(77)90015-0)
- Nag, R., Hambrick, D. C., & Chen, M. J. 2007. What is strategic management, really? Inductive derivation of a consensus definition of the field. *Strategic Management Journal*, 28(9): 935–55. <http://dx.doi.org/10.1002/smj.615>
- Ndofor, H. A., & Levitas, E. 2004. Signaling the strategic value of knowledge. *Journal of Management*, 30(5): 685–702. <http://dx.doi.org/10.1016/j.jm.2004.04.002>
- Ndofor, H. A., Wesley, C. L., & Priem, R. L. In press. Providing CEOs with opportunities to cheat: The effects of complexity-based information asymmetries in financial reporting fraud. *Journal of Management*. <http://dx.doi.org/10.1177/0149206312471395>
- O'Connor, J. P., Priem, R. L., Coombs, J. E., & Gilley, K. M. 2006. Do CEO stock options prevent or promote fraudulent financial reporting? *Academy of Management Journal*, 49(3): 483–500. <http://dx.doi.org/10.5465/AMJ.2006.21794666>
- Paine, L. S. 2000. Does ethics pay? *Business Ethics Quarterly*, 10(1): 319–30. <http://dx.doi.org/10.2307/3857716>
- Pangarkar, N., & Lie, J. R. 2004. The impact of market cycle on the performance of Singapore acquirers. *Strategic Management Journal*, 25(12): 1209–16. <http://dx.doi.org/10.1002/smj.434>
- Prentice, R. A. 2007. Flatland, ethicsland, and legalland. *Business Ethics Quarterly*, 17(3): 433–40. <http://dx.doi.org/10.5840/beq200717342>
- Quinn, D. P., & Jones, T. M. 1995. An agent morality view of business policy. *Academy of Management Review*, 20(1): 22–42.
- Reuer, J. J., & Ragozzino, R. 2006. Agency hazards and alliance portfolios. *Strategic Management Journal*, 27(1): 27–43. <http://dx.doi.org/10.1002/smj.446>

- Richard, P. J., Devinney, T. M., Yip, G. S., & Johnson, G. 2009. Measuring organizational performance: Towards methodological best practice. *Journal of Management*, 35(3): 718–804. <http://dx.doi.org/10.1177/0149206308330560>
- Rivoli, P. 2003. Making a difference or making a statement? Finance research and socially responsible investment. *Business Ethics Quarterly*, 13: 271–87. <http://dx.doi.org/10.5840/beq200313323>
- Roberts, R. W., & Mahoney, L. 2004. Stakeholder conceptions of the corporation: Their meaning and influence in accounting research. *Business Ethics Quarterly*, 14(3): 399–431. <http://dx.doi.org/10.5840/beq200414326>
- Rodin, D. 2005. The ownership model of business ethics. *Metaphilosophy*, 36(1–2): 163–81. <http://dx.doi.org/10.1111/j.1467-9973.2005.00361.x>
- Rosenberg, B., Reid, K., & Lanstein, R. 1985. Persuasive evidence of market inefficiency. *Journal of Portfolio Management*, 11(3): 9–17. <http://dx.doi.org/10.3905/jpm.1985.409007>
- Rumelt, R. P., Schendel, D., & Teece, D. J. 1991. Strategic management and economics. *Strategic Management Journal*, 12: 5–29. <http://dx.doi.org/10.1002/smj.4250121003>
- Ryan, L. V., & Buchholtz A. K. 2001. Trust, risk, and shareholder decision making: An investor perspective on corporate governance. *Business Ethics Quarterly*, 11(1): 177–93. <http://dx.doi.org/10.2307/3857876>
- Ryan, L. V., Buchholtz, A. K., & Kolb, R. W. 2010. New directions in corporate governance and finance: Implications for business ethics research. *Business Ethics Quarterly*, 20(4): 673–94. <http://dx.doi.org/10.5840/beq201020442>
- Sandbu, M. E. 2012. Stakeholder duties: On the moral responsibility of corporate investors. *Journal of Business Ethics*, 109(1): 97–107. <http://dx.doi.org/10.1007/s10551-012-1382-7>
- Sanders, W. G. 2001. Behavioral responses of CEOs to stock ownership and stock option pay. *Academy of Management Journal*, 44(3): 477–92. <http://dx.doi.org/10.2307/3069365>
- Sanders, W. G., & Carpenter, M. A. 1998. Internationalization and firm governance: The roles of CEO compensation, top team composition, and board structure. *Academy of Management Journal*, 41(2): 158–78. <http://dx.doi.org/10.2307/257100>
- Schneider, M., & Valenti, A. 2011. A property rights analysis of newly private firms: Opportunities for owners to appropriate rents and partition residual risks. *Business Ethics Quarterly*, 21(3): 445–71. <http://dx.doi.org/10.5840/beq201121326>
- Schwab, B. 1996. A note on ethics and strategy: Do good ethics always make for good business? *Strategic Management Journal*, 17(6): 499–500. [http://dx.doi.org/10.1002/\(SICI\)1097-0266\(199606\)17:6<499::AID-SMJ811>3.0.CO;2-B](http://dx.doi.org/10.1002/(SICI)1097-0266(199606)17:6<499::AID-SMJ811>3.0.CO;2-B)
- Schwartz, M. S., Dunfee, T. W., & Kline, M. J. 2005. Tone at the top: An ethics code for directors? *Journal of Business Ethics*, 58(1): 79–100. <http://dx.doi.org/10.1007/s10551-005-1390-y>
- Sloan, R. G. 1996. Do stock prices fully reflect information in accruals and cash flows about future earnings? *Accounting Review*, 71(3): 289–315.
- Spence, A. 1974. *Market signaling*. Cambridge, MA: Harvard University Press.

- Spurgin, E. W. 2001. Do shareholders have obligations to stakeholders? *Journal of Business Ethics*, 33(4): 287–97. <http://dx.doi.org/10.1023/A:1011819303241>
- Staubus, G. J. 2005. Ethics failures in corporate financial reporting. *Journal of Business Ethics*, 57(1): 5–15. <http://dx.doi.org/10.1007/s10551-004-3811-8>
- Stout, L.A. 2012. *The shareholder value myth: How putting shareholders first hurts investors, corporations and the public*. San Francisco: Berrett Koehler Press.
- Swaminathan, S., & Weintrop, J. 1991. The information-content of earnings, revenues, and expenses. *Journal of Accounting Research*, 29(2): 418–27. <http://dx.doi.org/10.2307/2491058>
- Tang, C. Y., & Tikoo, S. 1999. Operational flexibility and market valuation of earnings. *Strategic Management Journal*, 20(8): 749–61. [http://dx.doi.org/10.1002/\(SICI\)1097-0266\(199908\)20:8<749::AID-SMJ53>3.0.CO;2-L](http://dx.doi.org/10.1002/(SICI)1097-0266(199908)20:8<749::AID-SMJ53>3.0.CO;2-L)
- Teece, D. J. 1990. A question of industrial success. *Harvard Business Review*, 68(3): 215–15.
- Teets, W., & Wasley, C. 1996. Estimating earnings response coefficients: Pooled versus firm-specific models. *Journal of Accounting and Economics*, 21(3): 279–95. [http://dx.doi.org/10.1016/0165-4101\(96\)00423-5](http://dx.doi.org/10.1016/0165-4101(96)00423-5)
- Tengblad, S. 2004. Expectations of alignment: Examining the link between financial markets and managerial work. *Organization Studies*, 25(4): 583–606. <http://dx.doi.org/10.1177/0170840604042404>
- Teoh, S. H., & Wong, T. J. 1993. Perceived auditor quality and the earnings response coefficient. *Accounting Review*, 68(2): 346–66.
- United States Government Accountability Office. 2007. Financial restatements: Update of public company trends, market impacts, and regulatory enforcement activities. <http://www.gao.gov/new.items/d06678.pdf> (5 March 2007).
- Vera-Munoz, S. C. 2005. Corporate governance reforms: Redefined expectations of audit committee responsibilities and effectiveness. *Journal of Business Ethics*, 62(2): 115–27. <http://dx.doi.org/10.1007/s10551-005-0177-5>
- Weisbach, M. S. 1988. Outside directors and CEO turnover. *Journal of Financial Economics*, 20(1): 431–60. [http://dx.doi.org/10.1016/0304-405X\(88\)90053-0](http://dx.doi.org/10.1016/0304-405X(88)90053-0)
- Williamson, O. E. 1991. Comparative economic organization: The analysis of discrete structural alternatives. *Administrative Science Quarterly*, 36(2): 269–96. <http://dx.doi.org/10.2307/2393356>
- Yeh, Y. H., Lee, T. S., & Shu, P. G. 2008. The agency problems embedded in firm's equity investment. *Journal of Business Ethics*, 79(1–2): 151–66. <http://dx.doi.org/10.1007/s10551-007-9387-3>
- Zhang, X. M., Bartol, K. M., Smith, K. G., Pfarrer, M. D., & Khanin, D. M. 2008. CEOs on the edge: Earnings manipulation and stock-based incentive misalignment. *Academy of Management Journal*, 51(2): 241–58. <http://dx.doi.org/10.5465/AMJ.2008.31767230>

