Summer Research Grant Executive Summary

Title: Strategic Management Guidance and Insider Trading Activities

Keywords: Expectations management; Management forecasts; Analyst forecasts; Insider trading

Abstract: We assess whether managers engage in ex ante strategic behavior when issuing earnings forecasts in a novel context. We posit that some managers provide inaccurate downward guidance to increase the positive surprise and pricing premium at the earnings announcement, thereby maximizing profits from selling shares following the earnings announcement. In support, we document that managers are more likely to have issued prior inaccurate downward guidance when they sell more shares or increase their selling activities following the earnings announcement. Further, we show that these managers benefit economically by linking inaccurate downward guidance to greater pricing premiums at the earnings announcement date and more positive cumulative stock returns over the period from inaccurate downward guidance to subsequent insider trading.

Key Takeaways:
- Managers issue more inaccurate downward than upward earnings guidance, which we posit is in anticipation of selling their stock holdings in the company.
- Inaccurate downward guidance leads to a larger positive earnings surprise at the announcement date and greater stock price appreciation from management guidance date through post-earnings-announcement insider selling activities.
- We observe that in the 10 to 30 days following the subsequent earnings announcement, these managers sell more shares at a higher stock price yielding greater insider selling profits.

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This paper has been accepted for publication in the Journal of Accounting and Public Policy.
Title: Managerial Risk-taking Incentives and Risky Policy Choices

Keywords: Executive compensation; Managerial incentives; Risk taking; Research and Development

Abstract: Based on prior studies, we investigate whether CEO stock option incentives (i.e., the sensitivity of CEO wealth to stock return volatility, or vega) may lead to either excessive risk taking or lesser risk taking than suggested by the level of incentive. While prior research documents that vega encourages managers to increase the riskiness of firms’ investment profiles (i.e., more R&D and less capital expenditures), we show that this effect reverses for higher levels of vega. Specifically, R&D investment levels and profitability decline once vega increases past an inflection point. Investor pricing of R&D conditional on vega reflects a similar non-linear relation. As expected, these relations are concentrated in managers subject to less investor oversight and with a greater proportion of options “in the money.” Finally, we find similar evidence using alternative measures of riskiness and R&D success. Our evidence is consistent with lower and moderate levels of executive stock options encouraging managers to make riskier policy choices, while higher levels of risk-taking incentives are associated with less risky policy choices.

Key Takeaways:
- Higher risk-taking incentives created by managers’ stock option compensation do not always lead to higher risk-taking.
- A decline in R&D investment levels and profitability for higher vega managers is concentrated in firms with lower oversight and managers with a higher proportion of in-the-money stock options.

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This paper being revised for first-round submission to The Accounting Review.
Title: A Joint Assessment of the Patatoukas and Thomas (2011, 2015) and Ball, Kothari, and Nikolaev (2013) Explanations for Bias in Asymmetric Timeliness-based Conservatism

Keywords: Asymmetric timeliness; Conservatism; Bias; Persistence; Management forecast frequency

Abstract: Patatoukas and Thomas (2011, 2015) identify an asymmetric relation between lagged earnings and current returns, which they conclude is indicative of bias in the Basu (1997) conservatism model. They link this bias to two related but distinct scale and variance effects – more volatile returns and a higher incidence of loss associated with smaller firms. In contrast, Ball et al. (2013) posit and provide evidence that this bias results from a failure to control for asymmetry between expected earnings and expected returns. We empirically reconcile these two disparate explanations by showing that both have descriptive validity for explaining this bias, and our results demonstrate that a measure of asymmetric timeliness that controls for both asymmetric expectations and variance effects is uncorrelated with this bias. Perhaps more importantly, we extend the analysis to a context where bias matters most – hypotheses testing. Results from this analysis confirm our earlier results and further reveal that while this bias, on average, overstates asymmetric timeliness as a measure of conservatism, it can produce a measure that understates the relation between conservatism and a variable of interest.

Key Takeaways:
- Contrary to conclusions reached in Patatoukas and Thomas (2011, 2015) and Ball et al. (2013), lagged-earnings-related bias in the Basu (1997) conservatism model is related to two distinct effects: scale and variance effects and failure to control for expected earnings and expected returns.
- While this bias, on average, overstates asymmetric timeliness as a measure of conservatism, it can produce a measure that understates the relation between conservatism and a variable of interest.

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This paper being revised for first-round submission to Journal of Accounting Research.