Does Litigation Encourage or Deter Real Earnings Management?*

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Abstract

We examine whether litigation risk encourages or deters real earnings management (REM). The literature documents that litigation risk restricts opportunism in voluntary disclosure and financial reporting choices. This can encourage REM, if managers replace strategic disclosure and reporting with more opaque REM. However, since the intention of REM is to mislead shareholders, managers’ efforts to conceal REM can induce them to make misleading statements that become the subject of future lawsuits. Further, when shareholders litigate, they can use managers’ real actions as evidence of intent to mislead. This ex post settling-up by shareholders can ex ante deter managers from engaging in REM. We conduct differences-in-differences tests centered on an unanticipated court ruling that reduced shareholders’ ability to initiate class action lawsuits against firms headquartered in the Ninth Circuit. We observe significant increases in REM following the ruling for Ninth Circuit firms relative to other firms. These increases are more pronounced in firms with higher managerial entrenchment and lower institutional ownership, as well as lower accounting flexibility. We conclude that litigation deters REM, and this deterrence is more salient when corporate governance is weaker and managers have lower ability to manipulate accruals.

Keywords: Real Earnings Management, Earnings Management, Deterrence, Litigation, Corporate Governance

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