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Why Firms Voluntarily Disclose Bad News

DOUGLAS J. SKINNER*

1. Introduction

This paper provides evidence on corporate voluntary disclosure practices through an examination of the earnings-related disclosures made by a random sample of 93 *NASDAQ* firms during 1981–90.¹ I find that, consistent with prior studies, earnings-related voluntary disclosures occur infrequently (on average, one disclosure for every ten quarterly earnings announcements); good news disclosures tend to be point or range estimates of annual earnings-per-share (*EPS*), while bad news disclosures tend to be qualitative statements about the current quarter's earnings; the (unconditional) stock price response to bad

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¹I searched the *Dow Jones News Retrieval Service* for all statements that are attributable to the company or its officials and that convey information about the firm's earnings prospects. This search yielded point forecasts, range forecasts, and upper- and lower-bound forecasts, as well as qualitative statements about future earnings. Disclosures that related to either annual and/or quarterly earnings were included.

news disclosures is larger than the response to good news disclosures; quarterly earnings announcements that convey large negative earnings surprises are preempted about 25% of the time by voluntary corporate disclosures while other earnings announcements are preempted less than 10% of the time.

Overall, the evidence is consistent with the idea that managers face an asymmetric loss function in choosing their voluntary disclosure policies—managers behave as if they bear large costs when investors are surprised by large negative earnings news, but not when other earnings news is announced. There are at least two reasons managers may bear costs as a result of large negative earnings surprises. First, stockholders may sue when there are large stock price declines on earnings announcement days, since stockholders can allege that managers failed to disclose adverse earnings news promptly. Managers can be held personally liable in such suits, and their activities may be disrupted by having to deal with this litigation.

Second, managers may incur reputational costs if they fail to disclose bad news in a timely manner. Money managers, stockholders, security analysts, and other investors dislike adverse earnings surprises, and may impose costs on firms whose managers are less than candid about potential earnings problems. For example, money managers may choose not to hold the stocks of firms whose managers have a reputation for withholding bad news and analysts may choose not to follow these firms' stocks. These costs will affect managers' disclosure decisions as long as managers have an incentive to maintain the level of their firm's stock price through some (unspecified) mechanism.²

Not all the sample disclosures about earnings convey bad news, and these other disclosures appear similar to those evaluated in previous work. That is, they are typically point or range estimates of annual *EPS* that generally convey either little information or good news (see Lev and Penman [1990] and Pownall, Wasley, and Waymire [1993] for exceptions). My evidence suggests that by limiting their samples to point or range forecasts of annual *EPS*, some previous papers appear to have excluded an important subset of all voluntary disclosures, specifically qualitative disclosures that preempt the information in quarterly earnings releases.

The next section of the paper lays out why securities laws may motivate managers to preempt bad quarterly earnings news. Section 3 summarizes existing accounting research on discretionary disclosure, and section 4 details the research hypotheses. Section 5 describes the sample

² Recent analytical research suggests that managers disclose bad news to deter entry/competition in their firms' product markets (e.g., see Darrrough and Stoughton [1990] and Newman and Sansing [1993]) or to signal their "quality" (Teoh and Hwang [1991]). However, it seems unlikely that the earnings-related bad news disclosures in this study are driven by these incentives.

and data. In section 6 I report the results of the hypothesis tests. Section 7 concludes the paper with a summary and discusses some implications of the results for future research.

2. *Managers' Legal Incentives to Disclose Bad News*

I argue in this section that, to prevent large stock price declines on earnings announcement dates (and thereby reduce the potential costs of shareholder suits), managers have incentives to preempt the announcement of large negative earnings surprises. This strategy reduces expected legal costs in two ways. First, if the information is disclosed "voluntarily" (prior to the mandated release date), it is more difficult for the plaintiff, who does not know for sure when the manager first received the bad news, to argue that the manager withheld information. Second, disclosing early limits the period of nondisclosure, thereby reducing the damages that plaintiffs can claim.

Managers may also have reputational incentives to preempt negative earnings news. Articles in the financial press suggest that professional money managers, security analysts, and other investors impose costs on firms when their managers appear to delay bad news disclosures. (Because of the time lag between the end of the fiscal quarter and the earnings announcement date, it is difficult for managers to argue credibly that they too were surprised by the earnings outcome.) These articles claim that firms whose managers acquire a reputation for failing to disclose bad news are less likely to be followed by analysts and money managers, thus reducing the price and/or liquidity of their firms' stocks.³

Stockholder lawsuits based on earnings disclosures are typically brought under SEC Rule 10b-5, which makes it unlawful for any person "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading."⁴ Because I am interested in managers' legal incentives to disclose information, I focus on the law as it relates to omissions.

The case law is not clear-cut with respect to whether managers have an affirmative obligation to disclose information during the periods between the various quarterly and annual reports required by the SEC. However, legal scholars agree that there is no affirmative disclosure ob-

³ For two examples from the popular press that claim a link between negative earnings surprises and a deterioration in the firm's relations with the investment community, see R. King, "The Liar's Discount," *Forbes* (May 30, 1988) and R. L. Rose, "SEC Investigating Harley Stock Plunge; Angry Investors See Leak of Results," *Wall Street Journal* (October 25, 1991): A6.

⁴ Loss and Seligman [1991, chap. 9] describe the "catch-all" nature of Rule 10b-5 and its utility in securities fraud cases. I do not discuss Section 11 of the Securities Act (which addresses fraud in registration statements related to initial public offerings) since I am interested in the disclosure policies of established companies.

ligation unless there is a specific duty to disclose (see Hazen [1989, p. 753], Loss and Seligman [1991, p. 3517], or Walton and Brissman [1991, pp. 2–8]). This duty arises in two situations. First, the *SEC*'s "disclose or abstain" rule requires that corporate insiders disclose all material information or abstain from trading. Second, if the company has disclosed information, that disclosure must, under Rule 10b–5, be complete and accurate. Consequently, the company has a duty to update or correct preexisting disclosures, including information disclosed in quarterly earnings releases and other mandatory disclosures, if those disclosures become inaccurate, incomplete, or misleading (e.g., see Loss and Seligman [1991, p. 3517]).⁵

This second point forms the basis for claims that managers should have divulged information more quickly. Following Alexander's [1991, p. 514] argument that reporting requirements for public companies facilitate allegations that offering materials, annual reports, 10-Ks or 10-Qs, or press releases were or became misleading given the information that should have been disclosed, I argue that it is usually not difficult, given the existence of new information in an earnings announcement, to allege that managers should have divulged information earlier.

To be successful in a private right of action under Rule 10b–5, the plaintiff must show: (1) a misstatement or omission of (2) a material fact (3) made with intent (4) that the plaintiff justifiably relied on (5) causing injury in connection with the purchase or sale of a security. While each of these requirements involves subtle and complex issues of law, there is evidence to suggest that the law *operates* more simply. First, most 10b–5 cases are brought as a result of disclosures that lead to relatively large stock price declines and which can be tied to previously omitted or misleading disclosures. Second, most 10b–5 cases are settled, so that these legal issues become less important (in determining expected legal costs) than the events that trigger the suit.⁶

⁵ Because the *SEC* encourages, but *does not require*, the disclosure of "other materially important events" on Form 8-K, it is unlikely that the Form 8-K requirements trigger the types of earnings-related disclosures in this study. I provide evidence on the extent to which my disclosures are accompanied by Form 8-K filings in section 6.4.1. In addition, stock exchange and *NASD* rules impose an affirmative duty to disclose material information quickly. These rules must be enforced by the *NASD* or the exchanges, who can delist the firm's security. The extent to which these rules are enforced is an open empirical question.

⁶ O'Brien and Hodges [1991] report that 183 of 191 cases (96%) with available outcomes data were settled before trial. Alexander [1991, p. 525] cites data from the Office of the United States Courts: of the 5,147 private securities actions pending in federal courts in 1987, only 224 (4.3%) went to trial. Alexander [1991] and Romano [1991] argue that the relatively high incidence of settlement for securities class actions and derivative suits is due to risk aversion on the part of directors and officers who are usually named, along with the firm, as defendants in these cases, and to the fact that their liability insurance typically covers the costs of settling but *not* damages (Romano [1991, p. 57]). Macey and Miller [1991] discuss why the incentives of the plaintiff's attorney are biased toward settlement.

Francis, Philbrick, and Schipper [1993] provide evidence on a sample of 45 firms that were targets of earnings-related shareholder lawsuits from 1988 to 1992. All but two of the 45 firms experienced stock price declines at the time of the earnings or earnings-related announcement that corrected an allegedly misleading statement or omission and led to the lawsuit; the average decline in market value on the announcement day was \$141 million. O'Brien and Hodges [1991] examine 332 class action securities cases reported in *Securities Class Action Alert* between April 1988 and June 1991. Of the 297 sample firms with stock price data, 289 (97%) showed a decline in stock price during the period over which damages were claimed or during the last three weeks of the damages period. Although O'Brien and Hodges do not provide data on either the allegations in these suits or on the disclosures that triggered them, their data, together with the evidence in Francis, Philbrick, and Schipper [1993], demonstrates that the large majority of 10b-5 cases are filed after stock price declines.⁷

To summarize, prior research indicates that most 10b-5 cases are brought after disclosures that lead to stock price declines; if this occurs, it is fairly easy for plaintiffs to allege, based on the manager's duty to update, that managers failed to disclose material information; and almost all of these cases are settled. Thus, large stock price declines that accompany information releases generate higher expected legal costs than large stock price increases. As a result, I predict that managers will attempt to preempt adverse earnings outcomes more often than neutral or favorable earnings outcomes.

The preemptive disclosure strategy will not prevent lawsuits entirely. Stockholder lawsuits can arise whenever a large stock price decline is associated with an information release; preemptive disclosures themselves can trigger suits (see Francis, Philbrick, and Schipper [1993]). Nevertheless, early disclosure of bad news is probably still the best alternative available to managers for at least two reasons. First, earlier disclosures undercut plaintiff arguments that the manager failed to disclose the information promptly. Second, the shorter the period of nondisclosure, the smaller the size of the plaintiff class and the smaller the expected costs of the suit. (Only stock purchasers or sellers can sue. The shorter the class period, the smaller the number of purchasers or sellers.)

⁷ The legal reasons for this asymmetry appear to relate to proof of damages and the need to show a sufficient causal connection between the plaintiff's injury and the wrongful conduct. If an investor purchases a stock whose price subsequently declines, it is relatively easy to show both an out-of-pocket loss and (if the decline is accompanied by the release of information) causation. Conversely, a plaintiff who sells before good news is revealed suffers an opportunity loss and must show that he or she would not have sold had the information been available.

3. *Discretionary Disclosure Research*

3.1 EXISTING THEORY

Analytical research on discretionary disclosure has shown that in the absence of costs, full disclosure obtains (Grossman [1981] and Milgrom [1981]; see also Ross [1979]). For example, Verrecchia [1983] imposes a constant proprietary cost of disclosure and shows that only managers of firms with news above a certain threshold will disclose their news. Uninformed investors cannot distinguish firms which have information less than the threshold and so cannot infer bad news from nondisclosure. Relatedly, Dye [1985] proposes that investors are uncertain about the existence of managers' private information and so cannot infer from silence that managers are withholding bad news. Both models imply that managers disclose only *relatively* good news (bad news will be disclosed if the costs of disclosure are low enough or if the information asymmetry between managers and investors is sufficiently high).

Several recent analytical models examine managers' incentives to use disclosures to affect the behavior of product-market competitors. Darrough and Stoughton [1990] extend Verrecchia's [1983] model to endogenize proprietary disclosure costs and show that managers may disclose bad news to discourage entry (see also Wagenhofer [1990]). Dontoh [1989] shows that managers of firms in oligopolistic markets will disclose both good and bad news given the trade-off between wanting to provide good news to stockholders and bad news to competitors. Gigler [1992] and Newman and Sansing [1993] address similar questions using "cheap talk" models, in which disclosures are no longer constrained to be truthful. While these deterring-the-competitor models yield no precise empirical implications, they imply that bad news disclosures are intended to deter entry/competition in product markets.

Ajinkya and Gift [1984] examine the hypothesis that managers issue earnings forecasts when they believe the market's earnings expectations are sufficiently inaccurate that large price movements will occur when results are announced. Thus, Ajinkya and Gift assume managers dislike large earnings surprises of either sign equally, although they do not offer reasons. The argument is similar to the legal liability argument, except that the latter implies the costs of failing to disclose bad news before the earnings announcement exceed the costs of failing to disclose good news.

3.2 EMPIRICAL EVIDENCE

There are numerous empirical studies of managers' earnings forecasts. (See King, Pownall, and Waymire [1990] for a review.) Consistent with the idea that managers disclose relatively good news, papers by Patell [1976], Penman [1980], Waymire [1984], and Lev and Penman [1990] document that managers disclose good news forecasts more often than

bad news forecasts and, on average, that there is a positive stock price response to managers' earnings forecasts. In addition, there is evidence that managers are more likely to release earnings forecasts when their firms are performing relatively well (e.g., see Lev and Penman [1990]). However, for samples drawn from more recent time periods researchers find that management earnings forecasts are associated with a stock price response that is, on average, close to zero (Ajinkya and Gift [1984], McNichols [1989], and Pownall, Wasley, and Waymire [1993]). Thus, there is evidence that managers disclose both good and bad news forecasts voluntarily.

4. *Research Hypotheses*

The basic premise I seek to test is that managers' voluntary disclosures are either good news forecasts of *EPS* motivated by unusually good performance or preemptive bad news disclosures motivated by legal liability and/or reputational effects. Since most firms are not in either of these situations most of the time, I also expect a low overall frequency of voluntary disclosures. There are three research hypotheses.

First, according to the legal liability argument, voluntary disclosures of bad news are motivated by the need to avoid and/or mitigate large stock price declines on earnings announcement dates. Since earnings announcements (and the potential stock price declines that accompany them) occur every quarter, I hypothesize that bad news voluntary disclosures will tend to preempt the information contained in quarterly earnings releases rather than that in annual earnings releases. (Clearly, for the first three quarters of the year forecasts that relate to annual *EPS* will not preempt the information released on the next quarterly earnings announcement date.) Thus, I hypothesize that:

H1: Bad news earnings disclosures are more likely to relate to quarterly earnings releases and less likely to relate to annual *EPS* numbers, and conversely for good news earnings disclosures.

More generally, if motivated by the need to preempt a specific quarterly earnings realization, bad news disclosures may take a different form from disclosures designed primarily to signal good news. Thus I also provide descriptive evidence on whether there is a relation between the sign of earnings news and disclosure type.

The central prediction of the legal liability argument is that managers preempt earnings announcements that convey large negative earnings surprises more often than they preempt other quarterly earnings announcements. Thus, I hypothesize that:

H2: The probability the information conveyed by a given quarterly earnings announcement will be preempted by a voluntary corporate disclosure is higher for relatively large negative earnings surprises than for other types of earnings information.

By testing *H2* I provide evidence on the extent to which the legal liability argument has empirical validity relative to the expectations-adjustment hypothesis of Ajinkya and Gift. Under the expectations-adjustment hypothesis, the probability that a given quarterly earnings announcement will be preempted increases with the size of the earnings surprise (measured as the difference between the manager's and the market's earnings expectations) regardless of its sign; this is true only for large *negative* surprises under the legal liability argument.

According to the arguments developed in section 2, an important motivation for voluntary bad news disclosures is that managers wish to mitigate large stock price declines on earnings announcement dates or avoid them altogether. If this is the case, the stock price response associated with bad news disclosures will be larger than that associated with good news disclosures. Thus, I hypothesize that:

H3: The stock price response to preemptive bad news voluntary disclosures is larger in absolute value than the stock price response to good news voluntary disclosures.

5. Sample Selection, Data, and Descriptive Statistics

To investigate the extent to which corporate managers disclose bad news before they are required to do so on quarterly earnings announcement dates, I collect data on the voluntary disclosures of 93 *NASDAQ* National Market System (*NMS*) firms during the 1980s. I chose *NASDAQ* firms because they tend to be smaller and younger than exchange-listed firms, so they may be more likely to experience the earnings shocks that lead to securities lawsuits. In addition, *NASDAQ* firms are less closely followed by analysts than exchange-listed firms, so their voluntary disclosures are a relatively more important means of communication with outside investors. I chose *NASDAQ NMS* firms because they are the largest *NASDAQ* stocks. I impose this criterion based on Alexander's [1991] evidence that very small firms do not get sued because the potential settlement size does not justify bringing suit.

To collect a random sample of *NASDAQ NMS* firms, I first obtained a list of the 1,234 firms listed on the *NASDAQ NMS* on January 1, 1985 (the *NMS* began in 1982, but only a small number of firms were listed in 1982 and 1983). Of these, I randomly chose 100 of the 657 firms listed on the *NASDAQ* by January 1, 1981. I was able to identify 94 of the 100 firms on the 1990 *CRSP NASDAQ* tape. Of the 94 firms, 59 were still listed on the *NASDAQ* at the end of December 1990, another 13 had moved to an exchange, and 22 did not survive through the end of 1990.

Based on comparative market capitalization as of December 31, 1980 and consistent with the sample selection criteria, the sample firms were smaller than exchange-listed firms but larger than other *NASDAQ* firms. The sample firms had an average (median) market value of

\$117.2 million (\$61.9 million) compared to population statistics of \$534.4 million (\$98.4 million) for NYSE-ASE firms and \$49.9 million (\$18.0 million) for NASDAQ firms in general. As of the beginning of 1981 only 19 of the 94 firms were followed by *Value Line* analysts.

To investigate disclosure practices, I searched the *Dow Jones News Retrieval Service (DJNRS)* during the period January 1, 1981 through December 31, 1990, using the keywords "earnings," "income," "profit(s)," and "loss(es)." All articles retrieved as a result of this search were read to ensure that the statement was attributed to either the company or a company official. One of the 94 firms was not included in the *DJNRS* data base; thus the final sample contains 93 firms.

Table 1 provides descriptive information on the sample of earnings-related voluntary disclosures. I include *all* disclosures with implications for quarterly and annual earnings, not only quantitative statements such as point, range, and lower- and upper-bound forecasts, but also qualitative statements such as "earnings will be down" or "earnings will be disappointing," because they convey at least the direction of earnings changes to investors, and the hypothesis is principally about whether earnings surprises are preempted. (Pownall, Wasley, and Waymire [1993] examine a similar set of disclosures, although they exclude qualitative disclosures.)

There are 374 earnings-related disclosures reported in the *DJNRS* for these 93 firms over the 1981-90 period (less than one per firm per year).⁸ There is considerable cross-sectional variation in voluntary disclosure frequency; 17 sample firms make no voluntary disclosures during the ten-year period, and another 16 make only one. By contrast, 4 firms make 13 or more disclosures during the sample period, and 12 firms make 10 or more disclosures. I examine how this variation affects the results of my tests later in the paper (section 6.4.2).

The left-hand column of table 1 indicates that of the 374 disclosures, 109 (29%) relate exclusively to annual earnings, while another 94 (25%) have implications for both annual and quarterly earnings. Thus nearly half the sample disclosures (171 observations or 46%) relate exclusively to quarterly earnings and so would be excluded from many previous studies. Similarly, 36% of the 374 observations are preliminary earnings estimates that other studies exclude.

To provide information on the relative frequency of forecast type, the right-hand column of table 1 treats the 94 disclosures that relate to both annual and quarterly earnings as separate observations, yielding $(374 + 94 =) 468$ observations. The largest single group is point estimates (122 or 26% of the total) which, when combined with the range

⁸ For 91 sample firms over a similar period (1979-87), Pownall, Wasley, and Waymire [1993] obtain 1,252 disclosures, around three times as many as I observe. Their sample includes only firms covered by *Value Line* and includes NYSE-ASE as well as NASDAQ firms, and so is likely to contain larger firms than my sample.

TABLE 1
Several Categorizations of the 374 Earnings-Related Voluntary Disclosure Announcements¹

	374 Earnings-Related Announcements	468 Earnings-Related Disclosures
Panel A: Forecast Horizon		
Annual	109 (29.1%)	202 (43.2%)
Quarterly	171 (45.7%)	266 (56.8%)
Both	94 (25.2%)	NA
Panel B: Type of Forecast²		
Point	NA	122 (26.1%)
Range	NA	74 (15.8%)
Lower Bound	NA	83 (17.7%)
Upper Bound	NA	87 (18.6%)
Qualitative	NA	102 (21.8%)
Panel C: Type of News³		
Good News	159 (42.5%)	191 (40.8%)
Bad News	195 (52.1%)	251 (53.6%)
No News	20 (5.4%)	26 (5.6%)

¹This table is based on 374 disclosure announcements made by 93 *NASDAQ-NMS* firms during 1981–90. Ninety-four disclosure announcements contain forecasts of both annual and quarterly earnings, yielding a total of $374 + 94 = 468$ disclosures about particular earnings realizations. This set of observations forms the basis of the numbers reported in the right-hand column.

²Point forecasts convey a single point estimate of earnings; range forecasts provide a dollar range within which earnings are expected to fall; lower- (upper-) bound forecasts convey an expected lower (upper) bound for earnings; and qualitative forecasts contain specific comments about earnings but no quantitative information.

³The classification of forecasts into those that convey good news, bad news, and no news is done based on the researcher's assessment of the information contained in a particular announcement but is usually fairly straightforward.

estimates (74 or 16%), account for 42% of the total observations. Thus, as documented in Pownall, Wasley, and Waymire [1993], by excluding upper- and lower-bound and qualitative forecasts of *EPS* other studies exclude a large subsample of earnings forecasts. In addition, 102 (22%) of the observations are qualitative.

Finally, table 1 breaks down the disclosures into good, bad, or neutral (no) news disclosures based on my reading of the complete text of the *DJNRS* document. Disclosures are classified as good/bad/no news if they indicate that earnings will be better/worse/same than previously expected by investors or, in the absence of information about prior expectations, better/worse/same than the corresponding prior period's earnings (I resorted to this categorization method for 14 quarterly disclosures and 12 annual disclosures). When in doubt I classified an observation as "no news."⁹

⁹ I checked the accuracy of my subjective classification scheme for voluntary disclosures by comparing my classification to the sign of the corresponding change in split-adjusted

Consistent with prior research, the evidence in table 1, panel C indicates that firms disclose both good and bad news, although there are more bad news observations (251) than good news observations (191). Only about 5% of the observations fall into the “no news” category, consistent with the view that managers disclose information to change earnings expectations.

6. Results

6.1 GOOD VS. BAD NEWS AND THE NATURE OF VOLUNTARY DISCLOSURES

Under *H1*, I expect a relation between forecast horizon (annual vs. quarterly) and the sign of the news (good or bad) such that voluntary quarterly earnings disclosures are more likely to convey bad news than voluntary disclosures that relate to annual earnings. Panel A of table 2 presents the results of this test for the 266 disclosures that relate to either (but not both) annual or quarterly earnings. The results are consistent with *H1*. While the majority of good news disclosures relate to annual earnings (72 of 126 or 57%), over three-quarters (109 of 140 or 78%) of the bad news disclosures relate to quarterly earnings. Put differently, 70% of annual disclosures convey good news (72 of 103), while 67% of quarterly disclosures convey bad news (109 of 163). A chi-square test rejects the hypothesis that there is no relation between the sign of the news and forecast horizon at the .0001 level. These results indicate that quarterly disclosures tend to convey bad news while annual disclosures tend to convey good news.

Table 2, panel B provides descriptive information on the relation between the sign of earnings news and the form of its disclosure. Ignoring the lower- and upper-bound estimates (which account for 32% and 34% of the good and bad news disclosures respectively), it is clear that managers disclose good and bad news differently. Good news tends to be disclosed as a point or range estimate (52% of the time vs. 26% for bad news disclosures) while bad news tends to be disclosed qualitatively (39% of the time vs. 16% for the good news releases). Chi-square tests reject the null hypothesis of no relation between the sign of earnings news and forecast type at small probability levels both before and after excluding the lower- and upper-bound estimates.

There is evidence that bad earnings news tends to occur (or is at least given accounting recognition) more often in the fourth quarter (see DeAngelo, DeAngelo, and Skinner [1994], Elliott and Shaw [1988], and Zucca and Campbell [1992] for evidence that write-offs

quarterly earnings. The classifications were consistent (e.g., a good news disclosure accompanied an increase in split-adjusted *EPS*) around 85% of the time. I have reformed the tests in tables 3 and 4 after deleting the 43 observations for which my classification was inconsistent with the sign of the corresponding change in quarterly *EPS*. The results do not differ in any meaningful way from those reported in the tables.

TABLE 2
*The Relation between the Sign of Forecast News, Disclosure Horizon,
 and the Type of Forecast for 266 Earnings-Related Disclosures¹*

	Good News ²	Bad News ²
Panel A: Forecast Horizon		
Annual	72	31
Quarterly	54	109
$\chi^2_1 = 34.24, p < .001$		
Panel B: Type of Forecast		
Point	37 (29.4%)	27 (19.3%)
Range	28 (22.2%)	10 (7.1%)
Lower Bound	40 (31.8%)	2 (1.4%)
Upper Bound	1 (0.7%)	47 (33.6%)
Qualitative	20 (15.9%)	54 (38.6%)
$\chi^2_4 = 103.73, p < .001$		

¹This table is based on 374 disclosure announcements made by 93 NASDAQ-NMS firms during 1981–90. Of 374 disclosures, 94 contain forecasts of both annual and quarterly earnings; these observations were dropped because they did not necessarily have a unique forecast type. Of the remaining 280 disclosures, I dropped 14 observations that did not unambiguously convey good or bad news about earnings.

²The classification of forecasts into those that convey good news, bad news, and no news is done based on the researcher's assessment of the information contained in a particular announcement and is usually fairly straightforward.

occur disproportionately in the fourth quarter). In addition, despite the fact that fourth-quarter disclosures are generally labeled as referring to *either* quarterly or annual earnings, it is obvious that once a prediction about fourth-quarter earnings is provided, investors also have a prediction about annual earnings, and vice versa. As a result, the results in panel A of table 2 may be attributable to a preponderance of fourth-quarter bad news disclosures which are classified as quarterly rather than annual.

I investigated this in two ways. First, I reperformed the chi-square test in panel A of table 2 after dropping the 85 fourth-quarter disclosures. The relation between the sign of the earnings news and forecast horizon remains strong: the chi-square statistic is 26.68, significant at the .0001 level. Thus the table 2 result is not attributable to fourth-quarter disclosures. Second, I examined whether there are disproportionately more bad news disclosures in the fourth quarter. The evidence (not reported in tables) indicates that 47 of the 140 bad news disclosures (exactly one-third) occur in the fourth quarter, with the remainder divided evenly among the other three quarters. Thus more bad news is disclosed in the fourth quarter. However, this pattern also holds for the good news disclosures, so there does not appear to be any asymmetry in the quarterly distribution of disclosures that could explain the table 2 results.

Overall, the evidence in table 2 reveals that good news is more often disclosed as an annual point or range forecast of *EPS*, whereas bad news disclosures are more likely to be qualitative and related to quarterly earnings announcements. When combined with evidence (see table 5 below) that the bad news disclosures are typically associated with large negative stock price reactions, while good news disclosures generate more moderate positive effects, the evidence in table 2 suggests that bad news disclosures are more likely to be motivated by a need to preempt large negative quarterly earnings surprises, whereas good news disclosures are more likely to be driven by a desire to signal more generally that the firm is doing well. (I obtain similar results when I use the seasonal-random-walk earnings surprise measure described later in the paper: the average earnings surprise is -14.0% for the bad news disclosures compared with 3.2% for the good news disclosures.)

6.2 ARE LARGE NEGATIVE EARNINGS SURPRISES MORE LIKELY TO BE PREEMPTED?

To test the prediction that managers have incentives to preempt large negative earnings surprises but not other types of earnings news, I require a proxy for the manager's private information about the upcoming earnings release and how it differs from the market's expectation. (I assume the manager has the information in sufficient time to preempt the news contained in the earnings announcement.) Following previous studies, I assume the seasonal-random-walk model provides a good approximation for the market's expectation of quarterly *EPS* and that managers have superior information about earnings. I do not use analyst forecast data for these tests because most sample firms are not followed by *Value Line* analysts. I deflate the quarterly earnings change by stock price 60 trading days prior to the earnings announcement date. I use stock price approximately three months prior to the earnings announcement date because during quarters with disclosures, there are likely to be stock price changes that are correlated with the earnings surprise, so that using stock price immediately prior to the earnings announcement as the deflator might understate the size of the earnings surprise. The quarterly earnings data (quarterly *EPS* numbers and announcement dates) required for these tests are collected from the quarterly *Compustat* tapes, the *Wall Street Journal Index*, and the *DJNRS*.

For the 93 sample firms I obtain earnings surprise data for a total of 2,647 firm-quarters during 1981-90. I classify 292 earnings announcements (11%) as having been preempted by a voluntary disclosure. This number is less than the 374 voluntary disclosures initially identified for three reasons. First, sometimes there is more than one disclosure in a given quarter and each quarterly earnings announcement can be preempted only once (13 disclosures are dropped for this reason). Second, I exclude voluntary disclosures which are clearly not designed to preempt the information contained in the announcement that follows (52

disclosures). For example, a first-quarter disclosure of annual *EPS* that does not refer to the first quarter's results would not preempt the first quarter's earnings announcement. Third, in 17 instances I could not obtain the earnings surprise data that relate to a particular disclosure.

Tables 3 and 4 contain the results of the tests of *H2*. Both tables provide evidence on how the likelihood of preemption varies as a function of the earnings surprise. Table 4 presents formal logit analyses. In addition, because the economic significance of logit analyses is often difficult to gauge, table 3 provides simple frequency distributions.

Table 3, panel A partitions the sample of earnings announcements into those conveying "very good," "intermediate," and "very bad" news. I define very good (bad) earnings news as earnings changes greater (less) than .05 of stock price. All other earnings news is classified as intermediate. According to *H2*, very bad news will be preempted relatively often by managers, but otherwise there should be no relation between earnings news and the frequency of preemption: most of the time managers have little incentive to preempt earnings news. The evidence in table 3, panel A supports *H2*—bad news is preempted more often than other types of earnings news. Of the 156 "very bad" news announcements, 39 (25%) are preempted. This proportion is substantially higher than those for the overall sample (11.0%), the "intermediate" news observations (10.4%), and the "very good" news observations (5.7%). Binomial tests indicate that these three latter proportions are all significantly different from 25% at small probability levels (the proportions for the "intermediate" and "very good" news groups are not reliably different from one another at the 5% level). This evidence is inconsistent with the expectations-adjustment view, under which extreme news of both signs would be preempted relatively often while intermediate news would generally not be preempted.

Panel B of table 3 partitions the sample of earnings announcements into approximate deciles, formed after ranking the announcements according to the magnitude of the earnings change. Relative to the tests in panel A, which prespecify the magnitude of the earnings change required to generate a preemptive disclosure, the data in panel B indicate empirically where the cutoff lies. The results in panel B indicate that for the extreme bad news decile, quarterly earnings announcements are preempted 22% of the time, the highest number in the table. The frequency of preemption declines monotonically through the first five deciles. The differences in proportions between the two smallest deciles and each of the remaining deciles are all significant at the 5% level using a binominal test. There are no statistically reliable differences among the proportions in the other eight deciles of the table. Thus, consistent with *H2*, very bad news (earnings changes in the lowest 20% of the distribution) is preempted most often, but otherwise there is no relation between the magnitude of earnings news and the probability of preemption.

TABLE 3
Frequency of Quarterly Earnings News Preemption as a Function of the Earnings News¹

Earnings Change ²	Total Firm-Quarters	Number (%) of Firm-Quarters Preempted by a Voluntary Corporate Disclosure
Panel A: Earnings News Partitioned into Very Bad, Intermediate, and Very Good News		
< -0.05	156	39 (25.0%)
-0.05 to 0.05	2,369	246 (10.4%)
> 0.05	122	7 (5.7%)
Panel B: Earnings News Partitioned into Deciles		
< -0.0272	264	59 (22.3%)
-0.0272 to -0.0080	264	48 (18.2%)
-0.0080 to -0.0022	265	33 (12.5%)
-0.0022 to 0.0000	191	19 (9.9%)
0.0000 to 0.0013	339	23 (6.8%)
0.0013 to 0.0024	263	20 (7.6%)
0.0024 to 0.0041	265	16 (6.0%)
0.0041 to 0.0078	266	26 (9.8%)
0.0078 to 0.0194	264	23 (8.7%)
> 0.0194	266	25 (9.4%)

¹This table is based on 2,647 earnings announcements made by 93 NASDAQ-NMS firms during 1981-90.

²Earnings change is the change in split-adjusted quarterly earnings per share (from the corresponding quarter of the prior year) deflated by stock price 60 trading days prior to the earnings announcement.

TABLE 4
*Maximum Likelihood Estimates of the Probability
an Earnings Announcement for a Given Firm/Quarter is Preempted¹*

Intercept	Bad News Indicator	News	Regression <i>p</i> -Value
2.10 (33.59)		-1.38 (-2.85)	.0002
2.35 (30.50)	.98 (7.36)		.0000
2.34 (30.33)	.92 (6.66)	-0.50 (-1.47)	.0000

¹This table shows estimated coefficients (with asymptotic *t*-statistics in parentheses) from logistic regressions. Observations comprise 2,647 earnings announcements for 93 NASDAQ-NMS firms during 1981-90. The dependent variable is coded 1 for earnings announcements that are preempted by a voluntary corporate disclosure and 0 otherwise. The bad news indicator variable is coded 1 for earnings announcements in which the firm reports a decline in split-adjusted quarterly earnings per share of at least .008 of stock price (the lowest 20% of the distribution of News) and 0 otherwise. News is the change in split-adjusted quarterly earnings per share (from the corresponding quarter of the prior year) deflated by stock price 60 trading days prior to the earnings announcement.

The evidence in table 3 supports *H2* in *relative*, but not *absolute*, terms: although large negative earnings news is preempted more often than other types of earnings news, it is still the case that bad news is not preempted very often. One possible explanation stems from measurement error in the earnings surprise: because the seasonal-random-walk model uses information that is about a year old, it is likely to measure the market's expectation of earnings with error. For example, some firm/quarter observations classified as "very bad" news based on earnings changes may be fully expected by the market, in which case there is no need for preemption because there is no surprise.

Table 4 presents the results of logit regressions estimated using the same set of 2,647 earnings announcement observations analyzed in table 3. The dependent variable is coded 1 if the announcement is preempted and 0 otherwise. The "News" variable in table 4 is the deflated earnings change from table 3. The first regression in table 4 provides evidence on the relation between the magnitude of earnings surprises and the probability of preemption. The coefficient on News is negative and statistically significant (the *t*-statistic is -2.85), indicating that the worse the earnings news, the more likely it is to be preempted. To investigate whether *large* negative earnings surprises will be preempted more often than other types of earnings news, the next regression includes an indicator variable that takes the value 1 for earnings announcements of a decline in split-adjusted quarterly *EPS* of at least .008, and 0 otherwise. I thus define large negative surprises as the lowest 20% of the distribution. When I include this variable alone in the regression its coefficient is positive and statistically significant (the *t*-statistic is 7.36), indicating that, consistent with *H2*, large negative surprises are more often preempted than other types of earnings news. To rule out the possibility that the dummy variable proxies for the negative relation from the first regression, the third regression includes both independent variables. In this regression, the coefficient on the dummy variable remains positive and statistically significant (the *t*-statistic is 6.66), while the coefficient on News is negative but not reliably different from zero. This indicates that, consistent with *H2*, very bad news is preempted relatively often, but once this is accounted for there is no relation between the magnitude of the earnings news and the probability of preemption. Overall, the results in tables 3 and 4 suggest that managers face an asymmetric loss function in formulating their discretionary disclosure policies, consistent with the legal liability/reputation-effects arguments in section 2.

6.3 THE STOCK PRICE RESPONSE TO VOLUNTARY DISCLOSURES

According to *H3* the stock price response to bad news voluntary disclosures will be larger, in absolute value, than the stock price response to good news disclosures. To test this hypothesis, table 5 presents summary statistics for the abnormal stock returns associated with 313 sample

TABLE 5
Average Two-Day Market-Adjusted Abnormal Returns
Associated with 313 Earnings-Related Voluntary Disclosures¹

	Observations	Good News ²	Bad News ²	t-Statistic
All Disclosures	313	2.46% (n = 135)	-6.06% (n = 178)	-3.10**
Annual Horizon	79	-0.28% (n = 53)	-6.86% (n = 26)	-2.84**
Quarterly Horizon	152	4.62% (n = 50)	-5.59% (n = 102)	-0.53
Point Estimates	61	1.86% (n = 36)	-5.92% (n = 25)	-2.23*
Range Estimates	34	2.33% (n = 26)	-7.10% (n = 8)	-1.65
Lower-/Upper-Bound Estimates ³	67	3.14% (n = 26)	-7.61% (n = 41)	-1.21
Qualitative Statements	66	1.36% (n = 14)	-4.50% (n = 52)	-1.19

¹This table is based on the 313 earnings-related voluntary disclosures made by 93 *NASDAQ-NMS* firms during 1981–90 with available stock return data. The abnormal returns are two-day market-adjusted abnormal returns (cumulated over days 0 and +1 relative to the disclosure date from the *DJNRS*), where the market portfolio is the *CRSP NASDAQ* equal-weighted portfolio. In each category I report the average abnormal return, the number of observations, and a *t*-statistic that tests the null hypothesis that the absolute value of the average abnormal returns is the same for the good and bad news disclosures.

²The classification of forecasts into those that convey good news and bad news is done based on the researcher's assessment of the information contained in a particular announcement and is usually fairly straightforward.

³I report on lower-bound estimates for the good news disclosures and on upper-bound estimates for the bad news disclosures.

*Indicates that the difference in the absolute value of the means is significantly different from zero at the 5% level.

**Indicates that the difference in the absolute value of the means is significantly different from zero at the 1% level.

disclosures.¹⁰ I partition these disclosures by type of news, forecast horizon, and disclosure type because other studies find that the stock price response to voluntary disclosures varies as a function of these variables (e.g., Jennings [1987] and Pownall, Wasley, and Waymire [1993]).

The results in table 5 are consistent with *H3*. For the full sample, the average stock price reaction to the bad news disclosures is -6.06% compared to 2.46% for the good news disclosures. Thus, the stock price reaction to the bad news disclosures is, on average, over twice as large as that for the good news disclosures. The difference in the absolute value of the average abnormal returns is statistically significant at

¹⁰These disclosures are the full sample of 374 voluntary disclosures less disclosures that occur with earnings announcements and/or that convey "no news." The abnormal returns are two-day market-adjusted abnormal returns (cumulated over days 0 and +1 relative to the disclosure date from the *DJNRS*), where the market portfolio is the *CRSP NASDAQ* equal-weighted portfolio.

the .01 level. The larger stock price reactions associated with the bad news disclosures are also evident in the various sample partitions. For both the annual and quarterly disclosures the absolute value of the average stock price reaction is larger for the bad news disclosures, although the difference is significant only for the annual disclosures (this difference is significant at the .01 level). Similarly, when I partition the disclosures according to forecast type the magnitude of the stock price reaction is larger, on average, for the bad news disclosures than for the good news disclosures (although only the difference for the point estimates is significant at the .05 level).

The test in table 5 assumes that the *total* amount of earnings news is the same for the good and bad news cases, so that looking at the stock price reaction to the preemptive disclosures allows us to draw inferences about the *relative* extent to which the good and bad news is preempted. Table 6 investigates the validity of this assumption by comparing, for quarters when earnings news is preempted, the relation between the total amount of earnings news for the quarter and the amount of earnings news released on the earnings announcement date, for good and bad news disclosures.¹¹ Specifically, the table reports the average two-day earnings-announcement-period stock return for the quarter and the average of the daily stock returns cumulated over all announcements that relate to the quarter (the voluntary disclosure announcement[s] and the earnings announcement). This cumulative return provides a measure of the total amount of earnings news for the quarter.

The evidence in table 6 supports the legal liability argument. First, the size of the average cumulative return (the total earnings news for the quarter) is larger for the bad news quarters: the absolute value of the mean is 6.52% for the bad news quarters compared with 2.94% for the good news quarters, a difference that is statistically significant at the .01 level. This supports the view that managers make bad news disclosures when they have private information about large negative earnings surprises. Second, the magnitudes of the earnings-announcement-period returns are very similar for the good and bad news quarters: the absolute value of the mean is 0.49% for the bad news quarters compared with 0.47% for the good news quarters. This difference is not statistically significant at the .10 level. Thus, the total amount of earnings news is larger in the bad news quarters than in the good news quarters, while the amount of information released on earnings announcement

¹¹ Because some of the individual disclosures in table 5 are combined into a single quarterly disclosure return in table 6, there are fewer observations in this table. The fact that there are 299 preempted announcements in table 6, as compared to 292 announcements in tables 3 and 4, reflects different data requirements. The tests in tables 2 and 3 (but not table 6) require earnings change data, while the tests in table 6 (but not tables 2 and 3) require stock return data.

TABLE 6
*Average Market-Adjusted Abnormal Returns for 299 Quarters
during Which Earnings News Was Preempted¹*

	Good News	Bad News	<i>t</i> -Statistic ²
Observations	129	170	
Return Cumulated over All Earnings- Related Announcements for the Quarter ³	2.94%	-6.52%	<i>t</i> = -2.68
Earnings-Announcement-Period Return	0.47%	-0.49%	<i>t</i> = -0.03

¹This table is based on the 299 quarters during which earnings news was preempted by the managers of 93 *NASDAQ-NMS* firms during 1981-90. The abnormal returns are two-day market-adjusted abnormal returns where the market portfolio is the *CRSP NASDAQ* equal-weighted portfolio. For the voluntary disclosures the returns are cumulated over days 0 and +1 relative to the disclosure date from the *DJNRS*; for the earnings announcements the returns are cumulated over days -1 and 0 relative to the *Compustat* earnings announcement date.

²The *t*-statistic tests the null hypothesis that the absolute value of the average abnormal returns is the same for the good and bad news announcements.

³The abnormal returns are cumulated over the earnings announcement period plus the announcement period(s) associated with the quarter's voluntary disclosures.

dates is the same, indicating that managers preempt a larger proportion of bad earnings news than good earnings news.

6.4 SOME ADDITIONAL EVIDENCE

6.4.1. *The Extent to Which the Disclosures Accompany Form 8-K Filings.* The *SEC* requires managers to disclose, on Form 8-K, six types of corporate event within 15 days of the event's occurrence. In addition, the *SEC* encourages, but does not require, managers to disclose "other materially important events" on Form 8-K (an "item 5 filing"). There is no time limit for these disclosures. To investigate the possibility that the disclosures I observe are attributable to the Form 8-K filing requirements, I examined the 374 sample disclosures to see how many included announcements of write-downs, write-offs, charges, or provisions, because this type of announcement is a candidate for disclosure on the Form 8-K, item 5. (The other types of sample disclosures are forecasts of or statements about future earnings, not actual events. Conversely, the other categories of Form 8-K filing generally do not have earnings implications, and so were not included in my sample.) There are 35 such disclosures. Unfortunately, the *LEXIS* data base (my source for the 8-K filings) contains 8-K filings only after October 1988. Eleven of the 35 disclosures were made after October 1988 and, of these, only 4 were reported on Form 8-K filings. This suggests that the *SEC*'s Form 8-K filing requirements are unlikely to explain the bad news disclosures in my sample.

6.4.2. *Firms That Disclose Very Often or Very Little.* I investigate the extent to which 17 sample firms that make no voluntary disclosures during the ten-year sample period and 12 firms that make ten or more disclosures affect the results. Firms that make voluntary disclosures very often may be doing so for some reason unrelated to legal liability. I estimated the logit regression equations in table 4 after excluding ob-

servations for 12 firms disclosing very often (ten or more times). The results (not reported in tables) are similar to those in table 4. When both variables are included the t -statistic on the indicator variable is 5.55 and that on News is -1.74 . I have also reestimated the table 4 logit regressions after excluding observations for firms that made no voluntary disclosures during the sample period. These results are also similar to those in table 4.

6.4.3. Forecast Revisions. Throughout the paper I have argued that the asymmetric loss function due to legal liability creates incentives to preempt large negative earnings surprises more than other earnings news. If this argument is correct, then managers will also revise existing forecasts more often downward than upward. In other words, given legal liability managers again wish to avoid large negative earnings surprises. To investigate this, I examined the 374 voluntary disclosures for earnings predictions that were revised before the earnings announcement date. Of 24 such forecast revisions, 19 were downward, and 5 were upward. This asymmetry is consistent with the legal liability argument.¹²

7. Conclusion

This paper extends existing research on managers' discretionary disclosure practices in two ways. First, I argue that U.S. securities laws operate to impose an asymmetric loss function on managers: announcements of large negative earnings surprises increase the likelihood of potentially costly stockholder lawsuits, while similar announcements of large positive earnings surprises generate no such effects. As a result, managers have incentives to preempt large negative (but not large positive) earnings surprises by voluntarily disclosing that information early. Notice, however, that the operation of the securities laws is not the only reason to expect such an asymmetric response, since the goal of maintaining good relations with the investment community may also cause managers to be especially sensitive about the disclosure of negative earnings surprises.

Second, I provide evidence consistent with the idea that a large subset of earnings-related voluntary disclosures are designed to preempt bad quarterly earnings news. I find that bad news disclosures generate larger stock price reactions than good news disclosures, and that large negative earnings surprises are preempted more frequently (20–25% of the time) than other earnings releases (preempted less than 10% of the time). This evidence complements existing research, which documents the existence of point or range estimates of annual *EPS* but

¹²Waymire [1985] compares "repeat" forecasters with firms that forecast relatively infrequently and finds that the former have less volatile earnings series. Waymire argues that this relation is due to the legally imposed need for forecast accuracy; because the law operates asymmetrically, accuracy is more important for good news forecasts. Consistent with this argument, the negative relation between forecast frequency and earnings volatility holds only for good news forecasts.

which often excludes disclosures that relate specifically to quarterly earnings news. I find that bad news disclosures are more likely to relate to quarterly (as opposed to annual) *EPS* and are more likely to be disclosed qualitatively. Thus, because previous research tends to include only point or range estimates of annual *EPS*, it tends to exclude a potentially important subset of managers' earnings-related disclosures.¹³

Overall, my evidence, along with that from previous studies, suggests that managers voluntarily disclose earnings information for two mutually exclusive reasons. First, when their firms are doing relatively well managers make good news disclosures to distinguish their firms from those doing less well (e.g., see Lev and Penman [1990]). Second, consistent with legal ability and/or reputation-effects arguments, managers make preemptive bad news disclosures.

I rely on the *Dow Jones News Retrieval Service* to provide a comprehensive set of disclosure announcements. If there is any bias in the process through which items are included in this service such that (say) there is an editorial preference for bad news, the results that I report will not provide a true indication of the disclosure practices of firm managers; instead, they will also reflect the editorial policy of *Dow Jones*. However, I know of no reason to expect such a bias, nor of any evidence that such a bias exists.

My results also suggest that estimates of "short-window" earnings response coefficients might be improved by including stock returns around disclosure announcements. Because the worst, most surprising earnings news is more likely to be disclosed before the announcement, excluding these returns may lead to systematic biases in earnings response coefficient estimates. Finally, even though I define voluntary disclosures more broadly than much previous research, it would be interesting to examine an even broader set of managerial disclosures.¹⁴ For example, an examination of development announcements, market share predictions, and so forth, might provide evidence that bears on existing analytical research about how managers choose their discretionary disclosure policies given that these disclosures typically have to speak to at least two audiences—stockholders and competitors.

¹³ Pownall, Wasley, and Waymire [1993], who include annual and quarterly as well as point, range, and upper- and lower-bound forecasts, reach a similar conclusion.

¹⁴ Previous research that examines other types of announcements and disclosures includes Hoskin, Hughes, and Ricks [1986], who examine a variety of disclosures made concurrently with annual earnings announcements, and Thompson, Olsen, and Dietrich [1987], who examine all types of firm-specific news reported in the *Wall Street Journal Index*.

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