Market Reaction to Earnings Surprise Warnings: The Incremental Effect of Shareholder Litigation Risk on the Warning Effect

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We examine the incremental effect of shareholder litigation risk on market reaction to earnings surprise warnings, that is, the warning effect. *Prior research examines earnings warnings by firms reporting large earnings news (at least 1% of share price), and finds a negative warning effect for bad news firms but no warning effect for good news firms. We find similar results for a larger sample of firms. In addition, we find negative and positive warning effects, respectively, for firms reporting small bad and good earnings news, suggesting that the insignificant warning effect for good news firms is restricted to large earnings news. More importantly, we find that litigation risk magnifies the warning effect—for bad news firms, the warning effect is more negative for high-litigation-risk firms than for low-litigation-risk firms, but for good news firms, the warning effect is more positive for high-litigation-risk firms than for low-litigation-risk firms.*

1. Introduction

Prior studies suggest that shareholder litigation risk is an important motivator for companies' disclosures (Skinner [1994, 1997]). Kasznik and Lev (1995; hereafter, KL) examine return responses to earnings surprise warnings, but the

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effects of shareholder litigation risk on those return responses have not previously been examined.[1] This issue has become more important as firms increasingly issue earnings surprise warnings. In this study, we examine differences in return responses to earnings warnings for firms with different levels of shareholder litigation risk estimated from a litigation-risk model.

Skinner (1997) finds that timely earnings disclosures, including earnings warnings, may lower settlement costs in the event a firm is sued by shareholders, but he also finds that firms issue earnings surprise warnings much more frequently in lawsuit quarters than in nonlawsuit quarters, and conjectures that managers may issue warnings when they believe their firms are likely to face litigation. Investors' response to earnings warnings would therefore depend on both the expected cost of litigation signaled by earnings warnings and the reduced settlement cost incurred by warning firms (more specifically, timely disclosers) in the event of a lawsuit. The net effect of these two litigation-risk-related influences is likely to affect market reactions to earnings surprise warnings (i.e., the *warning effect*, defined as the incremental price reaction to the earnings news reported by warning firms beyond the price reaction to similar earnings news reported by no-warning firms).[2] This paper provides empirical evidence on the incremental effect of shareholder litigation risk on the warning effect.

We first confirm KL's (1995) finding that among firms reporting large earnings news (absolute values of at least 1% of share price), the warning effect is negative for bad news firms but insignificant for good news firms.[3] We extend KL by examining the warning effect for small earnings news (absolute values less than 1% of share price). This extension is motivated by prior studies showing that returns respond more strongly to small earnings surprises than to large earnings surprises (Freeman & Tse [1992]). We find negative and positive warning effects, respectively, for firms reporting small negative or positive earnings news. Thus, KL's conclusion that there is no warning effect for good news firms appears to be restricted to large-earnings-news firms.

Next, we investigate the incremental effect of shareholder litigation risk on the warning effect. We estimate shareholder litigation risk using firm characteristics before the warning quarter. Firms may face shareholder litigation risk when they fail to warn about bad earnings news that precedes a large stock price decline, and may issue earnings surprise warnings to reduce the expected cost of shareholder

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1. An *earnings surprise warning* is a voluntary disclosure of earnings news prior to the formal earnings announcement date, and is sometimes referred to as *earnings guidance*. We use the term *earnings surprise warning* for both good and bad news voluntary disclosures to be consistent with prior research.

2. We measure the warning effect as the difference between the combined price reaction to earnings surprise warnings and earnings announcements of firms that warn about their earnings surprise and the price reaction to earnings announcements of firms with similar earnings news that do not warn.

3. We classify firms as having bad news in a particular quarter if their actual earnings are less than analysts' earnings forecasts for that quarter, and as having good news if actual earnings exceed analysts' forecasts.