



# Capital market frictions and conservative reporting: Evidence from short selling constraints



Alex Young<sup>1,\*</sup>

College of Business, North Dakota State University, Fargo, North Dakota, United States

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## ABSTRACT

I use a natural experiment, Reg SHO, that relaxed short selling constraints on a random sample of U.S. stocks to study how capital market frictions affect conditional conservatism in financial reporting, defined as earnings reflecting bad news more quickly than good news. Since reducing short selling constraints increases the sensitivity of stock prices to bad news, managers may decrease conditional conservatism to delay the recognition of bad news in earnings. However, if equity investors anticipate this, then they may demand an increase in conditional conservatism such that there is no net effect. With a difference-in-differences design, I find that a decrease in short selling constraints causes a decrease in conditional conservatism. The result improves our understanding of how market regulation affects accounting choices and suggests that relaxing equity market frictions can have potentially negative consequences for financial reporting quality.

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## 1. Introduction

Financial reporting is an economic activity that facilitates resource allocation. What is observed in practice depends on market forces as well as political and regulatory influences. In this paper, I investigate how capital market regulation affects conditional conservatism in financial reporting, defined as the more timely recognition of bad news in earnings than good news (Basu, 1997).

An example of capital market regulation is restrictions on short selling (the sale of a stock that an investor does not own). Between February 8, 1938 and May 2, 2005, short sales were only allowed in exchange-listed stocks above the last trade price or at the last trade price if the last trade price was higher than the most recent trade at a different price (i.e. the “tick” or “zero-plus tick test”) (Securities and Exchange Commission, 2007). The SEC created a natural experiment via Reg SHO on September 7, 2004 to evaluate the overall effectiveness of short selling constraints. From May 2, 2005 to August 6, 2007, roughly 1000 U.S. stocks traded without short-sale price tests. These pilot stocks came from the Russell 3000 Index, comprised every third stock ranked by volume, and formed the “treatment” group; the remaining stocks in the Russell 3000 served as the “control” group (Diether et al., 2009).

One aspect of financial reporting that has a natural connection to short selling constraints is conditional conservatism, or earnings reflecting bad news more quickly than good news. Reducing short selling constraints can make it easier for stock

\* Tel.: +17012318437.

E-mail address: [alex.young.1@ndsu.edu](mailto:alex.young.1@ndsu.edu)

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prices to reflect bad news (Gilchrist et al., 2005). A straightforward prediction is that managers of Reg SHO pilot firms, in response to the positive shock to short selling, decrease the level of conditional conservatism to delay the recognition of bad news in earnings.

However, management's reluctance to recognize bad news is mitigated by legal and reputational concerns in the labor market (Kothari et al., 2010). In addition, prior literature has documented evidence consistent with equity investors demanding conditional conservatism.<sup>2</sup> For example, Ramalingegowda and Yu (2012) find that monitoring institutions' ownership is associated with higher conditional conservatism. If equity investors anticipate that managers will reduce conditional conservatism in response to Reg SHO, they may demand an increase in conditional conservatism such that there is no net effect. Hence, it is an empirical question whether relaxing short selling constraints affects conditional conservatism.

To conduct my empirical tests, I begin with the 2004 and 2005 Russell 3000 Index constituents. The main sample period covers one year before and one year after the start date of Reg SHO on May 2, 2005. I measure conditional conservatism with the Ball and Shivakumar (2006) piecewise accruals-cash flow model. Using a difference-in-differences approach, I find that pilot firms significantly reduce their level of conditional conservatism compared to non-pilot firms from the year before to the year after Reg SHO began. The decrease in conditional conservatism is robust to using a longer window covering two years before and after Reg SHO began. Given evidence that equity markets perceive conditional conservatism as improving earnings quality (Dechow et al., 2010), my result suggests that a reduction in capital market frictions may have potentially negative consequences for financial reporting.

In additional analyses, I conduct a falsification test by setting the event date to be one year before Reg SHO actually began. I find no evidence of a treatment "effect" in a one-year window around this pseudo-event date. I also find that the decrease in conservatism reverts after Reg SHO ended on August 6, 2007. Both of these tests alleviate concerns that the main result is due to a time-specific event other than Reg SHO.

My study makes several contributions. First, it adds to the broader literature on managerial reporting choices. Stock prices are one of the most important considerations in managers' reporting decisions (Graham et al., 2005; Beyer et al., 2010). However, the difficulty in locating exogenous variation in stock prices has resulted in a dearth of papers that provide causal evidence on the effect of stock price behavior on financial reporting (Li and Zhang, 2015; Fang et al., 2015).

Second, my study joins the literature on the real effects of short selling constraints. Recent research has examined the effect of Reg SHO on trading patterns (Diether et al., 2009) and investment (Grullon et al., 2015). Importantly for this paper, prior research has found mixed evidence on how relaxing short selling constraints affects financial reporting quality. For example, Li and Zhang (2015) show that relaxing short selling constraints reduced the readability of bad news annual reports, while Fang et al. (2015) find that reducing short selling constraints improved financial reporting quality by decreasing earnings management. My study contributes by examining the effect of Reg SHO on another aspect of financial reporting, conditional conservatism, and providing additional evidence that relaxing short selling constraints can negatively affect financial reporting quality.

## 2. Data and variable measurement

### 2.1. Data

Following Diether et al. (2009), I use the 2004 and 2005 Russell 3000 Index constituents to construct the initial sample, and I retain firms that were in the Russell 3000 Index in both years. I then merge this list with the list of pilot securities from the SEC by ticker or company name (available at <http://www.sec.gov/rules/other/34-50104.htm>). Consistent with Fang et al. (2015), I exclude financial firms (SIC 6000–6999) and regulated utilities (SIC 4900–4949). Finally, I obtain necessary data for the pilot and control firms from Compustat.

### 2.2. Measuring conservatism

I follow Ball and Shivakumar (2006) and use a piecewise accruals-cash flow model

$$ACC_{i,t} = \alpha_0 + \alpha_1 CF_{i,t} + \alpha_2 D_{i,t} + \alpha_3 D_{i,t} \times CF_{i,t} + \varepsilon_{i,t} \quad (1)$$

where (COMPUSTAT names in parentheses)

- $ACC_{i,t} = \frac{\text{Earnings (IBC}_{i,t}) - \text{Cash Flow from Operations (OANCF}_{i,t})}{\text{Average Total Assets}_{i,t}}$
- $CF_{i,t} = \frac{\text{Cash Flow from Operations (OANCF}_{i,t})}{\text{Average Total Assets}_{i,t}}$
- $D_{i,t}$  is an indicator variable equal to 1 if  $CF_{i,t} < 0$  and 0 otherwise.

Timely recognition of revisions in expected future cash flows requires accruals. To the extent that revisions in current period cash flow from a durable asset are positively correlated with revisions in the expected future cash flows, accruals and

<sup>2</sup> Conditional conservatism can enable shareholders to curb management's potentially value-destroying decisions by promoting timely abandonment of losing projects and to *ex ante* guard against the possibility of excess compensation (Ball, 2001; Watts, 2003; Kothari et al., 2010).

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