The Stock Market Reaction to Allegations of Fraud and Earnings Manipulation

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Abstract

We examine the stock price reaction to announcements that firms are alleged to be doing fraudulent financial reporting or manipulating earnings, using a sample of firms cited by the Securities Exchange Commission (SEC) in its Accounting and Auditing Enforcement Releases (AAERs) during the time period 1985-2005. We find a total 14% drop in stock price over a three day window surrounding the announcement. Subsamples of firms charged with fraud versus those charged with just earnings manipulation have stock prices drops of 16.64% and 8.51%, respectively, over this same window. There is a total 29% drop in stock price over a 30 day window surrounding the announcement. The post-announcement drift over the 30 trading days following the announcement is a total 7.6% drop in stock price with a negative 12.09% for the fraud subsample versus a negative 5.48% for the manipulator subsample. We also model the cross-section of the cumulative abnormal returns (CARs) using firm specific variables and find that the stock market reacts more negatively for high sales growth companies, for firms with more insiders on their Boards, for firms paying a larger percentage of total executive compensation in the form of stock options, and for firms whose CEO is not the company founder. Finally, we find that the size of a firm’s accounting accruals has no effect on the magnitude of the CAR. Forensic accountants and auditors can check for both financial and non-financial factors in assessing earnings management and fraud possibilities.

Keywords: Earnings manipulation, Fraudulent financial reporting, Stock market reactions.

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