The effect of accounting conservatism on opportunistic voluntary disclosures: evidence from pro forma earnings

Wen Li[1], Huai Zhang[2*]

(1.Shanghai Jiao Tong University, Shanghai 200240, China; 2. Nanyang Technological University, Singapore639798)

ABSTRACT: Wehypothesizethataccountingconservatism,definedastheasymmetricverifiabilityrequiredforthe recognitionofaccountinggainsversuslosses,reducesmanagerialincentivestoissueopportunistic voluntarydisclosures. Usinghandcollecteddataonvoluntaryproformadisclosures, wetestthis hypothesisempiricallyandobtainsupportiveevidence.Specifically, weshowthat,relativetofirms withmoreconservativeaccounting,firmswithlessconservativeaccountingexperienceadeclinein thelikelihoodofissuingproformaearningsafterRegulation G,theyaremorelikelytoincreasepro formaearningsandreverseGAAPmissesofearningsbenchmarksbyexcludingnon-specialitems, andtheirproformaexcludeditems tendtobeoflowerquality.Ourinferencesremain robust after we useseveralapproachestocontrolfortheendogeneityofaccountingconservatism.

Keywords: Accountingconservatism;Proformaearnings;Voluntarydisclosures

JELClassification:J14, M41

1. Introduction

Managers donotprovidevoluntarydisclosuresforthesolepurposeofinforming investors. Priorliteratureprovidesampleevidencethatmanagersdiscloseopportunistically tomanipulate upwardsinvestors'perceptionsoffirmperformance,andinvestorsseemunabletocompletelyunravel opportunisticmanagerialintentions.[1]

We argue that accounting conservatism, defined as the asymmetric verifiability required forthe recognition of accounting gains versus losses, curbs managerial incentives to issue opportunistic voluntary disclosures, for the following four reasons. First, if the manager discloses opportunistically to favorably influence investors' perceptions of firm performance, bad news results when the firm fails to meet investors' performance expectations based on the opportunistic disclosures. For firms with more conservative accounting, this bad news is charged to accounting earnings sooner, expediting reductions in managerial earnings-based compensation and revelations of the opportunistic nature of the disclosure (Ball and Shivakumar 2005; Watts 2003). Therefore, accounting conservatism reduces ex-ante managerial incentives to disclose opportunistically.

Second,priorliteratureprovidesampleevidencethatconservative accountingreduces informationasymmetrybetweeninsidersandoutsidersbycounteractingmanagerialincentivestobias earningsupwards(Watts2003;LafondandWatts2008;KahnandWatts2009;Armstrongetal. 2010; Kotharietal.2010).Thelowerinformation asymmetryenablesinvestorstodetecttheopportunistic natureofvoluntarydisclosuresanddiscouragesmanagersfromprovidingopportunistic voluntary

disclosures.

Third,numerouspriorstudiesshowthataccountingconservatism actsasacorporate governance mechanism andreducesmanagerial incentivestoengageinnegativeNPVprojects(Ball andShivakumar2005;Biddleetal.2009;FrancisandMartin2010;AhmedandDuellman2011; Bushmanetal.2011).LowerlikelihoodofnegativeNPVprojectslowerschancesofbadnewsin GAAPearningsandreducesmanagerialincentivestoprovideopportunistic voluntarydisclosuresin ordertodressupbadnews.

Lastly,Balletal.(2012)provideevidencethatthecommitment tohighqualityexpost verification offinancialstatementsencourages morepreciseandcrediblevoluntarydisclosures. By counteringmanagerialincentivestomanipulateearningsupwards,conservatism representssucha commitment.Wethereforeexpectmanagersofhighconservatismfirmstobelessopportunisticin theirproformadisclosures.

Wegeneratethreeempiricalhypotheses totestourpredictionthataccounting conservatism reducesmanagerialincentivestodiscloseopportunistically.Thefirsthypothesisisbasedonprior findingsthatRegulation GissuedbytheSECiseffectiveindeterringfirmswithopportunistic incentivesfromdisclosingproformaearnings.Ifaccountingconservatism reducesmanagerial incentivestoprovideopportunisticdisclosures,weexpectthatrelativetomoreconservativefirms, lessconservativefirmsexperience adeclineinthelikelihood ofissuingproformaearningsafterReg G,becausethesefirms havestrongeropportunisticincentivesandarerestrainedbytheregulationtoa greaterextent.

Oursecondhypothesisisbasedonthenotionthatproformadisclosuresthatincreasepro forma earningsandreverseGAAP missesofearningsbenchmarksbyexcludingnon-specialitemsare morelikelytobeopportunistic. Itisdifficulttojustifyexcludingnon-specialitemsfromthe perspective ofinforming investors,especiallyifexcludingtheseitemsleadstohigherproforma earningsandproformameet-or-beatofearningsbenchmarks.Ifaccountingconservatismreduces managerial incentives to provide opportunistic voluntary disclosures, we expect that more conservativefirmsarelesslikelytodisclosethesetypesofproformaearnings.

Ourthirdhypothesis isrelatedtothequalityofitemsexcludedfromproformaearningswith the qualitymeasuredbythe predictiveabilityfor futureearnings.Pro formaexclusionsare considered highquality,iftheyhavelowcorrelationwithfutureearnings.Ifaccountingconservatismreduces opportunisticmanagerialincentives,weexpectto observeahigherqualityofexcludeditemsfor firms withmoreconservativeaccounting.

Our empiricalresultssupportallthreehypotheses.First,we find that,afterRegG,the oddsof issuingproformaearningsdropby30%forfirmsintheleastconservativedecilewhiletheodds increaseby212% forfirms inthemostconservativedecile.Thedifferencebetweenthetwodeciles isnotonlyeconomically significantbutalsostatisticallysignificant.Ourresultsareconsistentwiththe notionthatfirmswithlessconservativeaccountinghavestrongeropportunisticincentivesandare restrainedbytheregulationtoagreaterextent.

Second,amongfirmsthatdiscloseproformaearnings, weobservethatfirmswithmore conservativeaccountingaremuchless likelytoissueopportunisticpro formadisclosuresthat increase proformaearningsandreverseGAAPmissesofearningsbenchmarksbyexcludingnon-special items.Forexample,thelikelihood ofreporting proformaearningsthatturnaGAAPlossintoapro formaprofitbyexcludingnon-specialitemsis16.5%forfirmsinthemostconservativequintileand46.6%forfirmsintheleastconservative

quintile,thelatterbeing2.82timestheformer.Our conclusionisnotaffectedbyadditionalcontrolsformanagerialcharacteristics, corporategovernance ordemandsforaccountingconservatism.

Third, among firms that disclose pro forma earnings,we documentthat the quality of excludeditemsissignificantlyhigher forfirmswithmoreconservativeaccounting.Themagnitudeof thecorrelationbetweenexcludeditemsandfutureoperatingincomeis0.286forfirmsintheleast conservative quintileand0.01forfirmsinthemostconservative quintile,suggestingthatfirmswith moreconservativeaccountingpoliciesaremorelikelytoissueproformadisclosuresforthelegitimate purposeof providing investorsa reasonablemeasureof“core earnings.” Overall,our research findings unambiguouslysupportthenotion thataccountingconservatism reducesmanagerialincentivestoissueopportunisticproformadisclosures.[2]

Weconducttworobustnesschecksonourprimaryresultsabove.Wefirsttestwhetherourmainfindingsare robusttousinganalternativemeasureofconservatism developedbyBasu(1997). Theanswerisyes. Second,wetestourmainhypothesisthataccountingconservatismreduces managerialincentivestoprovideopportunistic voluntarydisclosuresbyexaminingthestockreturns afterproformadisclosures.Assumingthatthemarketgraduallyunravelstheopportunisticintentionsinvolunta rydisclosures,weshallobservelessnegativepost-disclosurereturnsformoreconservative firms,ifourmainhypothesisistrue.Specifically,weregressthepost-disclosure 60-daymarket-adjustedreturnonaccountingconservatism,size,betaandthebook-to-marketratio.Ourresults, whichareuntabulatedforbrevity,aresupportiveofourmainhypothesis.Overall,ourresearch findingssupportthenotionthataccountingconservatism reducesmanagerialincentivestoissue opportunisticproformadisclosures.

Amajorconcernwithourresultsistheendogeneityofaccountingconservatism. Weuse severalapproaches toaddressthisconcern.First,Qiang(2007)showsthatconditional conservatism, whichisourfocusinthispaper,ismainlyinducedbythecontractingandlitigationexplanations amongthefourexplanationsforaccountingconservatismidentifiedbyWatts(2003).Inaddition, AhmedandDuellman(2007)andGarcíaLaraetal.(2009)documentanassociation between accountingconservatism andcorporategovernance.Wethereforecontrolformeasuresofcorporate governance, litigationexplanationandcontractingexplanation, inourregressions. Totheextentthat thesemeasurescapturetheknowndeterminantsofconditionalconservatism,ourmodelspecification atleastpartiallyaddressestheconcernthataccountingconservatismisendogenouslydetermined. Second,weusethestandardinstrumentalvariableapproachtocontrolforendogeneity. Our instrumentalvariableisbasedontheimplementationoftheSEC’sStaffAccountingBulletinNo.101 (SAB101).Bothpopularpressandacademic literature suggestthatSAB101mandates lesstimely revenuerecognitionandtherebyincreasesaccountingconservatism forawidecross-sectionoflisted firms(Vogt2001;MoffeitandEikner2003;Watts2003;Crawford etal.2010).What’smore,asa regulatory action,theimplementationoftheSEC’sSAB101isunlikelytoberelatedtoopportunistic managerialincentives.Ourconclusionsbased ontheinstrumentvariableapproachremainunchanged, whichalleviatestheendogeneityconcern.Third,weconsiderthereversecausalityexplanation that firmsissuingopportunisticproformaearningstendtoadoptlessconservativeaccountingpolicies. Thisexplanationimpliesanegativeassociationbetweentheissuanceofopportunistic proforma earningsandfutureaccountingconservatism.Ourun-tabulatedresultsshowthattheassociationis statisticallyinsignificant,whichisinconsistent withthereversecausalityexplanation.Lastly,we examinethepossibilitythataccountingconservatism andissuingopportunisticproformadisclosuresaredeterminedsimultaneously.Webuildupsimultaneousequ

ationsystemsto addressthispossibility. Wefindthatourconclusions continuetohold.Insum,althoughwecannotcompletelyruleoutthe endogeneityconcern,itseemsaremotepossibilitythatendogeneityaccountsforallourempirical results.[3]

Ourpapercontributestotheliteratureinthreeimportantways.First,wecontributetoourunderstandingofth eeffectofconservatism onfirms'decisionsonvoluntarydisclosures.Huietal. (2009)documentanegativeassociationbetweenaccountingconservatism andthefrequency, specificity,andtimelinessofmanagement forecasts.Theirevidenceisconsistentwiththenotionthat accountingconservatism isasubstituteformanagementforecastsbecauseconservatismreduces information asymmetryandlitigationrisksbyreportingbadnewssooner(LaFondandWatts2008).Hui et al. (2009),however,donot distinguishbetweenopportunisticand non-opportunistic disclosuresandaresilentonhowaccountingconservatism affectsmanagerialincentivestoissue opportunisticvoluntarydisclosures,thecentralresearchquestioninourpaper.

Second,wecontributetoanunderstanding ofthemonitoringeffectofaccounting conservatism.Severalstudiesarguethataccountingconservatismreducesmanagerial abilitiestotake onnegativeNPVprojectsbecausenegativeeconomicnewsisreflectedinaccountingearningsmorequickly (BallandShivakumar 2005;Biddleetal.2009;FrancisandMartin2010;Ahmedand Duellman 2011;Bushman etal.2011).Theirresultsareconsistent withthenotionthataccounting conservatismservesamonitoringroleforfirms'investmentdecisions. Weextendthislineof literaturebyshowingthataccountingconservatism reducesmanagerialincentivestoprovide opportunistic voluntarydisclosures,andourresultsareconsistentwithaccountingconservatism servingamonitoring roleforfirms'disclosuredecisionsaswell.Totheextentthatopportunistic voluntarydisclosuresaretheculpritforinefficientpricingandcapitalmisallocation, ourresults highlighttheimportantroleplayedbyaccountingconservatismintheproperfunctioningofthe capitalmarketandhaveimplicationsforthecurrentdebateonthemeritsofaccountingconservatism.

Third, ourpapercontributestoalargebodyofliterature onopportunistic voluntarydisclosures andonproformaearnings.Proformaearningsdisclosures havebeenpopularinrecent yearsandhaveattractedattentionfromacademics.Bhattacharyaetal.(2003)andBradshawand Sloan(2002)investigate theinformativenessandpersistence ofproformaearningsrelativetoGAAP earnings.LougeeandMarquardt(2004)analyzethefirmcharacteristicsassociatedwithandinvestors' responsestoproformadisclosures. Bowenetal.(2005)examinefirms'decisionsonwhethertoo emphasizeproformaearningsor GAAPearnings.Marques(2006),Kolevet al. (2008)andZhangand Zheng(2011)studytheimpactofrecentregulations onfirms'proformadisclosurepracticeand investors'valuationofproformaearnings.Ourcontributionistoprovideevidencethatasalient featureoftheaccounting system,i.e.,conservatism, curbsmanagerialincentivestoprovide opportunisticproformadisclosures.Animplicationofourfindingisthataccountingconservatismcan potentiallyserveasasubstituteforregulationstodeteropportunisticvoluntarydisclosures.

Therestofthepaperproceeds asfollows.Section2reviewspriorliterature onopportunistic disclosures.Section3developshypotheses.Section4 coverssampleformation,variablemeasurement anddescriptivestatistics.Section5,6and7testthethreeempiricalhypotheses. Section8conducts robustnesschecksandSection9concludes.

2.Literatureonopportunisticdisclosures

Priorresearchprovidesampleevidencethatmanagersprovideopportunistic voluntary disclosurestomanipulateupwardsinvestors'perceptionsoffirmperformance. SchrandandWalther (2000)findthatfirmsaremorelikelytodisclose priorperiodgainsthanpriorperiodlossesfromthe

saleofproperty,plantandequipment(PPE)atearningsannouncements. Theyalsoobservethatthis opportunistic disclosurebehaviorismorelikelytooccurwhenitenablesafirmtoavoidanegative earningssurprise.Totheextentthatinvestorsjudgefirmperformancebycomparingcurrentearnings withpriorperiodnumbers,theirresultsareconsistentwithmanagersopportunistically disclosing information tocastthefirmperformance inapositivelight.BradshawandSloan(2002)showthat firmsare morelikelytoexcludelossesthangainswhentheyreportproformaearnings.Consequently, thedisclosedproformaearningsnumberis,onaverage,higherthantheGAAPearningsnumber, suggestingahigherleveloffirmperformance.Bhattacharya etal.(2003)documentthatproforma earningshaveahigherlikelihoodofmeetingorbeatingearningsbenchmarks thanGAAPearnings, whileLougeeandMarquardt(2004)find thatfirmsaremorelikelytoreportproformaearningswhen GAAPearningsmissconsensus analysts'forecastsorarelowerthantheearningsofthepriorperiod. Theirevidencesuggeststhatmanagers opportunisticallydiscloseproformaearningstoavoidmissing earningsbenchmarks.Bowenetal.(2005)investigatethepresentation ofquarterlyfinancial information.Theyshowthat,consistentwithanopportunisticmotive,managersputmoreemphasis ontheearningsmetricthatportraysbetterperformancewhenbothproformaandGAAPearningsare disclosedinthepressrelease.

Priorliteraturealsoexaminesinvestors'reactionstoopportunistic disclosures,andthe evidencesuggeststhatinvestorsareunableto seethroughtheopportunisticnatureofsuchdisclosures. SchrandandWalther(2000)findthatequityinvestorsnaivelyusethepriorperiodearnings disclosed bymanagersasabenchmarktoevaluatefirmperformance. Frederickson andMiller(2004)conduct experiments andshowthatinvestorsvaluatethefirmmorehighlywhenitreportsahigherproforma earningsmeasureinadditiontoGAAPearningsthanwhenitreportsGAAPearningsonly.Lougee and Marquardt (2004) report evidence of over-valuation due to pro forma earnings when thetotheclaimmadebythemanagerthatthoseexcludedexpensesarenon-recurring andunimportant, higherlevelsofexclusionsleadtopredictablylowerfuturecashflows.Theirfurtherinvestigation showsthatinvestorsdonotfullyappreciatethelowercashflowimplications atthetimeofearnings announcements.Consequently,thehighertheproformaearningsrelativetoGAAPearnings,the lowerthefuturereturns.Theirresultssuggestthatinvestorsnaivelyrelyonproformaearningsto assessfirmperformanceandformearningsexpectations.Investorsarethen negativelysurprisedwhen firms'futureearningsfallshortoftheirexpectations. HirshleiferandTeoh(2003)proposethat investors'limitedattentionandprocessing powerexplaintheirinabilitytounravelopportunistic managerialintentions.

3. Hypothesisdevelopment

Weexpectaccountingconservatismtoreducemanagerialincentivestoissueopportunistic voluntarydisclosures,forthefollowingfourreasons.

First,opportunisticdisclosuresleadtoover-valuationandsubsequentdisappointments.When investorsdiscoverthatfirmscannotmeetexpectationsbasedonopportunisticdisclosures,thisbad newsisreflectedmorequicklyinaccountingearningsforfirmswithmoreconservative accounting policy,resultinginamoretimelyreductioninmanagerialearnings-based compensation. Moreover, thisprocesspromptsstakeholders toinvestigatetheunderlyingreasonsandtherebyrevealsthe opportunisticnatureofthedisclosuresooner,which resultsinpossibledisciplinaryactionsagainstthe manager.Recentstudiesprovideevidencethattheboardisconcernedaboutdisclosurequalityand thatitsdisciplinaryactionsimposesignificantcostsonthemanager.Forexample,Hazarikaetal. (2009)findthatthelikelihood andspeedofforcedCEOturnoverarehigherforfirmswithpoor accountingquality,andDesaietal.(2006)document thatmanagersaremorelikelytobedismissed

afterearningsrestatements.Totheextentthataccountingconservatism acceleratescompensation reductionandstakeholderinvestigations,itservesasaneffectivecorporategovernancemechanismin guardingagainstopportunisticvoluntarydisclosures.

Second, conservatismimposesahigher verificationstandard forrecognizinggainsandcounteractsmanagerial incentivesto biasearningsupwards,resultingin reducedinformationasymmetrybetweeninsidersand outsiders.Thisinsightiswellrecognized intheliterature(e.g.,Watts2003;LafondandWatts2008; KhanandWatts2009;Armstrongetal.2010;Kotharietal.2010).Conceivably, lowerinformation asymmetryimprovesinvestors'abilitiestodetectandunraveltheopportunisticnatureofdisclosures, diminishingmanagerialincentivestodiscloseopportunistically.

Third,bychargingeconomic lossesrelatedtonegativeNPVprojectsagainstaccounting earningsearlier,accountingconservatismlowersmanagerialincentives toengageinvalue-destroying projects(BallandShivakumar 2005;Biddleetal.2009;FrancisandMartin2010;Ahmedand Duellman 2011;Bushmanetal.2011).Lowerlikelihood ofnegativeNPVprojectslowerschances of badnewsinGAAPearnings,and,totheextentthatopportunisticvoluntarydisclosuresareintendedto castapositivelightonbadnews,reducesthelikelihoodofopportunisticdisclosures.

Lastly,Balletal.(2012)provideevidencethatthecommitment tohighqualityexpost verification offinancialstatementsencourages morepreciseandcrediblevoluntarydisclosures. Accounting conservatism representssuchacommitment, becauseitimposeshigherverification standardsforrecognizing goodnewsthanbadnews,effectivelycounteringmanagerialincentivesto manipulateearningsupwards.Wethereforeexpectmanagersofhighconservatism firmstobeless opportunisticintheirdisclosures.

Whiletheabovereasonssuggestthataccountingconservatism reducesopportunistic disclosures, thereexistargumentsthatsuggestotherwise.HelbokandWalker(2004)andLouisetal. (2008)find that sophisticatedinvestors,suchasfinancialanalysts,donot fullyappreciatethe negative impactofconservatismonreportedearningsnumbers.Theyshow thatinvestorsofmore conservative firmsaremorelikelytoexperiencebadnewsthaninvestorsoflessconservative firms.Thehigher likelihood ofbadnewspossiblyincreasesmanagerial incentives todiscloseopportunistically,leading totheoppositepredictionthataccountingconservatismincreasesopportunisticdisclosures.

Totesttheeffectofaccountingconservatism onopportunisticvoluntarydisclosures,werely onpriorfindingstogeneratethreetestablehypotheses.Ourfirsthypothesisisrelatedtotheexogenousconsiderablediscretionthatmanagershadoverthedefinitionofproformaearnings,theSECwas concernedthatopportunisticproformaearningswouldmisleadinvestors.Aseriesofactionstook placebetween2001and2003.InDecember 2001,theSECissuedawarning,cautioning public companiesnottoissueopportunisticdisclosurestomisleadinvestors(SEC2001).InJanuary2002, the SEC instituted cease-and-desist proceedings against Trump Hotels &Casino Resorts for misleading investors with opportunistic pro forma earnings, which included special gains but excludedspeciallosses(SEC2002).Finally,theSECissuedRegulationG,whichtookeffectin March2003,to deteropportunisticproformadisclosures.RegulationG requiresthatif a firm disclosespro formaearnings,itmustalsodisclosethe mostcomparableGAAPearnings,reconcilethe proformaearnings numberwiththeGAAPnumber, andfileForm8-Kwithinfivedaysofthepro formadisclosuretoexplainwhymanagementbelievestheproformanumberisusefultoinvestors.

Several recent studies show that Regulation G is effective in deterring firms with opportunisticmotivesfromdisclosingproformaearnings.Kolevetal.(2008)showthatthepre-Reg

Gproformaexclusionsareoflowerquality(i.e.,lesstransitory)forfirmsthatstoppedreleasingnon-GAAPearningsnumbers thanforfirmsthatcontinued doingsoafterRegG.HeflinandHsu(2008) document apost-RegGdeclineinthelikelihood ofproformaearningsreversingGAAPmissesof earningsbenchmarks.Yi(2007)presentsevidencethatfirmswithcommunication motives (opportunistic motives)aremore(less)likelytocontinuedisclosing proformaearningsafterRegG.[4]Pawlewicz(2011)suggeststhatRegGaffectsboththetimelinessofearningsannouncementsandinvestors' perceptions ofearningsreliability.Blacketal.(2012)concludethatRegGincreasesthe qualityof proformaearningsdisclosuresbyfilteringoutthosethatare mostlikelytobeopportunistic. Ifaccountingconservatismreducesmanagerialincentivestoprovideopportunisticdisclosures,we expectthat,relativetofirmswithmoreconservative accounting,firmswithlessconservative accountingexperienceadeclineinthelikelihoodofdisclosingproformaearningsafterRegG,becausethosefirmshavestrongeropportunisticincentivesandarerestrainedbytheregulationtoa greaterextent.

Hypothesis1:Relativetofirmswithmoreconservative accounting,firmswithlessconservative accounting experience adeclineinthelikelihoodofissuingproformaearningsafter RegG.

Oursecondhypothesisisrelatedtopriorliterature'sargumentthatproformaearningsare morelikelytobeopportunistic iftheyarehigherthanGAAPearningsoriftheyturnGAAPmisses intoproformameet-or-beat (Bhattarcharyaetal.2003;LougeeandMarquardt2004;HeflinandHsu2008).Thisargumentisbasedonmanagerialincentivestopaintarosypictureoffirmperformance andtheirincentivesto meetearningsbenchmarks.

Managersaremotivatedtomeetearningsbenchmarks becausefailingtodosowouldsubject themtothepenaltiesoflowercompensation andreducedjobsecurity.Specifically,Matsunagaand Park(2001)documentasignificantincrementaladverseeffectontheCEO'sannualcashbonuses whenthefirm'squarterlyearningsfallshortofearningsbenchmarks, suchastheconsensusanalyst forecast. Mergenthaleretal.(2009)showthattheCEOandCFOaremorelikelytobereplaced when thefirmdoesnotmeetquarterly analysts'forecasts,suggestingthatcontinuedemploymentisatstake ifthe firm'searningsfall shortofexpectations.Theseresearchfindingslendsupporttothenotionthat proformaearningsthatturnGAAPmissesintoproformameet-or-beat areprobablyissuedwith opportunisticintentions.

Inaddition, itiswellknownthatspecialitemsareeitherunusualornon-recurring.Excluding specialitemsislikelyaimedatinforminginvestors.Onthecontrary, excludingnon-specialitemsisa possiblesignalofopportunisticintentions,becausenon-specialitemsarelikelytoberecurringin natureandexcludingthemfromproformaearningsisdifficulttojustifyfromtheperspective of informinginvestors.

If accountingconservatismreduces opportunisticmanagerialincentives,we expect that, amongfirmsthatreportproformadisclosures,thosewithmoreconservativeaccountingarelesslikelytoincreaseproformaearningsandreverseGAAPmissesofearningsbenchmarksbyexcludingnon-specialitems.Thisconstitutesoursecondhypothesis.

Hypothesis2:Amongfirmsthatissueproformaearnings,firmswithmoreconservativeaccounting arelesslikelytoincreaseproformaearnings andreverseGAAPmissesofearnings benchmarksbyexcludingnon-specialitems.

Ourthirdhypothesisisrelatedtothequalityofitemsexcludedfromproformaearnings. Kolevetal.(2008)andDoyleetal.(2003)measure thequalityusingtheinverseofthecorrelation betweenexcludeditemsandfutureearnings.Theirreasoningisthat,ifproformaearningsareissued

toprovideamoremeaningful measureoffirmperformancethanGAAPearnings,theexcludeditems willbetransitoryinnature,implyingaweakcorrelation withfutureearnings.Ifaccounting conservatismreducesopportunisticmanagerialincentives,weexpectthatproformaexcludeditems areofhigherqualityforfirmswithmoreconservative accountingpolicies,becausethoseproforma earningsarelikelyissuedtoprovideinvestorswithabettermeasureoffirmperformance. This constitutesourthirdhypothesis.

Hypothesis 3:Proformaexcludeditemsareofhigherqualityforfirmswithmoreconservative accounting.

4.Sampleformation,variablemeasurementanddescriptivestatistics

4.1Measureofaccountingconservatism

FollowingKhanandWatts(2009),weuse*C_Score*tomeasureaccountingconservatism. To obtain*C_Score*,wefirstrunthefollowingregression:

$$X_{i,t} = \beta_{1,t} + \beta_{2,t}D_{i,t} + R_{i,t}(\mu_{1,t} + \mu_{2,t}Size_{i,t} + \mu_{3,t}M/B_{i,t} + \mu_{4,t}Lev_{i,t}) + D_{i,t}R_{i,t}(\lambda_{1,t} + \lambda_{2,t}SIZE_{i,t} + \lambda_{3,t}M/B_{i,t} + \lambda_{4,t}Lev_{i,t}) + \varepsilon_{i,t} \quad (1)$$

where*i*indexesthefirm;*t*indexestime;*X*isearnings(Compustatitem18)deflatedby marketvalueofequityattheendofthepriorfiscalyear(Compustat item25*Compustat item199); *R*is12-monthreturnsforthewindowstartingfromthefourthmonthafterthebeginningofthefiscalyear*t*(Basu1997);*D*is adummyvariablethatequals1when*R*<0and0otherwise; *Size*isthe logarithmof marketvalueofequity(Compustatitem25*Compustatitem199);*M/B*isthemarket-to-bookratio((Compustatitem25*Compustatitem199)/Compustatitem60);*Lev*isthesumoflong-termdebtanddebtincurrentliabilitydeflatedbymarketvalueofequity((Compustat item9+ Compustatitem34)/(Compustatitem25*Compustatitem199)).

Equation(1)isestimatedusingannualcross-sectionalregressions.*C_Score*iscalculatedusingthefollowingformula:

$$\text{C\_Score}_{i,t} = \hat{\lambda}_{1,t} + \hat{\lambda}_{2,t}Size_{i,t} + \hat{\lambda}_{3,t}M/B_{i,t} + \hat{\lambda}_{4,t}Lev_{i,t} \quad (2)$$

where$\hat{\lambda}_{1,t}$, $\hat{\lambda}_{2,t}$, $\hat{\lambda}_{3,t}$and$\hat{\lambda}_{4,t}$areestimatedfromEquation(1).

KhanandWatts(2009)showthatthe*C_Score*capturesvariationinconservatismandpredictsasymmetricearningstimelinessuptothreeyearsahead.

4.2Sampleformation

Oursampleperiodconsistsoftwopartsseparatedbytheissuanceof Regulation G.In December2001,theSECissuedawarningtopubliclylistedcompanies againstmisleading investors withproformaearnings.Asfirmscouldreasonably predicttheissuanceofRegulation Gafterthis warningandchangetheirproforma disclosurepracticesaccordingly,ourpre-RegGperiodispriorto theSEC's warning,specificallybetweenJanuary1998andDecember2001.AsRegulationGbecame effectiveonMarch28,2003,ourpost-RegGperiodisbetweenApril2003andDecember2004.

Ourinitialsampleconsistsofallfirm-quarter observations fromCompustatwithearnings announcement datesfallinginoursampleperiod.Inordertoexaminetherelationshipbetween accountingconservatismandthelikelihoodof issuingproformaearnings,werequirethatall thefirm- quarter observations have non-missing *C_Score*values. We also require the following control variables to be non-missing: *Hitech*, *LOSS*, *Size*, *BM*, *Lev*, *STD_ROA*, and *Prloss*(please see AppendixIIforvariabledefinitions).Ourdatarestrictionsresultinafinalsampleof93,802firm-quarterobservations. Topreventoutliersfromundulyaffectingourresults,wewinsorizethetopand

bottomonepercentileofallcontinuousvariables.

Wemanuallycollectdataonpressreleasesrelatedtoproformaearnings. Following Bhattacharya etal.(2003)andLougeeandMarquardt(2004),wesearchPRNewswireandBusiness WireintheLexis-Nexis AcademicUniversedatabaseusingkeywordsincluding“proforma,” “proforma”and“pro-forma.”Weexcludethosepressreleasesinwhich(a)theproformaearnings datacorrespond toaquarterotherthanthecurrentquarter;(b)theuseoftheterm“proforma”refers solelytotheretroactiveeffectofaninitialpublic offering, mergeroracquisition;or(c)theuseofpro formaearningsreflectsachangeintaxstatus,capitalstructureoraccountingmethod.Inaddition,we requirenon-missingCUSIPandPERMNOinformation, andwerequiretheearningsannouncement dateinCompustattomatchourpressrelease date.Thereare2,109proformaearningsreleasesinour finalsample.[5]

4.3 Descriptivestatistics

PanelAofTable1showsthesummary statistics fortheentiresample.*PF_D*isadummy variablethatequals1ifthefirm-quarterobservationdisclosesproforma earningsand0otherwise.Its meanvalueindicatesthatabout2.2%ofoursampleobservationsissueproformaearnings. Themean andmedian*C_Score*valuesare0.160and0.148,respectively.*Hitech*isadummyvariablethatequals1ifthefir misinthehigh-tech industryasdefinedbyFrancisandSchipper (1999)and0otherwise, while*LOSS*isadummyvariablethatequals1ifGAAPearningsarenegativeand0otherwise. The meanvaluesofthesetwovariablesindicatethataboutone-quarter ofoursamplefirmsarefromthe high-techindustry andasimilarpercentageofthemreportGAAPlosses.Themeanvalueof*Size*(the natural logoftotalassets)is6.412,whilethemedianvalueis6.321.Themeanandmedian valueof *BM* (the book value of equity divided by the market value of equity) are 0.591 and 0.485, respectively. For*Lev*(thebookvalueofdebtdividedbythemarketvalueofequity),itsmeanvalue (0.660)deviatesfromitsmedianvalue(0.225),indicatingthatthedistributionishighlyskewed.Themeanvalue of*STD_ROA*(thestandarddeviationofROAovertheprioreightquarters)is0.028.The meanvalueof*Prloss*(thenumberofconsecutivequartersoflossesovertheprioreightquarters)is1.057.Theme anvalueofthe*POST_G*(adummyvariablethatequals1forobservationsafterRegGand0otherwise)indicatest hatabout36%ofsampleobservationsarefromthepost-RegGperiod.

The nextseveralvariablesare indicativeofthe opportunisticnatureofpro formaearningsand theyarenon-missingforthesubsampleoffirmsthatdiscloseproformaearnings. FollowingDoyleet al.(2003), wedecomposethedifferencebetweenGAAP earningsandproformaearningsintospecial itemsandnon-specialitems.Sincespecialitemsare,bydefinition,unusualandnon-recurring, their exclusions arelikelymeanttoprovideamoreinformative earningsfiguretoinvestors,while exclusionsofnon-special items,onthecontrary,mayservethepurposeofmisleading investors.The firstvariable,*REVERSELOSS*,isadummyindicatingthatfirmsexcludenon-specialitemstoturn GAAPlossesintoproformaprofits.Ittakesthevalueof1,ifthefollowingthreeconditionsare satisfied:a)GAAPearningsarenegative; b)GAAPearningsadjustedforspecialitemsarenegative; andc)proformaearningsarepositive.Thecombinationofthethreeconditionsensuresthatnon-specialitemsareresponsible forturningGAAPlossesintoproformaprofits.Otherwise, ittakesthe valueof0.*REVERSEMISS/REVERSEDROP*indicatesthatfirmsusenon-specialitemstoturnGAAP missesofanalysts’forecasts/priorGAAPearningsintoproformameet-or-beat.Theircomputations areverysimilartothatof*REVERSELOSS*. Thelastvariable,*POS_NSI*,isadummywhichindicates excluding non-special itemstoincreaseproformaearnings.Itisequalto1,ifproformaearningsare higherthanGAAPearningsadjustedforspecialitems,and0otherwise.

The meanvalueof*REVERSELOSS*is0.132,suggestingthat13.2%ofproformaearningsturn aGAAPlossintoaproformaprofitvianon-special items.Similarly,themeanvaluesof *REVERSEMISS*and*REVERSEDROP*showthat36.2%ofproformaearningsturnaGAAPmissinto aproformameet-or-beat ofanalysts'forecastsand15.4%ofproformaearningsreverseadropin GAAPearningsthroughtheexclusionofnon-specialitems.Themeanvalueof*POS_NSI*indicates thatcloseto64.2%ofproformadisclosuresinvolveexcludingnon-specialitemstoincreasepro formaearnings.

PanelsBandCreportthedistributionoftheproformaearningsreleasesby yearandindustry, respectively. AsPanelBshows,thenumberofproformaearningsreleasesincreasessteadilyduring thepre-RegGperiod,from124in1998to702in2001,whichisconsistentwithBhattacharya etal. (2004)and Zhangand Zheng(2011).AfterRegG,thereisadropinpro formaearningsreleases.This findingisconsistent withtheresultsinMarques(2006)andHeflinandHsu(2008).Thelastcolumn reportsthemean*C_Score*acrossyears.Weobserveajumpin*C_Score*afterRegG,suggesting that firmsthatreportproformaearningsafterRegGaremoreconservativethanthosebeforeRegG.

ResultsfromPanelCindicatethatthemajorityoftheproformaearningsreleasesarefrom two industries:BusinessServices(42.6%)and ElectronicEquipment(16.7%).68.4%ofthepro forma earningsreleasesaremadebyfirmsinthehigh-techindustries, whilefirmsfromtheintangible-intensiveindustries accountfor52.8%oftheproformaearningsreleasesinthesample.High-tech industriesandintangible-intensiveindustriesaredefinedaccordingtoFrancisandSchipper(1999) andCollinsetal.(1997),respectively. Thispatternisconsistentwiththedistributiondocumentedin LougeeandMarquardt(2004).

5.Test of Hypothesis 1

5.1 Modelspecification

Ourfirsthypothesisisthatrelativetofirmswithmoreconservativeaccounting,firmswith lessconservativeaccountingexperienceapost-RegGdropinthelikelihoodofproformadisclosures.

Totestourhypothesis,werunthefollowinglogisticregression:

$$\Pr\left(PF\_\widehat{D}_{i,t}=1\right)=F(\beta_0+\beta_1 Rank\ of\ C\_Score_{i,t-1}+\beta_2 Post\_G_{i,t}+\beta_3 Rank\ of\ C\_Score_{i,t-1}*Post\_G_{i,t}+\beta_4 Control\ Variables_{i,t-1}+\varepsilon_{i,t}) \quad (3)$$

Where

*PF_D*equals1ifthefirm-quarterobservationdisclosesproformaearningsand0otherwise;

*POST_G*equals1forobservationsafterRegGand0otherwise;

*RankofC_Score*isthedecilerankbasedon*C_Score*.Specifically,werankteraw*C_Score*intotendecile seachyearandtransform thevalueof*RankofC_Score*tobebetween0(fortheleast conservativedecile)and1(forthemostconservativedecile).[6]

Weusethedecilerankinsteadoftherawvalueof*C_Score*,forthefollowingthreereasons.First,itpreventst heresultsfrombeingundulyaffectedbyextremevalues.[7]Second,itdoesnot assumealinear functionalformbetween *C_Score*andthedependentvariable.Ouruntabulatedresults showthatthelinearassumption isnotsupportedbythedata.Third,thisapproachoffersa straightforward interpretation of the coefficient on the variable: it measures the effect on the dependentvariablewhenwegofromtheleastconservativedeciletothemostconservativedecile.

In our model, the coefficient on *POST_G* represents the across-Reg G change in the likelihoodof issuingpro formaearningsfor firmsin the leastconservativedecilewhilethe coefficient

ontheinteractionterm(*RankofC_Score*POST_G*)reflectsthedifferenceintheacross-RegG changebetweenfirmsinthemostconservativedecileandfirmsintheleastconservativedecile.Ifour hypothesisistrue,weexpectthecoefficientontheinteractiontermtobepositiveandsignificant, suggestingthat,relativetofirmswithmoreconservative accounting,firmswithlessconservative accountingexperienceadeclineinthelikelihoodofissuingproformaearningsafterRegG.

Afterdiscussing ourempiricalprediction,wenowturntocontrolvariables.Priorliterature suggeststhat thelikelihoodof voluntarydisclosureis related to the value-relevanceof GAAP earnings(Chenetal.2002;LangandLundholm 1993;Tasker1998).Wethuscontrolforfour measuresofthevaluerelevanceofGAAPearnings(*Hitech*,*LOSS*,*STD_ROA* and*Prloss*).We additionally controlfor*Size*,*BM*and*Lev*toisolatetheeffectofthesethreefirmcharacteristics. Industrydummies(asdefinedinFamaandFrench(1997))areincludedtocontrolfortheindustry fixedeffects.

AhmedandDuellman(2007)showthatfirmswithmoreconservative accountingarethose withmoreindependent boards.Similarly,GarcíaLaraetal.(2009)findthatfirmswithstronger corporategovernanceprovisionsinplaceare moreconservative.We are thusconcernedthat theeffectattributedtoaccountingconservatism isdrivenbyitsassociationwithmanagerialcharacteristicsand corporategovernance. Toalleviatethisconcern,wecontrolforthefollowingfourvariables: *CEO_Own*(percentageofsharesheldbytheCEO),*CEO_Comp*(theratiooftheCEO'sequity-related compensationtototalcompensation),*CHAIR*(adummyvariablethat equals1ifthe CEOalso holdsa "Chairman"titleand0otherwise),and*INDEP*(theproportionofindependentdirectors intheboard). TheCEOcharacteristicsdataarefromtheCompustatExecutiveCompensationAnnualDatabase, whiletheboardindependencedataarefromtheRiskMetricsDatabase.

Inaddition,priorliteraturehasdocumented fourexplanations foraccounting conservatism: contracting, litigation,regulationandtaxation(Watts2003).Qiang(2007)furthershowsthat conditionalconservatism,whichisourfocusinthispaper,isprimarilydrivenbycontractingand litigationdemands.Itispossiblethattheeffectattributedtoaccountingconservatismisduetothe underlyinglitigationorcontractingdemands.[8]Wenotethatsomeofthecontrolvariablesdiscussed earliercanserveascontrolsfordemandsforaccountingconservatism. *Lev*and*CEO_Comp*canbe consideredascontrollingforthecontractingexplanationforaccountingconservatism, while*Hitech*, *LOSS*,*STD_ROA*and*Prloss*canbedeemedascontrollingforthelitigationexplanation,because firmsinahigh-tech industry,firmswithvolatileearningsandfirmswithcurrentorahistoryof operatinglossesfacehigherlitigationrisk(Francisetal.1994;JonesandWeingram 1996). Nevertheless,weadditionallycontrolfor*Litigation*.*Litigation*iscomputedaccordingtoKimand Skinner(2012)anditmeasuresdemandsforaccountingconservatismfromthelitigationperspective.

5.2 Results

Table2presentsresults ofthelogistic regressions.Becauserequiring measures ofmanagerial characteristics, corporategovernanceanddemandsforaccountingconservatismsignificantlyreduces thesizeofthesample(from93,802to32,804), wereportresultsbeforeandafterthisrequirement separatelyinRegression1and2.

Regression 1reportsresultsbasedonthelargersample.Consistent withthefindingofprior literaturethatthelikelihoodofvoluntarydisclosures ishigheramongfirmswithlessvalue-relevant GAAPearnings,wefindthatthelikelihoodofissuingproformaearningsincreasesinmembershipin a high-techindustry(*Hitech*),earningsvolatility(*STD_ROA*)andtheoccurrenceoflosses(*LOSS*).

Inaddition,wefindthatthecoefficientestimateon*POST_G*is-0.350,whichsuggeststhat theoddsofissuingproformaearningsdropby30%forfirmsintheleastconservativedecileafter

RegG.[9]Thesumofthiscoefficientandthecoefficientontheinteractionterm(whichisequalto1.489)is1.139,indicatingthattheoppositeistrue forfirmsinthemost conservativedecile.Forthosefirms,theoddsofissuingproformaearningsincreaseby212%afterRegG.Thecoefficient onthe interaction term,*RankofC_Score*POST_G*,issignificant atthe1%level,indicatingthatthedifferenceintheacross-Reg Gchangebetweenthetwodecilesishighlysignificant. Itsvaluereveals thaton average,theacross-RegG changein theoddsof issuingproformaearningsisreducedby15% whenwemovetothenextlowerdecileofaccountingconservatism.[10]

OurresultsfromRegression2arequalitativelysimilartothosefromRegression1.Wefindthatthecoefficient estimateontheinteraction term,*RankofC_Score*POST_G*,is1.318and significantat1%level.ThisevidenceisconsistentwithHypothesis1.[11]

Insum,Table2showsthat,relativetomoreconservative firms,lessconservative firms experienceadeclinein thelikelihoodofissuingpro formaearningsafterRegG. Thisfindingsupports Hypothesis1and isconsistentwiththe viewthatconservatismcurbsmanagerialincentivestoprovide opportunistic voluntarydisclosures. Since lessconservative firms have greater opportunistic incentives,theyarerestrainedby theregulationtoagreaterextent.

6. TestofHypothesis2

Our secondhypothesisisthat,amongfirmsthat reportpro formadisclosures,thosewithmore conservative accountingarelesslikelytoincreaseproformaearningsandreverseGAAPmissesof earningsbenchmarks byexcludingnon-specialitems.Weconsiderthreeearningsbenchmarks: a)the breakevenpoint;b)analysts'forecastsandc)earningsofthesamequarterofprioryear.

Totestourhypothesis, weexamine2,109proformaearningsreleasesinoursampleperiod. Wefirstsortthoseobservations intofivequintileseachyearaccordingtotheraw*C_Score*,andthen withineachquintile,wereporttheprobabilityofreversingGAAPmissesofearningsbenchmarks by excluding non-special items,andtheprobability ofincreasingproformaearningsbyexcluding non-specialitems.InPanelAofTable2,Column (2),"Numbofobs.",reportsthetotalnumber of observationsinthefive*C_Score*quintiles,Column(3),"Numofobs.withGAAPloss"indicatesthe numberofobservationsthatreportGAAPlosseswithineachquintile,andColumn(4),"Numofobs. with *REVERSELOSS*=1",showsthenumberofobservationswhereproforma earningsreverseGAAPlossesthroughtheexclusionofnon-special items.Ourfocusisonthelastcolumn"Prob(Proforma earningsreverseGAAPlossthroughnon-SI)", computed asColumn(4)dividedbyColumn(3).It showstheprobability ofproformaearningsreversingGAAPlossesthroughtheexclusionofnon-specialitems,conditionalonfirmsreporting GAAP losses. Wecanseethatthisprobabilitydecreases monotonicallyfromthelowesttothehighest*C_Score*quintile.Itis46.6%inthelowestquintileand16.5%inthehighestquintile. Thus,firmsinthelowest*C_Score*quintileare182%morelikelyto reportproformaearnings thatreverseGAAPlossesthanfirmsinthehighest*C_Score*quintile.The differencebetweenthetwoquintilesisnotonlyeconomically significantbutalsostatistically significant.Ourfindingsareconsistentwiththenotionthatmoreconservative firmsaresignificantly lesslikelytouseproformadisclosurestocreatetheimpressionofaprofitablequarter.

Thenextpanelreportstheprobability ofproformaearningsthatturnGAAPmissesof analysts'forecastsintoproformameet-or-beat byexcludingnon-specialitems.Wefindthatthe probabilitydecreasesmonotonically fromthelowesttothehighest*C_Score*quintile.Itis60.1%for firmsinthelowestquintileand37.1%forfirmsinthehighestquintile.Thus,firmsinthelowest *C_Score*quintileare62%morelikelytoissueproformaearnings thatreverseGAAPmisses of analysts'forecaststhan firms in the highest*C_Score*quintile.The differencebetweenthe

twoquintilesiseconomicallyandstatisticallysignificant.Ourfindingssuggestthatmoreconservative firmsaresignificantly lesslikelytoexcludenon-specialitemstoreverseGAAPmissesofanalysts' forecasts.

Thenextpanelreportstheprobabilityofproformaearningsthatreverseadropin GAAP earningsbyexcludingnon-specialitems.Thisprobabilitydecreasesfromthelowesttothehighest *C_Score*quintile.Itis35.7% forfirms inthelowest quintilewhile itis24.2% forfirmsinthehighest quintile,indicating thatfirmsinthelowest*C_Score*quintileare48%morelikelytoissueproforma earnings thatreverseadropinGAAPearnings thanfirmsinthehighest*C_Score*quintile.The differencebetweenthetwoquintilesissignificantatthe5%level,usingatwo-tailed *t*test.Our findingssuggestthat moreconservativefirmsare significantlyless likelytoexcludenon-specialitems toreverseadropinGAAPearnings.

Thelastpanelreportstheprobabilityofexcluding non-special itemstoincreaseproforma earnings.Thisprobability decreasesfromthelowesttothehighest*C_Score*quintile.Itis66.5%for firmsinthelowestquintilewhileitis59.2%forfirmsinthehighestquintile,indicating thatfirmsin thelowest*C_Score*quintileare12%morelikelytoexcludenon-special itemstoincreaseproforma earningsthanfirmsinthehighest*C_Score*quintile.Thedifference betweenthetwoquintilesis significantatthe 5% level,usingatwo-tailed*t*test.Our findingssuggestthatmoreconservativefirms aresignificantlylesslikelytoexcludenon-specialitemstoincreasetheproformaearnings.

Wenextconductmultivariate logisticregressionstocontrolfortheeffectofCEO characteristics,corporategovernanceand demandsforconservatism.Our dependentvariableisone of thefourdummies:*REVERSELOSS*,*REVERSEMISS,REVERSEDROP* and*POS_NSI*.Inadditionto controlvariablesthatwehavepreviouslyspecifiedinModel(3),weaddvariablesrepresenting the distancebetweentheearningsbenchmarks andtheGAAPearningsadjustedforspecialitems (*DIS_loss,DIS_miss,andDIS_drop*), becausemanagerialincentivestoreverseGAAPmissesof earningsbenchmarksmaybe affectedby howfarawayGAAPearningsarefromthebenchmarks.The signonthesevariablesisdifficulttopredict.WhenGAAPearningsarefarfromearningsbenchmarks, managersmayfinditmorecostlytoissuebenchmark-beatingproformaearnings,butthebenefitsof doingsoarelargeraswellandtheneteffectisuncertain.Thesedistancevariablesaregenerallycomputed astheearningsbenchmark minusGAAPearningsadjustedforspecialitems.Forexample, *DIS_drop*iscomputedasthepriorquarterGAAP earningspershare(theearningsbenchmark)minus currentquarterGAAPearningspershareadjustedforspecialitems.

Wenotethatthelikelihoodofturning GAAPmisses intoproformameet-or-beatrepresentsa probabilityconditionalonGAAPmisses.Forexample,ifafirmreportsprofits,*REVERSELOSS* can onlytakeonthevalueof0.Thismechanicalrelationconfoundsourinterpretation oftheresults. Therefore,welimitourrelatedanalysestothesubsampleofGAAPmisses.Specifically, whenthe dependent variableis *REVERSELOSS/ REVERSEMISS/ REVERSEDROP*,the sample we use includesonlyobservationsthat reportGAAPlosses/GAAPdrops/GAAPmisses.Althoughthe sample sizevariesasaresult,thisresearchdesigneliminatesthepossibility thatourresultsareinfluencedby themechanicalrelationship.

Ourregression resultsarereportedinPanelBofTable3.PanelBshowsthatwhenthe dependentvariableis*REVERSELOSS*,thecoefficientson*CEO_Own*and*INDEP*arenegativeand significant, suggesting thatthelikelihoodofproformaearningsreversingGAAPlossesthroughthe exclusionofnon-special itemsishigherforfirmswhoseCEOholdsalowerproportionofthefirm's equityandforfirmswhoseboardhasalowerproportionofindependentdirectors.Thecoefficienton *CHAIR*ispositiveandsignificantatthe5%level,implyingthatopportunisticproformadisclosures

aremorelikelytotakeplacewhentheCEOisalsothechairman oftheboard.Ourinterestliesinthe coefficienton*RankofC_Score.*Itis-1.793,significantatthe5%level.Therelatedoddsratio indicatesthattheoddsofproformaearningsreversingGAAPlossesarelowerby83%forfirmsin themostconservative quintilethanforfirmsintheleastconservative quintile.Thisfindingis consistentwithourhypothesis.

Whenthedependentvariableis*REVERSEMISS*,thecoefficienton*Litigation*ispositiveand marginallysignificant. Firmsfacinghighlitigationthreatsareprobablymorelikelytoresorttopro formadisclosurestopaintarosy pictureofprofitabilityinorderto avoidpotentiallycostlylawsuitsas aresultofinvestorsbeingdisappointedbyfirmperformance.Thecoefficienton*RankofC_Score*is-0.899,significantat the10%level.The relatedoddsratiosuggeststhattheoddsof proformaearnings reversingGAAPmissesofanalysts'forecastsarelowerbycloseto60%forfirmsinthemostconservativequintil ethanforfirmsin theleastconservativequintile.Thisfindinglendssupportto our hypothesis.

Whenthedependentvariableis*REVERSEDROP*,thecoefficienton*RankofC_Score*is-1.803, significantatthe5%level.Therelated oddsratioindicatesthattheoddsofproformaearnings reversingadropinGAAPearningsthroughtheexclusionofnon-special itemsarelowerby83%for firmsinthemostconservativequintilethanforfirmsintheleastconservativequintile.

Finally,whenthedependentvariableis*POS_NSI*,thecoefficienton*RankofC_Score*is-1.713,significant atthe1%level.Therelatedoddsratioindicatesthattheoddsofexcluding non-specialitemstoincreaseproformaearningsarelowerby82%forfirmsinthemostconservative quintilethanfor firmsinthe leastconservativequintile.Similartothe *REVERSEMISS*regression,the coefficienton*Litigation*ispositiveandsignificant, suggesting thatfirmsfacinghigherlikelihoodof lawsuitsresorttoproformaearningsinaneffforttoamelioratetheperceivedperformance.

Overall,wefindthatconservative firmsaremuchlesslikelytoincreaseproformaearnings andreverseGAAPmissesofearningsbenchmarksbyexcludingnon-specialitems.Thisfindingis robusttocontrollingforCEOcharacteristics, corporategovernanceanddemandsforaccounting conservatism.OurresultssupportHypothesis2andareconsistentwiththenotionthataccounting conservatismreducesmanagerialincentivestoissueopportunisticvoluntarydisclosures.

7. TestofHypothesis3

Ourthirdhypothesis isthattheproformaexcludeditemsareofhigherqualityformore conservativefirms.

WefollowKolevetal.(2008)inmeasuringthequalityofexcludeditems.Specifically, we regressfutureoperatingincome(*FOI*)onproformaearningsandproformaexcludeditems.We defineproformaexcludeditemsasofhighqualityifthoseitemsareexcludedtoprovideamore meaningfulmeasureoffirmperformance. Inthatcase,weexpecttheexcludeditemstobetransitory and havelow predictive power for future earnings. Thus, inour regression, a less significantcoefficientandacoefficientwithsmallermagnitudeontheexcludeditemsindicatehigherqualityof excludeditems.

Totestourhypothesis,wespecifyourmodelasfollows:

$$POI_{i,t+1} = \alpha_0 + \alpha_1 PF\_EPS_{i,t} + \alpha_2 Diff_{i,t} + \alpha_3 Rank\ of\ C\_Score_{i,t-1} + \alpha_4 Rank\ of\ C\_Score_{i,t-1} * Diff_{i,t} + \alpha_5 Hitech_{i,t} + \alpha_6 LOSS_{i,t} + \alpha_7 STD\_ROA_{i,t} + \alpha_8 Size_{i,t} + \alpha_9 BM_{i,t} + \alpha_{10} Lev_{i,t} + \alpha_{11} Prloss_{i,t} + \varepsilon_{i,t+1} \quad (4)$$

where

*FOI*isfutureoperatingincome,definedasoperatingincomepershareaccumulated overthe

followingfourquartersstartingfromquartert+1,scaledby assetspershare;

*PF_EPS*isproformaearningspershareinthepressrelease forquarter t,scaledbyassetsper share;

*Diff*isproformaearnings pershareminusGAAPearnings pershareforquartert,scaledby assetspershare;

*RankofC_Score*isourmeasureofconservatism(werank therawC_*Score*intofivequintiles eachyearandtransformthevaluefortheRankofC_*Score*tobebetween0and1);

Hitech,*LOSS*,*STD_ROA*,*Size*, *BM*, *Lev*and*Prloss*aredefinedas beforeandserveascontrol variables.Industrydummiesareincludedtocontrolfortheindustryfixedeffects.

Inourmodel,ifthecoefficienton*Diff*andthecoefficienton*RankofC_Score*Diff* takeon oppositesigns,itwillbeevidenceinsupportofHypothesis3.

Ouradditionaldatarequirementsresultinasampleof1,862proformareleasesonwhichthe regressionisrun.WeestimatetwoOLSregressions.Model1doesnotincludecontrolvariables, whileModel 2does.Weallowerrorstoclusterbyfirmandyeartoaccount fortime-seriesandcross-sectionalcorrelationinresiduals(Petersen,2009).OurresultsarereportedinPanelAofTable4.

Consistentwithpriorliterature(Doyleetal.,2003;LougeeandMarquardt,2004),in Model1, thecoefficienton*Diff*is-0.286,significantat the1%level,indicatingthat,contraryto theclaimmade bymanagers, excludeditemsarenotperfectlytransitory; instead,theynegativelypredictfuture earnings,forfirmsintheleastconservativequintile.Thecoefficientontheinteractionterm*RankofC_Score*Diff* is0.276, significantatthe5%level,indicatingthatthemoreconservativethefirmis, theweakerthecorrelationbetween *Diff*and*FOI*,andthehigherqualitytheproforma excludeditems are.Thesumofthetwocoefficientsreflectsthepredictivepowerofproformaexcludeditemsfor*FOI* inthemostconservative quintile.Ithasamuchlowermagnitude (0.01)thanthecoefficienton*Diff* alone.Inaddition,the*F*-testfailstorejectthenullhypothesis thatitisequalto0,indicatingthatfor firmsinthemostconservative quintile,proformaexcludeditemshavenostatisticalassociationwith futureearningsandthusarepurelytransitory.Weobservesimilarresultsin Model2.

GiventheresearchfindingsinAhmedandDuellman (2007),GarcíaLaraetal.(2009)and Watts (2003),itispossiblethatourresultsreportedinPanel Aaredrivenbyaccountingconservatism being aproxy for CEO characteristics,corporategovernanceor demandsfor conservatism.To alleviate thisconcern,weuseatwo-stageregressionapproach.[12]Wefirstregress*C_Score*onthefive variables:*CEO_Own*,*CEO_Comp*, *CHAIR*,*INDEP*and*Litigation*.Theresidualfromtheregression (*Res_C*)isthemeasureofaccountingconservatism afterbeingcleansedofitsassociationwithCEO characteristics,corporate governanceand demands for conservatism. We rank*Res_C*into five quintileseach yearandtransformthevaluefor*RankofRes_C*tobebetween0and1.Thenwere-run themodelinEquation(4)using*RankofRes_C*insteadof*RankofC_Score*.

Specifically,ourfirst-stageregressionisasfollows:

$$C\_Score_{i,t-1} = \beta_0 + \beta_1 CEO\_Own_{i,t-1} + \beta_2 CEO\_Comp_{i,t-1} + \beta_3 CHAIR_{i,t-1} + \beta_4 INDEP_{i,t-1} + \beta_5 Litigation_{i,t-1} + \varepsilon_{i,t-1} \quad (5)$$

Oursecondstageregressionisasfollows:

$$POI_{i,t+1} = \alpha_0 + \alpha_1 PF\_EPS_{i,t} + \alpha_2 Diff_{i,t} + \alpha_3 Rank\ of\ C\_Score_{i,t-1} + \alpha_4 Rank\ of\ C\_Score_{i,t-1} * Diff_{i,t} + \alpha_5 Hitech_{i,t} + \alpha_6 LOSS_{i,t} + \alpha_7 STD\_ROA_{i,t} + \alpha_8 Size_{i,t} + \alpha_9 BM_{i,t} + \alpha_{10} Lev_{i,t} + \alpha_{11} Prloss_{i,t} + \varepsilon_{i,t+1} \quad (6)$$

In our second stage model, if the coefficient on *Diff* and the coefficient on *Rank of Res_C*Diff* takeonoppositesigns,itwillsuggestthatourfindingisrobusttocontrollingforCEO characteristics,corporategovernanceanddemandsforaccountingconservatism.Industrydummies areincludedtocontrolfortheindustryfixedeffects.

Thefirststageregression resultisreportedinAppendix I.WefindthatC_Scoreispositively associated with*INDEP*andnegativelyassociated with*CHAIR*(althoughthecoefficient estimatesare insignificant), suggesting that firms with more conservative accounting policies have more independentboardsandarelesslikelytohaveCEO/Chairmanduality.Thisfindingisconsistentwith AhmedandDuellman(2007)andGarciaLaraetal.(2009).Consistent withQiang(2007)andWatts (2003),wefindthatthecoefficienton*Litigation*ispositiveandhighlysignificant,suggestingthat accountingconservatismincreaseswiththethreatoflitigations.

ThesecondstageregressionresultisreportedinPanelBofTable4.Model1reportsthe regression resultswhenwedonotincludecontrolvariables.Thecoefficient on*Diff*is-0.827, significantatthe1%level;whilethecoefficienton*RankofRes_C*Diff*is0.716,significantatthe1%levelaswell.T he*F*-testfailstorejectthenullhypothesisthatthesumofthetwocoefficients is equalto0.Theseresultsindicatethatthequalityofexcludeditemsishigherforfirmswithmore conservativeaccounting.Moreimportantly,theysuggestthatourresultsinPanelAarenotdrivenby accountingconservatismbeing aproxy forCEOcharacteristics,corporategovernanceordemandsfor conservatism.Thecolumn“Model2” showsthataddingmorecontrolvariablesdoesnot influenceour inferences.

Insum,Table4providesstrongevidencethatthequalityofproformaexcludeditemsis higherforfirmswith moreconservativeaccounting,lendingsupporttoHypothesis3.

8. Robustnesschecks

8.1 UsingtheBasu(1997)model

Ourpriorresultsshowthatmoreconservative firmsarelesslikelytoissueopportunistic pro formadisclosuresthatreverseGAAPmissesofearningsbenchmarks andtheyarelesslikelyto excludenon-specialitemsfrompro formaearnings.Thissectiontests whetherthis findingisrobustto usingtheBasu(1997)measureofaccountingconservatism.

Ourmodelsarespecifiedasfollows:

$$X_{i,t-1} = \beta_1 + \beta_2 D_{i,t-1} + \beta_3 R_{i,t-1} + \beta_4 D_{i,t-1} * R_{i,t-1} + \beta_5 REVERSELOSS_{i,t} + \beta_6 REVERSELOSS_{i,t} * D_{i,t-1} + \beta_7 REVERSELOSS_{i,t} * R_{i,t-1} + \beta_8 REVERSELOSS_{i,t} * D_{i,t-1} * R_{i,t-1} + \varepsilon_{i,t-1} \quad (7)$$

$$X_{i,t-1} = \beta_1 + \beta_2 D_{i,t-1} + \beta_3 R_{i,t-1} + \beta_4 D_{i,t-1} * R_{i,t-1} + \beta_5 REVERSEMISS_{i,t} + \beta_6 REVERSEMISS_{i,t} * D_{i,t-1} + \beta_7 REVERSEMISS_{i,t} * R_{i,t-1} + \beta_8 REVERSEMISS_{i,t} * D_{i,t-1} * R_{i,t-1} + \varepsilon_{i,t-1} \quad (8)$$

$$X_{i,t-1} = \beta_1 + \beta_2 D_{i,t-1} + \beta_3 R_{i,t-1} + \beta_4 D_{i,t-1} * R_{i,t-1} + \beta_5 REVERSEDROP_{i,t} + \beta_6 REVERSEDROP_{i,t} * D_{i,t-1} + \beta_7 REVERSEDROP_{i,t} * R_{i,t-1} + \beta_8 REVERSEDROP_{i,t} * D_{i,t-1} * R_{i,t-1} + \varepsilon_{i,t-1} \quad (9)$$

$$X_{i,t-1} = \beta_1 + \beta_2 D_{i,t-1} + \beta_3 R_{i,t-1} + \beta_4 D_{i,t-1} * R_{i,t-1} + \beta_5 POS\_NSI_{i,t} + \beta_6 POS\_NSI_{i,t} * D_{i,t-1} + \beta_7 POS\_NSI_{i,t} * R_{i,t-1} + \beta_8 POS\_NSI_{i,t} * D_{i,t-1} * R_{i,t-1} + \varepsilon_{i,t-1} \quad (10)$$

Allthevariablesaredefinedasbefore.Industrydummiesareincludedinallregressions.Our inferences arebasedonallowingtwo-wayclusteringatboththefirmlevelandtheyearlevelinorder tocontrolforcross-sectionalandtime-seriescorrelationsinresiduals(Petersen2009).

Iffirmswithmoreconservativeaccountingarelesslikelytoissueopportunisticproformadisclosures,weex

pectthecoefficient$\beta_8$tobesignificantlynegativeinallmodels,indicatingthatfirmsthatissueopportunisticproformadisclosuresarelessconservative.Weestimatethe fourregressionsusingthesampleoffirmswithproformadisclosures.OurresultsarereportedinTable5.

Model1-4reportresultsrelatedto*REVERSELOSS*,*REVERSEMISS*,*REVERSEDROP*and *POS_NSI*respectively. Wefindthatthecoefficientestimateontheinteractionterm, *REVERSELOSS*D*R*, is -0.134, the coefficient estimate on the interaction term, *REVERSEMISS*D*R*, is-0.030,thecoefficientestimateontheinteractionterm, *REVERSEDROP*D*R*,is -0.051,andthecoefficientestimateon theinteractionterm,*POS_NSI*D*R*, is-0.062, allsignificantatthe10%level.Thus, ourresults related toHypothesis2arerobust tousing thealternativemeasureofaccountingconservatism.[13]

8.2Theinstrumentalvariableapproach

Bothaccountingconservatism andopportunisticbehaviorsmaybedeterminedbysomefirm characteristics,suchasthethreatoflitigations,givingrisetoanendogeneityconcern.Wenextapplya standardtwo-stageinstrumental variableapproachtoexaminewhetherourresultsarerobusttothe endogeneityconcern.

Ourinstrumentalvariable(*SAB101*)isbasedontheimplementation oftheSEC'sStaff AccountingBulletinNo.101.[14]OnDecember3,1999,theSECreleasedStaffAccountingBulletin ("SAB")No. 101:*RevenueRecognitionin FinancialStatements*.SAB101in generalrequiresfirmsto belesstimelyinrecognizingrevenue.Forexample,priortoSAB101,DatalinkCorp.recognizedrevenueonhar dwareandsoftwareproductswhentheproductswereshipped.SAB101causedthe firmtodelayrevenuerecognitionuntiltheinstallationandconfigurationserviceswerecompleted (MoffeitandEikner2003).Byreducingthetimelinessofrevenuerecognition,theimplementationof SAB101resultsinanexogenousincreaseinaccountingconservatismforabroadcross-sectionof listedfirms.Consistentwiththisview,Vogt(2001)findsthatSAB101requiresrevenuerecognition tobelesstimelythanimpliedbycontractinglawandWatts(2003) citesSAB101asanexamplethat the SECappreciatesthe benefits of accountingconservatism.Using asample of 10-Q filings, Crawford etal.(2010)providesempirical evidencethatSAB101leadstoanincreaseinaccounting conservatism.

Specifically,ourinstrumentalvariable,*SAB101*,isequalto1forfiscalquartersafterthe implementation dateofSAB101,and0otherwise.Theimplementation dateofSAB101isnolater thanthefourthfiscalquarteroffiscalyearsbeginningafterDecember15,1999.

Inthefirststage,weregressrawvaluesof*C_Score*on*SAB101*andthecontrolvariablesin thesecondstageregression.Ouruntabulatedresultsshowthatthecoefficienton*SAB101*is positivein allregressionsandtherelated*t*-statisticsrangesbetween7.80and11.07,significantatbetterthan0.1%level.Thisfindingindicatesthattheimpl ementation ofSAB101increasesaccounting conservatism,whichisconsistentwithpriorliterature(Watts,2003;Crawfordetal.,2010).

Thefittedvaluefromthefirst-stage regression isusedasaninstrument for*C_Score*. Tobe consistent withpriorresults,werankfirmsintofivequintileseachyearbasedonthefittedvalueand thequintileranktakesvaluesbetween0,forthelowestquintile,and1,forthehighestquintile.

TotestwhetherourresultsrelatedtoHypothesis2arerobusttotheendogeneityconcern,in thesecondstage,weuselogisticregressionstoregress*REVERSELOSS /REVERSEMISS / REVERSEDROP/POS_NSI* ontheinstrumentedRankof*C_Score*andcontrol variables. Ourcontrol variablesinclude*Size,BM,Lev*,*CEO_Own, CEO_Comp,CHAIR,INDEP,Lev*,*Litigation.*Whenthe

dependentvariableis*REVERSELOSS*,*REVERSMISS*or*REVERSEDROP,*weadditionallycontrol for thedistancebetweenGAAPearningsandearningsbenchmarks(*DIS_loss/DIS_miss/DIS_drop*).Our resultsarereportedinPanelAofTable6.

PanelAshowsthatwhenthedependentvariableis*REVERSELOSS*,thecoefficientonthe instrumented*RankofC_Score*is-1.832,significantatthe10%level.Whenthedependentvariableis *REVERSEMISS*,thecoefficientontheinstrumented *RankofC_Score*is-2.113,significantatthe1% level. Whenthedependentvariableis*REVERSEDROP*,thecoefficientontheinstrumented*Rankof C_Score*is-1.675,significant atthe10%level.Thecoefficient is-1.473,significant atthe1%level, whenthedependent variableis*POS_NSI*. Thesefindingssuggestthatfirmswithmoreconservative accounting arelesslikelytoincreaseproformaearningsandreverseGAAPmissesofearnings benchmarksbyexcludingnon-specialitems,indicatingthatourresultsrelatedtoHypothesis2are robusttotheendogeneityconcern.

TotestwhetherourresultsrelatedtoHypothesis 3arerobusttotheendogeneityconcern,we replace *RankofC_Score*withitsinstrumentedvalue andre-runtheregressionspecifiedinModel(4). OurresultsarereportedinPanelBofTable6.

PanelBshowsthatthecoefficienton*Diff*is-0.135,significantatthe5%level,suggesting thatproformaexcluded itemsnegativelypredictfutureearnings. Thecoefficienton*RankofC_Score*(*instrumented*)**Diff*is0.099,significantatthe5%level,indicatingthatthem oreconservativethe firmis,theweakertheassociationbetween*Diff*and*FOI*andthehigherqualitytheproforma excludeditemsare.Ourresultiseconomically significant:whenwegofromthebottomtothetop conservatism quintile,themagnitudeofthecoefficienton*Diff*goesdownfrom0.135to0.036,the latterbeingonly27%oftheformer.

Insum,Table6providesevidencethatourconclusionscontinuetoholdwhenweusethe standardinstrumental variableapproachtoaddresstheendogeneityconcernofaccounting conservatism.

8.3 Testofreversecausality

Inun-tabulatedtests,weconsiderthealternativereversecausalityexplanation: firmsissuing opportunisticproformaearningstend tochooselessconservativeaccountingpolicy.This explanation predictsanegativeassociationbetweentheissuanceofopportunistic proformaearningsandfuture accounting conservatism. To test the prediction, we regresscurrent year *C_Score*on lagged*REVERSELOSS/REVERSEMISS/REVERSEDROP /POS_NSI*andwecontrolforlagged*C_Score*, *Hitech*,*LOSS*,*STD_ROA*,*Prloss*,*CEO_Comp*, *Lev*and*Litigation*inourOLSregressions.Industry dummiesarealsoincluded inthemodels.Allvariables areaspreviouslydefined.Becausethe dependentvariable,*C_Score*,isavailableannually,weobtain afirm-yearmeasureforallindependent variablesby takingtheaverageofthequarterlyvaluesinyear*t*-1whenevernecessary.

If the reverse causality explanation is true, we expect the coefficient on lagged *REVERSELOSS/REVERSEMISS/REVERSEDROP /POS_NSI*tobenegativeandsignificant, indicatingthatfirmsissuingopportunistic proformaearningstendtoadoptlessconservative accountingpolicysubsequently. Ourun-tabulated resultsshowthatthecoefficientsonlagged *REVERSELOSS*, *REVERSEMISS,REVERSEDROP* and*POS_NSI*areallnegative,butnoneare significantat the10%level:the*p*-valueis 0.803for*REVERSELOSS*,0.142for*REVERSEMISS,*0.490 for*REVERSEDROP,*and0.347for*POS_NSI*.

Ourfindingsareinconsistentwiththereversecausalityexplanationand,jointlywithTable5, suggestthataccountingconservatism affectsopportunistic managerialdisclosureincentivesbutthe

reverseisnottrue.

8.4 Simultaneousequationsystemapproach

Thechoiceofaccountingconservatism andthechoiceofissuingopportunistic proforma disclosurescouldbesimultaneously determined.Toinvestigatethispossibility,webuildup simultaneousequationsystems,whichincludeamodelforaccountingconservatism andamodelfor opportunisticproformadisclosures.

Themodelforaccountingconservatismisasfollows.

$$\text{Rank of C\_Score} = \alpha_0 + \alpha_1 * REVERELOSS + \alpha_2 * \text{Size} + \alpha_3 * BM + \alpha_4 * Lev + \alpha_5 * CEO\_Own + \alpha_6 * CEO\_Comp + \alpha_7 * CHAIR + \alpha_8 * INDEP + \alpha_9 * Litigation + \alpha_{10} * SAB101 + \varepsilon \quad (11)$$

Themodelforopportunisticproformadisclosurevarieswiththedependentvariable.

Whenthedependentvariableis*REVERSELOSS*,themodelisspecifiedasfollows.

$$\text{REVERSELOSS} = \alpha_0 + \alpha_1 * \text{Rank of C\_Score} + \alpha_2 * \text{Size} + \alpha_3 * BM + \alpha_4 * Lev + \alpha_5 * CEO\_Own + \alpha_6 * CEO\_Comp + \alpha_7 * CHAIR + \alpha_8 * INDEP + \alpha_9 * Litigation + \alpha_{10} * DIS\_loss + \varepsilon \quad (12)$$

Themodelspecificationsfor*REVERMISS*and*REVERSEDROP*aresimilar. Themodelspecificationfor*POS_NSI*isasfollows:

$$POS\_NSI = \alpha_0 + \alpha_1 * \text{Rank of C\_Score} + \alpha_2 * \text{Size} + \alpha_3 * BM + \alpha_4 * Lev + \alpha_5 * CEO\_Own + \alpha_6 * CEO\_Comp + \alpha_7 * CHAIR + \alpha_8 * INDEP + \alpha_9 * Litigation + \alpha_{10} * Opt\_Sensitivity + \varepsilon \quad (13)$$

*Opt_Sensitivity*isameasureforoptionsensitivity.[15]BurnsandKedia(2006)demonstratethatthesensitivityofCEOoptiontostockpriceissignificantlypositivelyrelatedtothepropensityto misreport.FollowingCoreandGuay(2002),itiscomputedastheoptiondeltamultipliedby1%of thestockprice.

Ouruntabulatedresultsshowthat,inthesimultaneous equationsystem,whenthedependent variableisameasureofopportunisticproformadisclosure(*REVERSELOSS /REVERSEMISS/ REVERSEDROP /POS_NSI*),thecoefficienton*RankofC_Score*isnegativeandatleastsignificant atthe5%level;whenthedependent variableis*RankofC_Score*,thecoefficient onthemeasure of opportunisticproformadisclosureisnegativebutneversignificant.

Ourfindingssuggestthatourconclusionisrobusttothesimultaneous equationapproach whereaccountingconservatismandtheissuanceofopportunisticproformadisclosuresaremodeled as mutuallydependent.

9. Conclusions

We hypothesizethatconditionalconservatism reducesmanagerialincentivestodisclose opportunisticproformaearnings.Wefindthatlessconservativefirmsarelesslikelytoissuepro formaearningsafterRegulationG.Thisisconsistentwiththeviewthatthesefirmstendtoissue opportunisticproformaearningsandRegGincreasestheircostsofdoingso.

In addition,weshowthat conservativefirmsarelesslikelytoincreaseproformaearningsand reverseGAAPmissesofearningsbenchmarksbyexcludingnon-specialitems.Sincenon-special itemsarelikelytoberecurring, excluding theseitemsisdifficulttojustifyfromtheperspective of informinginvestors. Thisisespecially truewhendoingsoleadstohigherproformaearningsandpro formameet-or-beatofearningsbenchmarks.Thisfindingisthereforeconsistentwithourhypothesis.

Lastly,weexaminethequalityofproforma exclusions.Highqualityofexclusionsshallhave lowercorrelationwithfutureearnings.Wefindthatproformaearningsareofhigherqualityifthey

areissuedbymoreconservativefirms.

Collectively,ourfindingsareconsistentwiththeviewthataccounting conservatismactsasa corporategovernancemechanismandcurbsmanagerialincentivestoissueproformaearningsfor opportunisticpurposes.

Ourresearchhoweverissubjecttoanimportantcaveat.Thatis,accountingconservatismis notexogenous.Weconductseveralrobustnesschecksto addressthisconcern.Specifically,we controlforexplanationsforaccounting conservatisminregressions, weusethestandardinstrumental variableapproach,wetestforreversecausalityandwebuildsimultaneousequationsystems.Our conclusions seemabletosurvivethetests.However,totheextentthattheendogeneityofaccounting conservatismisnotfullycapturedbythetestsweconduct,wecannotclaimcategoricallythatour resultsareentirelyimmune tothisconcern andthatourresults indicatecausality ratherthan association.

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Table1Descriptivestatistics

PanelA presentsthesummarystatisticsforthesampleof93,802firm-quarterobservationsfrom 1998-2004. All thecontinuous variablesarewinsorizedatthetopandbottom one percentile.PleaserefertoAppendixIIfor detailedvariabledefinitions.PanelBandPanelCpresentthedistributionof2,109proformaearningsreleases byyearandby industry,respectively.IndividualindustriesareasdefinedinFamaandFrench(1997).High-tech firmsareas definedinFrancisandSchipper(1999). Intangible-intensive firmsareasdefinedinCollinsetal. (1997).

PanelA: Summary Statistics

Variables	N	Mean	Std.Dev.	Q1	Median	Q3
PF_D	93,802	0.022	0.148	0	0	0
C_Score	93,802	0.160	0.148	0.080	0.148	0.216
Hitech(dummy)	93,802	0.252	0.434	0	0	1
LOSS (dummy)	93,802	0.253	0.435	0	0	1
Size	93,802	6.412	1.893	5.041	6.321	7.612
BM	93,802	0.591	0.480	0.284	0.485	0.748
Lev	93,802	0.660	1.237	0.025	0.225	0.715
STD_ROA	93,802	0.028	0.057	0.004	0.011	0.027
Prloss	93,802	1.057	2.369	0.000	0.000	0.000
POST_G	93,802	0.360	0.480	0	0	1
REVERSELOSS (dummy)	2,109	0.132	0.339	0	0	0
REVERSEMISS (dummy)	2,109	0.362	0.481	0	0	1
REVERSEDROP (dummy)	2,109	0.154	0.361	0	0	0
POS_NSI	2,109	0.642	0.479	0	1	1

Panel B: Distributionofproforma earnings releasesbyyear

Year	Numberof Pro Forma Press Releases	% of Sample	Mean *C_Score*
1998	124	5.88%	0.036
1999	110	5.22%	0.070
2000	260	12.33%	0.090
2001	702	33.29%	0.091
2003	390	18.49%	0.168
2004	523	24.80%	0.189
Total	2,109	100.00%	0.125

PanelC: Distributionofproforma earnings releases byindustry

Industry	Numberof Pro Forma Press Releases	% of Sample	% of Compustat
BusinessServices	898	42.58%	14.67%
ElectronicEquipment	352	16.69%	4.59%
Computers	141	6.69%	3.25%
Electrical Equipment	115	5.45%	2.80%
Pharmaceutical Products	58	2.75%	4.19%
Wholesale	56	2.66%	4.03%
Machinery	53	2.51%	2.28%
Measuring and ControlEquipment	50	2.37%	1.69%
Retail	50	2.37%	3.84%
Communication	28	1.33%	3.84%
Medical Equipment	24	1.14%	2.53%
Trading	22	1.04%	8.66%
Other	18	0.85%	1.10%
Banking	17	0.81%	9.33%

ConsumerGoods	16	0.76%	1.30%
Construction Materials	16	0.76%	1.42%
Transportation	16	0.76%	2.03%
PersonalServices	15	0.71%	1.21%
Restaurants, Hotels,Motels	14	0.66%	1.89%
Healthcare	13	0.62%	1.86%
Petroleumand Natural Gas	13	0.62%	3.17%
Construction	12	0.57%	1.10%
Automobilesand Trucks	12	0.57%	1.04%
Recreation	9	0.43%	0.85%
Rubber andPlastic Products	9	0.43%	0.69%
Textiles	9	0.43%	0.36%
Entertainment	8	0.38%	1.37%
Business Supplies	8	0.38%	0.85%
Real Estate	8	0.38%	1.05%
PrintingandPublishing	7	0.33%	0.80%
Chemicals	7	0.33%	1.32%
Insurance	7	0.33%	2.41%
Candy&Soda	5	0.24%	0.19%
Utilities	5	0.24%	1.82%
Food Products	4	0.19%	1.12%
Apparel	4	0.19%	0.77%
Agriculture	3	0.14%	0.26%
Beer& Liquor	2	0.09%	0.32%
SteelWorksEtc.	2	0.09%	1.11%
Tobacco Products	1	0.05%	0.11%
FabricatedProducts	1	0.05%	0.24%
Defense	1	0.05%	0.14%
Aircraft	0	0.00%	0.32%
Shipbuilding, Railroad Equipment	0	0.00%	0.17%
PreciousMetals	0	0.00%	0.77%
Non-Metallic and Industrial Metal Mining	0	0.00%	0.64%
Coal	0	0.00%	0.18%
ShippingContainers	0	0.00%	0.32%
Total	2,109	100.00%	100.00%
High-tech Firms	1,443	68.42%	25.11%
Intangible-IntensiveFirms	1,113	52.77%	24.60%

Table2Therelationship betweenaccountingconservatism andthelikelihoodofissuingpro formaearningsacrossRegulationG

Thistablepresentsresultsoflogisticregressions basedonboththe fullsamplewith93,802firm-quarter observationsandthelimitedsamplewith32,804firm-quarterobservationsfrom 1998-2004.Thelimitedsample requires non-missingvaluesforthefollowingfive variables:*CEO_Own*,*CEO_Comp*,*CHAIR*,*INDEP*and *Litigation*.Thedependentvariableis*PF_D*,whichequals1ifthefirm-quarterobservationissuesproforma earningsand0otherwise.ThePre-RegGperiodisfrom January1998toDecember2001,whilethePost-RegG periodisfromApril2003toDecember2004.*p*-valuesbasedonatwo-tailed*WaldChi-square*testarereported inparentheses.Thesymbols*,**,and *** denotesignificanceat the10%,5% and 1%levels,respectively.

Variable	Regression 1	Regression 2

Intercept	-6.902	-7.704
	(0.689)	(0.837)
Rankof C_Score	-1.511***	-1.096***
	(<.001)	(<.001)
Rankof C_Score POST_G*	1.489***	1.318***
	(<.001)	(<.001)
POST_G(dummy)	-0.350***	-0.470***
	(<.001)	(0.004)
Hitech(dummy)	0.825***	0.454**
	(<.001)	(0.012)
LOSS (dummy)	0.820***	0.545***
	(<.001)	(<.001)
Size	0.146***	-0.061
	(<.001)	(0.119)
BM	0.050	-0.313**
	(0.385)	(0.032)
Lev	-0.211***	-0.148*
	(<.001)	(0.077)
STD_ROA	2.582***	4.038***
	(<.001)	(<.001)
Prloss	-0.011	-0.053**
	(0.277)	(0.025)
CEO_Own		-0.202
		(0.774)
CEO_Comp		0.693***
		(<.001)
CHAIR (dummy)		0.086
		(0.322)
INDEP		0.500*
		(0.056)
Litigation		1.571***
		(<.001)
Industrydummy	YES	YES
Max-RescaledR^2(%)	19.85	24.24
Number of obs.	93,802	32,804

Table3Thelikelihoodofopportunisticproformadisclosures

Panel Areportsthelikelihood ofopportunistic proforma disclosures forthesampleof2,109proformaearnings releasesintheperiod1998-2004.PanelBreportsresultsofthelogisticregressionbasedonalimitedsampleof722firm-quarterproformaearnings releases.Thelimitedsamplerequiresnon-missingvalues forthefollowing five variables: *CEO_Own*, *CEO_Comp*, *CHAIR*,*INDEP*and *Litigation*.The dependentvariablesare *REVERSELOSS*,*REVERSEMISS,REVERSEDROP*and*POS_NSI*respectively.The numberofobservations varieswhenweexamine*REVERSELOSS*/*REVERSEMISS/REVERSEDROP*,becauseweadditionallyrequire that there is aGAAP loss/miss/drop respectively. InPanelA,*p*-valuesbasedon atwo-tailed *t* test arereported in parentheses.In PanelB, *p*-valuesbased on atwo-tailed*WaldChi-square* testarereportedin parentheses.The symbols*,**,and***denotesignificanceatthe10%,5%and1%levels,respectively.Pleasereferto Appendix IIfordetailed

variable definitions.

PanelA: Theprobability of opportunisticpro forma disclosuresacross*C_Score*quintiles

C_Score Ranking (1)	Numof obs. (2)	Numof obs. with GAAPloss (3)	Numof obs. with *REVERSELOSS*=1 (4)	Prob (Pro formaearningsreverse GAAP loss through non-SI) (5)=(4)/(3)
Lowest	418	148	69	0.466
2	425	186	58	0.312
3	422	201	65	0.323
4	425	249	45	0.181
Highest	419	254	42	0.165
		Lowest-Highest		0.301***
		p-value		(<.001)
C_Score Ranking (1)	Numof obs. (2)	Numof obs. with GAAPmiss (3)	Numof obs. with *REVERSEMISS*=1 (4)	Prob (Pro formaearningsreverse GAAPmiss through non-SI) (5)=(4)/(3)
Lowest	418	291	175	0.601
2	425	302	165	0.546
3	422	305	169	0.554
4	425	303	149	0.492
Highest	419	283	105	0.371
		Lowest-Highest		0.230***
		p-value		(<.001)
C_Score Ranking (1)	Numof obs. (2)	Numof obs. with GAAPdrop (3)	Numof obs. with *REVERSEDROP*=1 (4)	Prob (Pro formaearningsreverse GAAPdropthrough non-SI) (5)=(4)/(3)
Lowest	418	207	74	0.357
2	425	220	76	0.345
3	422	199	62	0.312
4	425	202	64	0.317
Highest	419	202	49	0.242
		Lowest-Highest		0.115**
		p-value		(0.011)

C_Score Ranking	Numof obs.	Prob Increase pro formaear ıingsthrough non-SI)
Lowest	418	0.665
2	425	0.661
3	422	0.659
4	425	0.635
Highest	419	0.592
Lowest-Highest		0.073**
p-value		(0.028)

Panel B: Regressionbasedon a limitedsample of proforma earningsreleases

Variable	*REVERSE LOSS*	*Odds ratio*	*REVERSE MISS*	*Odds ratio*	*REVERSE DROP*	*Odds ratio*	*POS_ NSI*	*Odds ratio*
Intercept			*Lev*					
Rankof C_Score					*CEO_Own*			
Size					*CEO_Comp*			
BM					*CHAIR (dummy)*			

INDEP	-6.326		-6.885		-7.103		-2.773	
	(0.961)		(0.924)		(0.943)		(0.960)	
Litigation	-1.793**	0.166	-0.899*	0.407	-1.803**	0.165	-1.713***	0.180
	(0.047)		(0.088)		(0.023)		(<.001)	
DIS_loss	-0.270	0.764	0.134	1.143	-0.034	0.967	-0.046	0.955
	(0.157)		(0.234)		(0.822)		(0.637)	
	-1.375**	0.253	0.030	1.031	0.902	2.465	-0.749**	2.115
	(0.020)		(0.943)		(0.106)		(0.043)	
	0.977	2.656	-0.050	0.951	0.739	2.095	-0.136	0.873
	(0.138)		(0.916)		(0.306)		(0.677)	
	-10.120*	<.001	-0.989	0.372	-1.956	0.141	-1.037	0.354
	(0.067)		(0.629)		(0.514)		(0.554)	
	1.105*	3.019	0.086	1.090	-0.091	0.913	-0.242	0.785
	(0.097)		(0.810)		(0.855)		(0.422)	
	0.749**	2.114	-0.040	0.960	0.176	1.192	0.166	1.181
	(0.050)		(0.862)		(0.562)		(0.392)	
	-1.742*	0.175	0.299	1.348	-1.354	0.258	1.020	2.772
	(0.099)		(0.663)		(0.110)		(0.109)	
	0.840	2.316	0.794*	2.213	0.572	1.773	1.613***	5.019
	(0.315)		(0.073)		(0.339)		(<.001)	
	0.534	1.706						
	(0.183)							
DIS_miss			0.520	1.682				
			(0.188)					
DIS_drop					-0.247	0.781		
					(0.461)			
Industry dummy	YES		YES		YES			
	YES Max-Rescaled							
R^2 (%)	34.27		27.54		27.99		28.72	
Number of obs.	248		495		337		722	

Table4Thequalityofexcludeditems

PanelApresentsresultsoftheOLSregressionbasedonthesampleof1,862proformaearningsreleases.Panel Bpresentsthesecond-stageOLSregressionresultsbasedonalimitedsampleof676proformaearnings releases.Thelimitedsamplerequires non-missingvaluesforthefollowingfivevariables: *CEO_Own*, *CEO_Comp*, *CHAIR*, *INDEP* and *Litigation*. In the first stage, we regress *C_Score*on five variables (*CEO_Own*,*CEO_Comp*,*CHAIR*,*INDEP* and *Litigation*)andobtaintheRes_C.Inthesecondstage,we use *Rankof Res_C*as ameasure of conservatism.In both panels, the dependent variable is *FOI*,definedasoperating incomepershareaccumulatedoverthe followingfourquarters.Inferencesarebaseduponerrorsclusteredby bothfirm andyeartoaccountforcross-sectionalandtime-seriesresidualdependence(Petersen2009). *p*-values basedonatwo-tailedttestarereportedinparentheses.Thesymbols*,**,and***denotesignificanceatthe10%,5% and 1% levels,respectively. Pleaserefer to Appendix II for detailed variable definitions.

PanelA: Fullsample

Variable	Model1	Model2
Intercept	0.074***	0.053
	(<.001)	(0.264)
PF_EPS	0.264***	0.139***
	(<.001)	(0.002)
Diff	-0.286***	-0.224***
	(0.007)	(0.003)
Rankof C_Score	-0.084***	-0.024**
	(0.002)	(0.049)
*Rankof C_Score * Diff*	0.276**	0.249***
	(0.012)	(0.003)
Hitech(dummy)		-0.007
		(0.368)
LOSS (dummy)		-0.068***
		(<.001)
Size		0.002
		(0.407)
BM		-0.041***
		(<.001)
Lev		0.036***
		(<.001)
STD_ ROA		-0.040
		(0.190)
Prloss		-0.022***
		(0.002)
Industrydummy	YES	YES
F-Test: [illegible] *F*-statistic: 0.070		*F*-statistic: 0.420
	p-value:0.789	*p*-value:0.516
Adj.R^2(%)	18.50	26.28
Number of obs.	1,862	1,862

Panel B:Limited samplewith managerialcharacteristics, corporategovernancevariablesand demands foraccountingconservatism

Variable	Model1	Model2
Intercept	0.029*	0.019
	(0.052)	(0.304)
PF_EPS	0.152***	0.067***
	(0.002)	(0.005)
Diff	-0.827***	-0.482***
	(0.001)	(0.001)
Rankof Res_C	-0.046*	-0.007
	(0.052)	(0.439)
*Rankof Res_C * Diff*	0.716***	0.602***
	(<.001)	(<.001)
Hitech(dummy)		-0.012
		(0.267)
LOSS (dummy)		-0.069***
		(<.001)
Size		0.001
		(0.396)
BM		-0.055**
		(0.019)
Lev		0.039***
		(0.004)
STD_ROA		-0.014
		(0.245)
Prloss		-0.014**
		(0.021)
Industrydummy	YES	YES
F-Test: $\alpha_{\blacksquare} + \alpha_{\blacksquare} = 0$	*F*-statistic: 0.470	*F*-statistic: 0.600
	p-value:0.495	*p*-value:0.439
Adj.R^2(%)	19.30	29.89
Number of obs.	676	676

Table5RobustnesscheckusingtheBasu(1997)Model

Thistable reportsOLS regression resultsbased on thesampleof 2,109 firm-quarter pro formaearnings releases. ThedependentvariableXisearningsscaledbymarketvalueofequitymeasuredinyeart-1,thefiscalyear beforecurrentearningsannouncements;Risreturnscumulatedoverthefiscalyeart-1; Disa dummyvariable thatequals1whenR<0and0otherwise.Inferencesarebaseduponerrorsclusteredbybothfirm andyearto account foranycross-sectionalandtime-seriesresidualdependence(Petersen2009).*p*-valuesbasedonatwo-tailed*t*testarereportedinparentheses.The symbols*, **, and *** denotesignificance atthe10%,5%and 1% levels, respectively. Pleaserefer to Appendix II for detailedvariable definitions.

Variable	Model1	Model2	Model3	Model4
Intercept	0.092*** (<.001)	0.093*** (<.001)	0.092*** (<.001)	0.101*** (<.001)
D	0.027*** (0.001)	0.025*** (0.005)	0.026*** (0.003)	0.030** (0.029)
R	-0.011 (0.156)	-0.018* (0.076)	-0.015* (0.075)	-0.021 (0.151)
*D *R*	0.156*** (<.001)	0.148*** (<.001)	0.152*** (<.001)	0.182*** (<.001)
REVERSELOSS	-0.050 (0.185)			
*REVERSELOSS*D*	-0.024 (0.370)			
REVERSELOSS R*	-0.003 (0.403)			
*REVERSELOSS*D*R*	-0.134*** (<.001)			
REVERSEMISS		-0.016 (0.190)		
*REVERSEMISS*D*		-0.012 (0.324)		
REVERSEMISS R*		0.011 (0.190)		
*REVERSEMISS*D*R*		-0.030* (0.073)		
REVERSEDROP			0.011 (0.187)	
*REVERSEDROP*D*			-0.024 (0.102)	
REVERSEDROP R*			0.006 (0.317)	
*REVERSEDROP*D*R*			-0.051** (0.044)	
POS_NSI				-0.022 (0.139)
*POS_NSI*D*				-0.012 (0.321)
*POS_NSI*R*				0.011 (0.273)
*POS_NSI*D*R*				-0.062** (0.016)
Industrydummy	YES	YES	YES	
	YESAdj.R^2(%) 11.30	12.00	11.32	11.25

Number of obs.	2,109	2,109	2,109	2,109

Table6Resultsoftheinstrumentalvariableapproach

Thistablereportssecond-stageregressionresultsoftheinstrumentalvariableapproach,basedonthesampleof2,109proformaearningsreleases. *SAB101*isourinstrumentalvariable.Inthefirststageregression,weregress rawvaluesof*C_Score*on*SAB101*andthecontrolvariablesinthesecond-stageregression.Thefittedvalue from theregressionisusedasaninstrumentfor*C_Score*.Tobeconsistentwithpriorresults,werankfirmsinto five quintiles each year based on the fitted value and the quintile ranktakes values between 0(the lowest quintile)and1(thehighestquintile).PanelAreportslogisticregressionresults.Thedependentvariablesare *REVERSELOSS*,*REVERSEMISS*,*REVERSEDROP* and *POS_NSI*respectively. *p*-valuesbased onatwo-tailed *WaldChi-square*testarereportedinparentheses.PanelBreportsOLSregressionresults.Thedependent variableis*FOI*.*p*-valuesbasedonatwo-tailed*t*testarereportedin parentheses.The symbols *,**,and*** denotesignificanceatthe10%,5%and1% levels,respectively.PleaserefertoAppendixIIfordetailedvariable definitions.

PanelA Thelikelihoodof opportunisticproformadisclosures

Variable	REVERSE LOSS	*REVERSE MISS*	*REVERSEDROP*	*POS_NSI*
Intercept	6.664	1.113	1.772	-4.198
	(0.971)	(0.987)	(0.986)	(0.940)
Rankof C_Score(*instrumented*)	-1.832*	-2.113***	-1.675*	-1.473***
	(0.095)	(0.003)	(0.081)	(0.003)
Size	-0.148	0.015	-0.405*	0.175**
	(0.502)	(0.901)	(0.074)	(0.037)
BM	-2.085***	0.251	-1.614**	0.383
	(<.001)	(0.562)	(0.011)	(0.256)
Lev	0.026	0.547*	1.790	-0.158
	(0.971)	(0.053)	(0.128)	(0.625)
*CEO_OwnCEO_*	-13.017***	-3.209	-2.928	-3.025
	(0.007)	(0.126)	(0.254)	(0.102)
CompCHAIR	-0.324	-0.418	-0.179	-0.766**
	(0.559)	(0.299)	(0.703)	(0.047)
(dummy) INDEP	0.443	-0.163	0.628*	0.189
	(0.198)	(0.509)	(0.053)	(0.330)
Litigation	-1.330	0.322	0.505	1.395**
	(0.201)	(0.641)	(0.579)	(0.014)
DIS_loss	-1.557**	-0.579	-0.354	1.552***
	(0.035)	(0.229)	(0.543)	(<.001)
	-0.168			
	(0.371)			
DIS_miss		-0.302*		
		(0.065)		
DIS_drop			0.487**	
			(0.014)	
Industrydummy	YES	YES	YES	YES
Max-RescaledR^2(%)	40.40	21.73	31.67	28.00
Numberof obs.	248	495	337	722

Panel B:Thequalityof excluded items

Variable	*FOI*
Intercept	0.022
	(0.412)
PF_EPS	0.139***
	(0.003)
Diff	-0.135**
	(0.017)
Rankof C_Score(*instrumented*)	0.005
	(0.437)
Rankof C_Score(*instrumented*) * *Diff*	0.099**
	(0.012)
Hitech(*dummy*)	-0.005
	(0.404)
LOSS (dummy)	-0.072***
	(<.001)
Size	0.004
	(0.326)
BM	-0.041***
	(<.001)
Lev	0.033***
	(0.006)
STD_ROA	-0.017
	(0.329)
Prloss	-0.023***
	(0.002)
Industrydummy	YES
F-Test: $\alpha_{\beta_1} + \alpha_{\beta_2} = 0$	*F*-statistic: 1.330
	p-value:0.249
Adj.R^2(%)	26.13
Number of obs.	1,862

AppendixI ResultsfromthefirststageregressionusedtoobtainRes_C

Thisappendixpresentsthefirst-stageOLS regressionbasedonalimitedsampleof676proformaearnings releases. Weregress *C_Score*on five variables(*CEO_Own*,*CEO_Comp*,*CHAIR*,*INDEP*and*Litigation*),and the*Res_C*istheresidual fromthismodel.*p*-valuesbasedonatwo-tailed*t*testarereportedin parentheses. The symbols*,**,and***denotesignificanceatthe10%,5%and1%levels,respectively.Pleasereferto Appendix IIfordetailed variable definitions.

Variable	*C_Score*
Intercept	0.195***
	(<.001)
CEO_Own	-0.236***
	(0.005)
CEO_Comp	-0.088***
	(<.001)
CHAIR(*dummy*)	-0.014
	(0.180)
INDEP	0.036
	(0.198)
Litigation	0.077***
	(<.001)
Adj.R^2(%)	9.83
Number of obs.	676

AppendixII Variabledefinitionsinalphabeticalorder

VariableName	VariableDefinition
BM	Theratioofbookvalueofequity(Compustat#60)tomarket valueofequity (Compustat#61*Compustat#14).
C_Score	Conservatismmeasure,computedaccordingtoKhanandWatts(2009).*CEO_Comp*
	TheratiooftheCEO'sequity-relatedcompensationtototalcompensation. *CEO_Own*
	Percentageofthefirm'ssharesheldby theCEO.
CHAIR	Adummyvariablethatequals1iftheCEOalsoholdsa"Chairman"titlein thefirmand0otherwise.
Diff	ProformaearningspershareminusGAAPearningspershareforquartert, scaledby assetspershare.
FOI	Theoperatingincomepershare(Compustat#177)summedoverthefour quartersstartingwithquartert+1,scaledby assetspershare.
DIS_drop	Thedistancebetween GAAPearningspershareadjusted forspecialitems andthepriorquarterGAAPearningspershare,thelatterconsidered asan earningsbenchmark.It's computedaspriorquarterGAAPearningspershare minuscurrentquarterGAAPearningspershareadjustedforspecialitems.
DIS_loss	Thedistance between GAAP earnings adjusted forspecialitemsandthe breakevenpoint,thelatterconsideredas a benchmark.It iscomputedas zero minusGAAPearningsadjustedforspecialitems.
DIS_miss	ThedistancebetweenGAAPearningsadjustedforspecialitemsandthe mostrecentconsensusanalystforecast,the latterconsideredasabenchmark. Itiscomputed astheconsensus analystforecastminusGAAPearnings adjustedforspecialitems.
Hitech	Adummyvariablethatequals1ifthefirmisinthehigh-techindustryas definedby FrancisandSchipper(1999)and0otherwise.
INDEP	Theproportionofindependentdirectorsintheboard.
Lev	Thebook valueofdebt (Compustat#51+Compustat#45) deflatedbymarket valueofequity(Compustat#61*Compustat#14).
Litigation	Litigationrisk measure,computedaccordingtoKimandSkinner(2012).
PF_EPS	Proformaearningspershareinthepressreleaseforquartert,scaledby assetspershare.
POS_NSI	Adummyvariablethatindicates whetherthefirmincreases proforma earnings byexcluding non-special items. It equals1 if the pro forma earningsarehigherthanGAAPearningsadjusted forspecialitems,and0 otherwise.
Prloss	Numberofconsecutivequartersoflossesovertheeightquarterspriorto currentquarter.

Res_C	Theresidualfromtheregressionof*C_Score*onthefollowingfivevariables: *CEO_Own*,*CEO_Comp*,*CHAIR*,*INDEP*and*Litigation*.
REVERSEDROP	Adummyvariableindicatingwhetherthefirmexcludesnon-specialitemsto turnGAAP dropintoproformagrowth.Itequals 1,ifGAAP earnings(both beforeandafteradjusting forspecialitems)arelowerthanwhileproforma earningsarehigherthanpriorperiodGAAPearnings,and0otherwise.
REVERSELOSS	Adummyvariableindicatingwhetherthefirmexcludesnon-specialitemsto turnGAAPlossesintoproformaprofits.Itequals1,if GAAPearnings (bothbeforeandafteradjustingforspecialitems)arelessthanwhilepro formaearningsaregreaterthanzero,and0otherwise.
REVERSEMISS	Adummyvariableindicatingwhetherthefirmexcludesnon-specialitemsto turnGAAPmissintoproformameet-or-beat ofthemostrecentconsensus analyst forecast. It equals 1, if GAAP earnings (both before and after adjustedforspecialitems)arelowerthanwhile proformaearningsare higher than the most recent consensus analyst forecast as reported by I/B/E/S,and0otherwise.
SAB101	A dummyvariableindicatingwhetherSAB101isimplemented.It equals1if theobservationisaftertheimplementation dateoftheSEC'sStaff AccountingBulletin101and0otherwise. Theimplementationdateisno laterthanthefourthfiscalquarteroffiscalyearsbeginningafterDecember 15,1999.
Size	Naturallogoftotalassets(Compustat#44).
STD_ROA	ThestanddeviationofROA(earningsdividedbythebeginning-of-year total assets) over the prioreight quarters.

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*Correspondingauthor. Tel:+65-6790-4097.Email: huaizhang@ntu.edu.sg.Li is fromShanghai Jiao Tong University and ZhangisfromNanyangTechnologicalUniversity. We acknowledge helpful comments from SudiptaBasu,BinKe,Wei ChernKoh,CliveLennox,Siew HongTeoh,and seminarparticipants atNanyang TechnologicalUniversity and ShanghaiJiaotong University.

[1]This line of literature is reviewed in Section 2.

[2]Analternative explanationfor ourempiricalfindingsisthatmanagersmisleadinvestorsinto overestimatingthe negative impact ofaccountingconservatism onaccounting numbers,reducingthe likelihoodoflowGAAP earnings regardedasbadnewsand,consequently,theneedto useopportunistic voluntarydisclosurestodressup badnews.Thisexplanationpredictsthatinvestorsoverestimatethenegativeimpact ofaccountingconservatism onaccountingnumbers. However, Louis etal.(2008) findthatthe negative impactisunderestimatedby sophisticatedinvestors, such as financial analysts, whichis inconsistentwiththis explanation.

[3]Thereexistsaconvolutedargumentthatourresultsaredrivenby amechanicalrelationship.Lougeeand `Marquardt (2004)findthat proforma earnings are more strongly associated withannouncement returns when GAAPinformativenessislow,suggestingthatinvestors priceproformaearningstoagreaterextentwhenpro formaearningsareissuedtoinform investorsthanwhentheyareissuedforopportunisticmotives.Asproforma earningsareonaveragehigherthanGAAPearnings,largenegativeGAAPearningsareassociatedwithless dramaticmarketresponse(i.e.,alowerERC)forinformativeproformadisclosersthanforopportunisticpro

formadisclosers.Giventhat theBasu(1997)'smeasureofconservatismandthe*C_Score*measureredefinedas thedifferenceinameasuresimilartotheinverseofERCbetweengoodnewsandbadnews,ourfindingthat moreconservativefirmsaremorelikelytoissueinformativeproformadisclosuresmaybeexplainedbythe lowerERCforinformativepro formadisclosers whenGAAPearnings are negative, assumingthat negative (positive) GAAPearningsindicate bad(good)news.However,therearetwoimportantreasonswhythis argument doesnotapplytoour setting. First,the keypoint ofthisargumentisthataccountingconservatism,by definition,isaffected bythe differentialmarket's responsetoGAAPearnings acrossinformativeproforma disclosers and opportunistic proforma disclosers, suggestingthat this argument onlyapplies tothe situation whereboththeaccountingconservatismandproformadisclosuresaremeasuredcontemporaneously.Thiscondition isnotsatisfiedinouranalysis.Inouranalysis,conservatism ismeasuredintheyear priortoproforma disclosures,when pro formadisclosuresmay not exist.Second,bad newsinthe Basu(1997)'s model is intended toindicateeconomic newsandismeasuredby negativerawannual returns.Inorderfor theargument toapply to our setting, we needtoassume that negative (positive)GAAP earnings are equivalent to bad(good) news. This assumptionis questionable.SinceBallandBrown(1968),ithasbeenwellrecognizedintheliterature thatnews shallbe measuredby unexpectedearningsnotearnings itself.FirmswithnegativeGAAPearnings may experiencepositivereturns(i.e., have good news) becauseinvestors haveanticipatedworseresults;similarly, firmswithpositiveGAAPearningsmayexperiencenegativereturns(i.e.,havebadnews)becauseinvestors haveanticipatedeven better results.

[4]Intheory,firmswithopportunisticmotivescanchoosetoprovidenon-opportunisticproformaearningsafter RegG.However,theempiricalfindingsinKolevetal.(2008)andYi(2007)indicatethatthosefirmstendto stopdisclosing proformaearningsaltogether,suggestingthat forthosefirms,themarginal cost ofissuingnon- opportunistic pro forma disclosures outweighs the marginalbenefit.

[5]Oursearchmaynotbecomprehensive.However,thismeasurementerrorislikelytobiastowardsinsignificant findings.To the extent thatour results are significant, this is unlikely to bea serious concern.

[6]Weobtainsimilar inferenceswhen weuse the average*C_Score*in thepre-Reg Gperiodto formthe deciles.

[7]Forexample,beforewinsorizationatthetopandbottompercentile,theraw*C_Score*canbeaslargeas

13,657.47,whichmay unduly affect theregression results.

[8]Thisalternativeview howevercannotexplainourfindingthatrelativetofirmswithmoreconservative accounting,firmswithlessconservativeaccountingexperienceadeclineinthelikelihoodofissuingproforma earnings after Reg G.

[9]The marginaleffect of abinary variable on the oddsof theevent coded as1 canbe computed asraisinge tothe powerof the coefficient estimate.*e*tothe powerof -0.350 is 0.70 while*e* tothe power of 1.139is3.12.

[10]Thevalueof15%isestimatedbyraising*e*tothepowerof-0.165,whichisobtainedbymultiplying1.489 withthe decrease inthevalueof thedecile rankwhen wemovetothe next lowerlevel (-0.111).

[11]Ourinferencesremainunchangedwhenweallowthecoefficientsonallcontrolvariablestovaryacross Reg

Gin both regressions.

[12]Anotherapproachistodirectlycontrolformanagerialcharacteristics,corporategovernanceanddemandsfor conservatismintheregressionbyinteractingthem withthevariable, *DIFF*.Thisapproachisnotdesirable because it produces severe multicollinearity among independent variables. Since many explanatory variables are interactions with*DIFF*, by definition,they arecorrelatedthrough*DIFF*.Theseveremulticollinearityeffectively amountstoasubstantialreductioninthenumberofobservations,leadingtoalow-powertest.Incomparison, ourapproach doesnot suffer fromthis problem.

[13]Weare unabletotestwhether our resultsrelatedto Hypothesis3arerobusttothe Basu(1997) measure, becausethe approachusedtomeasurethe qualityofexcludeditemsrequiresa firm-yearspecificmeasure of accounting conservatism.

[14]Huietal.(2009)useR&Dexpenditures,leverageanddividendsasinstrumentsinaddressingtheendogeneity problemof accounting conservatism.Usingtheir instrumental variables,we find that ourresults arerobust to the endogeneityconcern.

[15]*Opt_Sensitivity*is added sothat thesimultaneousequation systemcan beestimated.