

Securities law precedents, legal liability, and financial reporting quality

Benedikt Franke¹, Allen H. Huang^{2,*}, Reeyarn Z. Li³, Hui Wang⁴

¹University of Würzburg, Sanderring 2, 97070 Würzburg, Germany

²The Hong Kong University of Science and Technology, Hong Kong

³Paderborn University, Warburger Str. 100, 33098 Paderborn, Germany

⁴Renmin Business School, Renmin University of China, Beijing, 100872, China

*Corresponding author: Allen H. Huang, School of Business and Management, The Hong Kong University of Science and Technology, Hong Kong, Email: allen.huang@ust.hk

Abstract

In common-law systems, firms' litigation risk depends both on written laws and how courts interpret these laws. Using 321 US circuit court rulings, we introduce a novel measure capturing courts' attitudes toward defendants in securities lawsuits. Our results confirm that financial misreporting firms in more defendant-friendly circuits face fewer lawsuits. Consistent with lower expected litigation costs, firms in these circuits face less negative market reactions when misreporting is revealed, invest less in preventing misreporting, and are more likely to engage in aggressive misreporting. We conclude that defendant-friendly precedents reduce firms' legal liability and worsen their financial reporting quality.

Keywords: securities litigation; case law; precedents; legal liability; financial reporting quality.

JEL classifications: G14, K22, K40, M41.

1. Introduction

Securities class actions (SCAs), which allow investors to recoup investment losses caused by violations of federal securities laws, are a significant source of legal liability for US firms. In principle, SCAs should increase firms' expected litigation costs and deter financial misreporting. However, the common-law doctrine of *stare decisis* grants judicial precedents (i.e., prior rulings in the presiding court or a higher court) a pivotal role in defining what constitutes violations of a law. Therefore, SCAs' deterrence effect depends critically on courts' interpretations of written securities laws in their past rulings.

In this article, we exploit variations in securities law precedents across the US Courts of Appeals—the circuit courts—to examine how regional courts' ruling histories affect firms' legal liability associated with financial misreporting. Although the Supreme Court has ultimate jurisdiction over all cases, the circuit courts are the de facto arbiters for the vast majority of SCAs (Cross 2007; Choi and Pritchard 2012). Each circuit creates precedents by issuing rulings on cases with different facts, and these rulings become binding for that circuit court and the district courts under its jurisdiction. Because case facts and random factors, such as the case sequence or judge assignments, affect ruling outcomes, each circuit's precedent evolves in an idiosyncratic and path-dependent manner (Gennaioli and Shleifer 2007; Leibovitch 2016). The resulting different interpretations of the same securities law induce within-country and over-time variations in firms' expected litigation costs associated

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with securities law violations. We also explore whether investors understand the implications of legal precedents' effect on firms' expected litigation costs and how managers incorporate this effect into their financial reporting decisions.

To study the effects of circuit courts' securities law precedents, we introduce a novel cross-sectional and time-series measure capturing each circuit's case law related to financial misreporting. Using data from the Stanford Securities Class Action Clearinghouse (SCAC), Federal Judicial Center (FJC), and Google Scholar Case Law search, we collect 321 circuit court rulings between 1999 and 2021 that have precedential value for future SCAs. To further identify circuit court rulings most relevant to financial misreporting, we read the opinions and classify 127 rulings in which the defendants are accused of violating Generally Accepted Accounting Principles (GAAP) as GAAP precedents. We label the remaining 194 rulings, which mostly cover allegations related to management forecasts or the omission of material information, as non-GAAP precedents. Moreover, we code a ruling as defendant-friendly if it sides with the firm alleged to have violated a securities law (i.e., it affirms a district court's dismissal decision) and not defendant-friendly otherwise.¹ We observe substantial variation in defendant friendliness across circuits and over time, consistent with a divergence of interpretations of the same securities laws and evolving judicial attitudes.

We begin by empirically validating the relevance of circuit court precedents for firms' litigation risk using case-level analyses. First, we show that in SCA rulings, district courts are more likely to cite precedents from their home circuit than from other circuits, in line with the legal doctrine that district courts should follow their home-circuit precedents. District courts are also more likely to cite home-circuit GAAP precedents than non-GAAP precedents, especially in cases involving firms' alleged GAAP violations. Second, we find that district courts are more likely to dismiss cases when their home circuits accrue defendant-friendly rulings during the district court case's pending window. The key source of variation in this test is the change in case law that occurs between filing and deciding a lawsuit, which effectively rules out the main source of endogeneity (i.e., plaintiffs' lawsuit-filing decisions). Two falsification tests further confirm that neither time-invariant, circuit-specific defendant friendliness nor a general trend in SCAs affecting all circuits explains our results.

Next, we turn to firm-level analyses to study the effects of securities law precedents on firms' legal liability associated with financial misreporting. We start by aggregating the outcomes of existing precedents in a circuit at each point in time to construct a defendant friendliness measure capturing each circuit's evolving attitude toward defendants. To account for variations in precedents' importance, we assign each precedent a weight based on its district court citations relative to the citations received by other precedents in the same circuit. Using subsequently restated financial statements to identify detected financial misreporting, we find that defendant-friendly GAAP precedents reduce the likelihood of lawsuits against misreporting firms. Consistent with non-GAAP precedents being less relevant to future lawsuits involving financial misreporting, we observe no effect of non-GAAP precedents.

When separating financial misreporting based on severity, we find that the effect of defendant-friendly GAAP precedents on the likelihood of litigation is concentrated in non-egregious financial misreporting. This finding is consistent with circuit courts' attitudes being more influential in non-egregious cases (i.e., when managerial intent to deceive is more difficult to judge and establish in court). In contrast, for egregious misreporting cases, plaintiffs can more easily establish that managers willingly defrauded investors, rendering courts' attitudes less relevant.

We also explore whether investors incorporate circuits' defendant-friendly precedents into their valuations when observing a restatement. We find that although investors react

¹ Throughout the article, we refer to dismissals as defendant-friendly because they lower defendants' litigation cost and introduce principles and rules that heighten the pleading hurdle for future plaintiffs.

negatively to restatement announcements in general, the magnitude of those reactions is smaller for firms in circuits with more defendant-friendly precedents, in line with investors expecting lower litigation costs for these restating firms. Consistent with the results of the lawsuit likelihood test, we also find that the differential market reaction is driven primarily by non-egregious misreporting.

Last, if managers anticipate the moderating effect of defendant-friendly precedents on litigation costs attributable to financial misreporting, we expect them to reduce prevention efforts and engage in more aggressive misreporting. Indeed, firms located in circuits with more defendant-friendly precedents invest less in internal controls and compliance—they pay their general counsel and auditor less and exhibit more internal control weaknesses. These firms also engage in more aggressive earnings management—they show higher discretionary accruals, are more likely to meet or just beat the previous year's earnings, and exhibit more subsequent restatements, especially for non-egregious misstatements. These results are consistent with managers incorporating courts' attitudes into financial reporting decisions, albeit with a moderate economic magnitude.

Our study's contribution is threefold. First, we contribute to the literature on how legal systems shape the development of capital markets (e.g., La Porta et al. 1997; Beck, Demircuc-Kunt, and Levine 2003, 2005; Leuz, Nanda, and Wysocki 2003; La Porta, Lopez-de Silanes, and Shleifer 2006). Prior studies rely on cross-country differences in legal origins, statutory securities laws, or enforcement mechanisms, or they use the passage of a new statute in a country to analyze the effects of its legal system on capital markets and firm behavior (e.g., Ali and Kallapur 2001; Johnson, Kasznik, and Nelson 2000, 2001; Siegel 2005; Burgstahler, Hail, and Leuz 2006; Johnson, Nelson, and Pritchard 2007; Srinivasan, Wahid, and Yu 2015; Karpoff and Wittry 2018). We document substantial cross-circuit and over-time variation in judicial precedents within one country and under the same statute. More importantly, we find that such variation leads to differences in firms' misreporting-related legal liability and financial reporting quality. Our findings have implications for regulators and investors alike by informing their enforcement and investment decisions.

Second, our article is the first to introduce a comprehensive measure of courts' attitudes toward violations of securities law based on circuit courts' ruling histories. Recent studies, such as Huang, Hui, and Li (2019); Cassella and Rizzo (2022); Chow et al. (2023); and Huang, Hui, and Zheng (2023), have taken advantage of biases in judges' decision-making and use their ideology to measure courts' attitudes. However, political ideology reflects judges' general preferences, which can influence the outcomes of a wide set of different cases affecting firms, such as labor relations, product liabilities, environmental issues, and tax disputes. Thus, using judge ideology to empirically test the effect of legal liability specific to SCAs, in principle, requires researchers to control for other types of lawsuits. Our measure of judicial precedents originates from legal theory and directly captures case law—the most prominent institutional feature of common-law systems—specifically related to financial misreporting. Our results show that relevant precedents establish principles and rules that determine firms' legal liability, enabling researchers to identify within-country variations specific to securities law.

Third, our work extends the financial economics literature on the effects of circuit court rulings. Prior studies focus on a single circuit court ruling, such as *In re Silicon Graphics Inc.*, to examine the effect of judicial decisions on firms, and they assume that other circuits experience no concurrent change in legal liability (Hopkins 2018; Huang, Roychowdhury, and Sletten 2020). Our circuit court rulings data show that this assumption often violated. In addition, by considering the rulings from all circuit courts over an extended period, our research design is less confounded by events that influence one region during the period surrounding a single circuit court ruling, such as the burst of the Internet bubble following *In re Silicon Graphics Inc.*, which arguably affected firms in the Ninth Circuit more than those

in other circuits. Thus, our study offers more generalizable results on how circuit court rulings affect firms' legal liability and financial reporting quality.

2. Institutional background

2.1 The role of judicial precedents under common law

When judges interpret applicable statutes to decide cases, they should draw analogies to prior cases and follow the principles and rules established in those cases (Carpenter 1917). Specifically, the common-law doctrine of *stare decisis* requires the courts to follow judicial precedents and apply the law as established in their own or a higher court's prior rulings (Shapiro 1972; Landes and Posner 1976; Perino 2006; Niblett, Posner, and Shleifer 2010).

In the USA, the federal courts consist of three levels. The first (and lowest) level has ninety-four geographically divided districts, each with a district court that exercises original (first instance) jurisdiction. The second level has twelve regional circuit courts that exercise appellate jurisdiction to affirm, amend, or overrule the decisions of the district courts within their respective jurisdiction. Each circuit court sets precedents that are binding for itself and its lower district courts. Figure 1 depicts the twelve circuits and the ninety-four districts. The third level comprises the Supreme Court, which has ultimate appellate jurisdiction over all federal cases. However, it receives many requests for review and only grants fewer than 1 percent of those requests each year (e.g., during the 2018 term, the Supreme Court reviewed only 73 of the 7,622 cases for which review was requested), making the circuit courts the final arbiters of most lawsuits. Cross (2007, p. 2) concludes that "it is the circuit courts that create U.S. law. They represent the true iceberg, of which the Supreme Court is but the most visible tip. The circuit courts play by far the greatest legal policymaking role in the United States judicial system."

Because cases have different facts, and these facts and random factors such as case sequence, assigned judges' characteristics, or even their emotional state, can affect case outcomes (Leibovitch 2016; Eren and Mocan 2018), each circuit's precedent develops in an idiosyncratic and path-dependent fashion (Holmes 1897; Easterbrook 1988; Hathaway 2003; Niblett 2013). As a result, judicial interpretations of the same statute can diverge across circuits, leading to variation in legal liability in the USA (Landes and Posner 1976; Gennaioli and Shleifer 2007).

2.2 Judicial precedents in securities class-action lawsuits

SCAs are crucial for enforcing securities laws and deterring financial misconduct (Thompson and Sale 2003; Mahoney 2009). The effectiveness of their deterrence is determined by the legal system and thus the courts. Following the Private Securities Litigation Reform Act (PSLRA), the motion to dismiss has become the most important procedural hurdle. Only after a case survives this motion can plaintiffs engage in discovery, the costliest part of litigation for defendants (Sale 1998; Choi and Pritchard 2012). Cases that are not dismissed invariably settle before trial, which is regarded as a win for the plaintiffs (Pritchard and Sale 2005; Johnson, Nelson, and Pritchard 2007). To survive the motion to dismiss, plaintiffs must convincingly argue that a case has merit by showing that the defendant acted with scienter—the intent to deceive (Choi 2007; Johnson, Nelson, and Pritchard 2007). However, the PSLRA does not clearly define what constitutes an intent to deceive, leaving the issue to the courts. That is, each circuit court must develop its own pleading standard through subsequent rulings. As such, the outcomes and deterrence of SCAs in a circuit depend on how the circuit court interprets scienter in its rulings (Pritchard and Sale 2005).

To assert managerial intent to deceive, plaintiffs and their attorneys regularly use GAAP violations as evidence and argue that these violations imply merit (Choi 2007; Choi, Nelson, and Pritchard 2009). However, circuit courts show diverging attitudes toward this

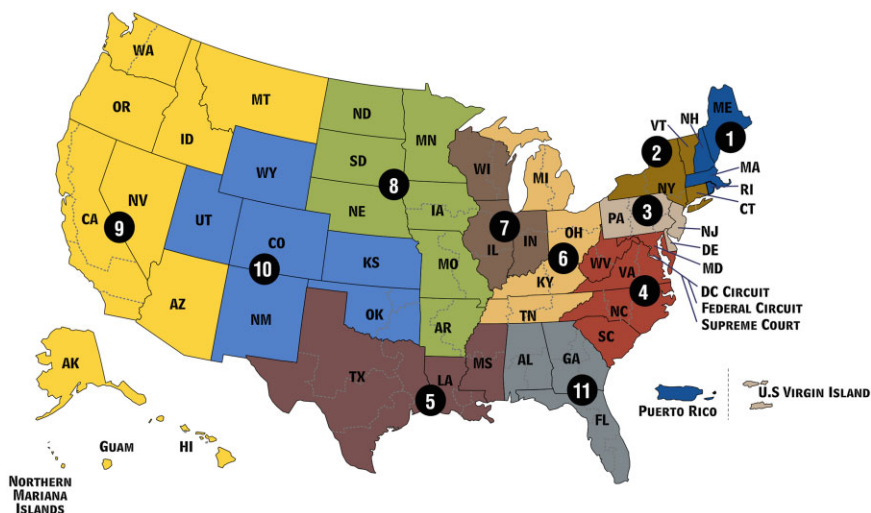


Figure 1. Geographic boundaries of United States Courts of Appeals and District Courts.

Source: https://www.uscourts.gov/sites/default/files/u.s._federal_courts_circuit_map_1.pdf.

claim, resulting in different pleading hurdles across circuits (Pritchard and Sale 2005; Mark 2007). For instance, several circuits accept that GAAP violations are sufficient to show managerial intention and allow cases involving GAAP violations to survive a motion to dismiss (e.g., see the Tenth Circuit's opinion in *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083), whereas other circuits disagree and regularly dismiss such cases (e.g., see the First Circuit's opinion in *Greebel v. FTP Software, Inc.*, 194 F.3d 185). Compared with circuits accepting this argument, circuits rejecting it set more defendant-friendly precedents, which increase potential plaintiffs' hurdle to pleading scienter and decrease their chances of surviving a motion to dismiss in future misreporting cases. Our empirical analysis focuses on capturing each circuit's case law using their securities law rulings and investigating its effect on firms' legal liability and financial reporting quality.

3. Securities law precedent data and measurement

3.1 Securities law precedent data

Legal theory provides that the collection of rulings, rather than a single case, defines the applicable law. Each ruling contributes to the law by covering specific aspects relevant to the courts' interpretation of the statute. Thus, we use all relevant circuit court securities law rulings after 1996, when the PSLRA required the courts to develop a new pleading standard for SCAs. Our sample selection starts with the 5,187 SCAs filed between 1996 and 2018 listed by SCAC. We match the SCAs with data on federal appeals from the FJC and find 1,146 circuit court appeals. We remove 401 appeals terminated by the circuit courts for non-merit-based, procedural reasons as they offer no insight into the courts' stand on scienter. Because only published opinions have precedential value (Keele et al. 2009), we further exclude 348 appeals with unpublished opinions. Next, to identify case law covering practices that deceive investors, we use SCAC's data supplemented by our reading of the opinions to verify that the original complaints allege violations of Section 10(b) of the Securities Exchange Act of 1934—the primary anti-fraud statutory provision in the Act (Rose 2008); we drop another forty-nine appeals in this step. We further remove twenty-seven appeals in

Table 1. Circuit court precedents—sample selection and composition.

This table reports the sample selection process for the circuit court precedents. A detailed description of the sample selection procedure is in [Supplementary Appendix A](#).

	# SCAs lawsuits	
SCAs from the Stanford Class Action Clearinghouse database with initial complaints filed between 1996 and 2018		5,187
Less: SCAs without appeals in the FJC	(4,041)	1,146
SCAs with circuit court appeals		1,146
	# precedents	
Circuit court appeals of SCAs		1,146
Less: appeals not focusing on merit according to the FJC	(401)	745
Less: appeals without published and written (precedential) opinions according to the FJC or missing opinions on Google Scholar Case Law Search	(348)	397
Less: appeals without a Section 10b claim	(49)	348
Less: appeals in which the firm is neither the defendant nor the plaintiff in the appeal	(27)	321
Circuit court precedents		321
GAAP precedents		127
Non-GAAP precedents		194

which a publicly traded firm is neither a defendant nor a plaintiff.² Our final sample comprises 321 circuit court rulings between 1999 and 2021 with precedential value (hereafter, circuit court precedents) for future SCAs. [Supplementary Appendix A](#) summarizes the sample selection procedure and [Table 1](#) summarizes the steps.

Circuit court precedents alleging GAAP violations should be more relevant to future SCAs covering financial misreporting than precedents that do not. Furthermore, focusing on these precedents holds case facts relatively constant and improves our ability to measure courts' pleading standards. Therefore, we read all opinions and classify 127 circuit court precedents as GAAP precedents and the remaining 194 as non-GAAP precedents.³ Finally, we code the defendant friendliness of each precedent according to its outcome. A precedent is defendant-friendly if it sides with the firm that has been alleged to have violated a securities law, that is, affirms a district court's dismissal. It is not defendant-friendly if it reverses a district court's dismissal (reversal). When a circuit court ruling affirms, reverses, or vacates a part of a district court's dismissal ruling, we code the outcome as not defendant-friendly because the ruling results in some legal liability for the defendant ([Eisenberg 2004](#)).

We provide the full list of GAAP and non-GAAP precedents and their outcomes in [Supplementary Appendix B](#) and the precedents' distribution by year and circuit in [Supplementary Appendix Table IA2](#). There are eight–twenty-four precedents each year (with an average of 14). Out of 321 precedents, 207 (64.5 percent) are defendant-friendly, that is, they affirm district court dismissals. Similar to [Pritchard and Sale \(2005\)](#), we do not observe statistically different dismissal rates between precedents that cover alleged GAAP violations (63.8 percent) and those that do not (64.9 percent).

The Second and Ninth Circuits have the most precedents (59 and 61, respectively) and the DC Circuit has the fewest (3), which is in line with the pattern in [Choi and Pritchard \(2012\)](#) and is likely due to differences in the number and characteristics of firms in these

² In these twenty-seven cases, the defendants are securities brokerages, investment funds, or law firms.

³ [Supplementary Appendix Table IA1](#) shows that most GAAP precedents concern misstated income statement or balance sheet items, whereas non-GAAP precedents are related to misleading disclosures and omissions of material information, class certification, disputes, or statutes of limitations.

circuits. Other circuits have between fourteen and thirty-four precedents. The proportions of dismissals and reversals vary across circuits, consistent with circuits having different attitudes toward defendants in SCAs. Most circuits, including the First, Third, Fourth, Seventh, Eighth, Tenth, and Eleventh Circuits, show more than twice as many dismissals as reversals. Others, such as the Second, Fifth, and Ninth Circuits, have similar numbers of dismissals and reversals. Some circuits, such as the Ninth Circuit, exhibit different proportions of dismissals and reversals for GAAP allegations than for non-GAAP allegations.

3.2 Precedents' effect on district court cases

Legal doctrine requires district courts to heed relevant home-circuit precedents. Not following relevant precedents can impose high costs on district court judges, such as reputation damage or potential reversals by the home-circuit court (Gulati and McCauliff 1998). However, judges may have incentives to deviate from precedents, such as their own political ideology or pragmatism (Posner 2008; Huang, Hui, and Li 2019). Given the complexity of SCAs, a judge could justify a ruling that deviates from a precedent by arguing that the case is sufficiently different from that precedent (Gennaioli and Shleifer 2007). In this section, we test whether district courts follow relevant precedents set by their home-circuit courts in SCAs using district courts' citations and opinions.

We start by analyzing district court citation patterns to show that district courts use arguments from home-circuit precedents, especially precedents involving similar allegations, to support their legal reasoning. We search for citations of the 321 precedents in the district courts' opinions in SCAs obtained from Google Scholar Case Law Search (1,552 district court cases), yielding 10,631 citations. When a district court ruling cites a precedent more than once, we count it as one citation. In [Supplementary Appendix Table IA3](#), Panel A, we summarize the sample selection for the district court rulings in the citation test.

We conduct a regression analysis at the precedent-case level to control for other precedent and case characteristics that may affect the citation likelihood. This analysis includes 300,151 precedent-case pairs in which the district court rulings occur after the precedents' publication date. We estimate the following linear probability regression model because logit models with a large number of fixed effects introduce a potential incidental parameter problem (Greene 2004):

$$Cited = f(GAAP\ Precedent, GAAP\ Case, Consistent\ Pair, Controls\ Citation) + \varepsilon, \quad (1)$$

where *Cited* is an indicator variable that equals one if the district court ruling cites the precedent, and zero otherwise. The variables of interest are *GAAP Precedent*, *GAAP Case*, and *Consistent Pair*, which is an indicator variable that equals one if both the precedent and case are GAAP or non-GAAP, and zero otherwise. We control for whether the precedent and case are in the same circuit (*Home Circuit*). We also include controls for whether the district court judge presiding over the case was nominated by a Democratic president (*Liberal District Judge*), whether the precedent affirms a district court dismissal (*Dismissal Precedent*), and whether the district court judge's ideology is consistent with the outcome of the precedent (*Consistent Ideology*) to control for judges' tendency to cite precedents that align with their ideology (Niblett and Yoon 2016). We further include circuit, precedent-year, and case-year fixed effects. We provide detailed variable definitions in [Appendix A](#) and descriptive statistics for the variables used in the district court citation test in [Supplementary Appendix Table IA3](#), Panel B. We cluster the standard errors by precedent.

[Table 2](#) presents the results. Consistent with district courts using arguments from precedents involving similar allegations, the district courts cite GAAP precedents considerably more often than non-GAAP precedents when deciding a GAAP case (*Consistent Pair + GAAP Precedent* is 0.030, which is significant at the 1 percent level). In terms of economic magnitude, ceteris paribus, a GAAP case is more than twice as likely to cite a GAAP

Table 2. District court citations of circuit court precedents.

This table reports the relation between the district court citations of circuit court precedents, precedent type, and district court case type. We estimate the linear probability model of $Cited = \beta(GAAP\ Precedent, GAAP\ Case, Consistent\ Pair, Controls\ Citation) + e$. *Controls Citation* includes *Home Circuit*, *Liberal District Judge*, *Dismissal Precedent*, and *Consistent Ideology*. Column (1) includes precedent-year, case-year, and circuit fixed effects. Column (2) replaces precedent-year, case-year, and circuit fixed effects with precedent and case fixed effects and omits precedent- and case-level controls, including *GAAP Precedent*, *GAAP Case*, *Liberal District Judge*, and *Dismissal Precedent*. The *t*-statistics based on standard errors clustered by precedent are reported in the parentheses below the coefficients. The last four rows report the sums (or differences) of the coefficients and *F*-tests of whether they differ significantly from zero. *, **, and *** indicate significance at the 0.1 percent, 0.05 percent, and 0.01 percent levels, respectively. The variable definitions are in [Appendix A](#).

Dependent variable	(1)	(2)
		Cited
<i>GAAP Precedent</i> (A)	0.025*** (3.62)	
<i>GAAP Case</i> (B)	0.003*** (2.64)	
<i>Consistent Pair</i> (C)	0.005*** (3.95)	0.004*** (3.87)
<i>Home Circuit</i>	0.173*** (13.28)	0.178*** (13.62)
<i>Liberal District Judge</i>	-0.002 (-1.54)	
<i>Dismissal Precedent</i>	0.003 (0.46)	
<i>Consistent Ideology</i>	-0.000 (-0.11)	-0.000 (-0.03)
<i>Intercept</i>	-0.003 (-0.79)	0.010*** (4.97)
Precedent-Year and Case-Year FE	Yes	No
Circuit FE	Yes	No
Precedent and case FE	No	Yes
Numbers of observations	300,151	300,151
Adjusted R ² s	0.109	0.170
<i>F</i> -tests for Column (1):		
<i>GAAP Case citing GAAP Precedent</i> – <i>GAAP Case citing Non-GAAP Precedent</i> = (A + B + C) – B = C + A		0.030***
<i>Non-GAAP Case citing Non-GAAP Precedent</i> – <i>Non-GAAP Case citing GAAP Precedent</i> = C – A		-0.020***
<i>GAAP Precedent cited by GAAP Case</i> – <i>GAAP Precedent cited by Non-GAAP Case</i> = (A + B + C) – A = C + B		0.008***
<i>Non-GAAP Precedent cited by Non-GAAP Case</i> – <i>Non-GAAP Precedent cited by GAAP Case</i> = C – B		0.002*

precedent (5.9 percent) than it is to cite a non-GAAP precedent (2.8 percent). We also find that non-GAAP cases are more likely to cite GAAP precedents than non-GAAP precedents, albeit to a smaller extent (*Consistent Pair* – *GAAP Precedent* equals -0.020, which is significant at the 1 percent level).⁴ We find similar results (i.e., *Consistent Pair* is positive and significant) when replacing the precedent and case characteristics with precedent and case

⁴ *F*-tests also show that GAAP precedents are more likely to be cited in GAAP cases than in non-GAAP cases (*Consistent Pair* + *GAAP Case* is 0.008, which is significant at the 1 percent level) and that non-GAAP precedents are more likely to be cited in non-GAAP cases than in GAAP cases (*Consistent Pair* – *GAAP Case* is 0.002, which is significant at the 10 percent level).

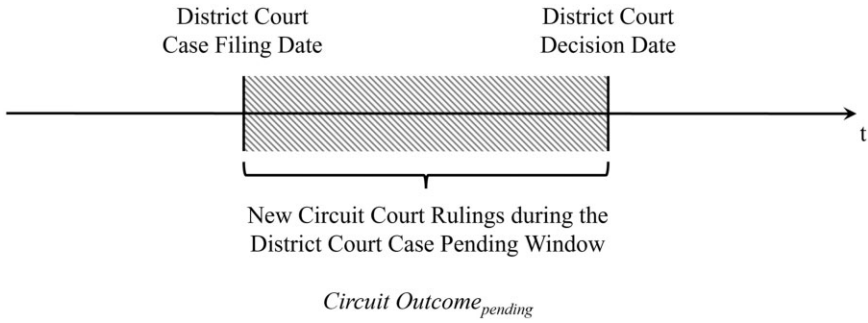


Figure 2. District court decision test timeline.

fixed effects (Column (2)). In sum, the citation analyses show that compared with non-GAAP precedents, GAAP precedents have a greater influence on district court cases, especially on those that allege GAAP violations.

Although legal research frequently uses citations to study the importance and influence of rulings (for a review, see discussions in Landes, Lessig, and Solimine [1998] and Choi and Gulati [2004]), district court judges can use prior circuit court rulings to justify decisions *ex post*. Thus, we use district court decisions to measure the effect of circuit court rulings on district court case outcomes more directly.

Each time a circuit court issues a defendant-friendly ruling, the circuit accumulates principles and rules that increase plaintiffs’ pleading hurdle for future cases; in contrast, rulings that are not defendant-friendly decrease plaintiffs’ pleading hurdle. We therefore test whether district courts are more likely to dismiss cases when their home circuits accrue defendant-friendly rulings. Because circuit court rulings prior to the case filing date can affect lawsuit filing decisions (Cotropia et al. 2017), we focus on new circuit court rulings during the district court case pending window (i.e., the period between the case filing date and the decision date) to mitigate endogeneity concerns. Figure 2 illustrates the timing of this test. Empirically, defendant friendliness during the pending window (*Circuit Outcome_{pending}*) is the sum of the ruling outcomes in the circuit court, where the ruling outcome equals one if a circuit court ruling is defendant-friendly, and negative one otherwise.

To construct the sample, we merge the district court cases from SCAC with home-circuit-court rulings based on their jurisdiction and the district court case pending window. After further requiring data from the FJC and CRSP to calculate the control variables, the sample covers 2,448 district court cases. We tabulate the sample selection procedure in Supplementary Appendix Table IA4, Panel A. We estimate the following linear probability regression model:

$$\begin{aligned}
 \text{Dismissed} = f(\text{Circuit Outcome}_{GAAP_{pending}} \times \text{GAAP Case}, \text{Circuit Outcome}_{GAAP_{pending}}, \text{Circuit Outcome}_{Non-GAAP_{pending}} \times \text{GAAP Case}, \\
 \text{Circuit Outcome}_{Non-GAAP_{pending}}, \text{Controls Decision}) + \varepsilon.
 \end{aligned}
 \tag{2}$$

The dependent variable, *Dismissed*, is an indicator variable that equals one if a district court dismisses a case, and zero otherwise. Our variables of interest are *Circuit Outcome_{GAAP_{pending}}* and *Circuit Outcome_{Non-GAAP_{pending}}*, which, respectively, indicate the defendant friendliness of GAAP and non-GAAP circuit court rulings during the case pending window, along with their interactions with the district court case type (*GAAP Case*). If a circuit court’s defendant-friendly rulings in GAAP cases increase the tendency of district court judges to dismiss pending GAAP cases, we expect the sum of *Circuit Outcome*

$GAAP_{pending} \times GAAP$ Case and *Circuit Outcome* $GAAP_{pending}$ to be positive. We also construct two alternative versions of *Circuit Outcome* variables to ensure that the results in this test are driven by home-circuit-court rulings during the case pending period. First, to verify that time-invariant circuit-specific defendant friendliness does not explain our results, we use home-circuit-court rulings during a pseudo window of 30.8 months (the median length of a district court case's pending period) beginning from one year *after* the district court ruling date (*Circuit Outcome* $GAAP_{post}$). Second, to ascertain whether our results capture a general trend in SCAs affecting all circuits, we randomly assign a non-home circuit to a district court case and use that circuit court's rulings during the case pending window (*Circuit Outcome* $GAAP_{non-home}$). We expect the sums of the two alternative versions of *Circuit Outcome* $GAAP$ and their respective interactions with $GAAP$ Case to be insignificant.

We control for the district court case type ($GAAP$ Case), ideology of the judges who may handle the appeal (*Liberal Circuit_{at ruling}*), ideology of the district court judge assigned to the case (*Liberal District Judge*), length of the pending period (*Pending Period Duration*), and case severity based on the market reaction surrounding the lawsuit filing date (*Filing CAR*). We provide descriptive statistics for the variables in the district court decision test in [Supplementary Appendix Table IA4](#), Panel B. We also include district court ruling year and circuit fixed effects to control for macroeconomic trends and cross-circuit differences, such as demographics and growth potential, both of which might affect case outcomes. We cluster the standard errors by district court ruling year.

[Table 3](#), Column (1) presents the results. In line with the citation analysis, we find that circuit court rulings in $GAAP$ cases influence subsequent district court rulings. The F -test for the sum of *Circuit Outcome* $GAAP_{pending} \times GAAP$ Case and *Circuit Outcome* $GAAP_{pending}$ is significant at the 5 percent level, suggesting that a district court is more likely to dismiss a $GAAP$ case if its home-circuit issues more defendant-friendly $GAAP$ rulings during the district court case pending period. In terms of economic magnitude, one additional dismissal affirmation by the circuit court during the case pending window increases the likelihood of the district court dismissing a case by 1.7 percent, which translates into around US\$1 million in expected settlement costs based on the average settlement amount of US\$57.7 million over 1996–2016 ([Cornerstone Research 2017](#)). Consistent with circuit court rulings having a smaller effect on less similar cases, we do not find that the circuits' $GAAP$ rulings affect the district courts' rulings in non- $GAAP$ cases (the base term *Circuit Outcome* $GAAP_{pending}$ is insignificant). Moreover, the coefficients associated with the non- $GAAP$ circuit court rulings are not significant at conventional levels, regardless of the district court case type, which suggests that non- $GAAP$ precedents are less influential in future cases. With respect to the control variables, we observe that more severe cases are less likely to be dismissed (a negative coefficient on $GAAP$ Case and a positive coefficient on *Filing CAR*, which are both significant at the 1 percent level), consistent with our intuition. Last, the insignificant results in both placebo tests (tabulated in Columns (2) and (3)) confirm that it is indeed the home-circuit-court rulings during the case pending period that influence district court outcomes.⁵

3.3 Measure of defendant friendliness in securities law precedents

The district court citation and decision tests highlight that home-circuit $GAAP$ precedents shape district court decision-making in future $GAAP$ cases. To capture the principles and rules in each circuit's precedents that define its evolving pleading standard (i.e., its attitude toward defendants), we aggregate the outcomes of existing $GAAP$ precedents in the circuit at each point in time into a measure of defendant friendliness (*Defendant Friendliness*

⁵ In an additional analysis, we explore whether circuit courts influence each other. We estimate a regression in the spirit of [Equation \(2\)](#), replacing the district court with a circuit court decision variable. We find no relation between a circuit court's decisions and non-home circuit outcomes during the circuit court case pending window.

Table 3. Defendant friendliness and district court decisions.

This table reports the relation between the defendant friendliness of circuit court rulings during the district court case pending period and district court decisions. We estimate the linear probability model of *Dismissed* = $f(\text{Circuit Outcome GAAP}_j \times \text{GAAP Case}, \text{Circuit Outcome GAAP}_j, \text{Circuit Outcome Non-GAAP}_j \times \text{GAAP Case}, \text{Circuit Outcome Non-GAAP}_j, \text{Controls Decision}) + \varepsilon$. *Controls Decision* includes *GAAP Case*, *Liberal Circuit_{at ruling}*, *Liberal District Judge*, *Pending Period Duration*, and *Filing CAR*. *Circuit Outcome_j* measures the defendant friendliness of the circuit court rulings during the case pending window in the home circuit (Column (1)), during the pseudo case-pending window, which is in the home circuit but after the district court ruling date (Column (2)); and during the case pending window in a non-home circuit (Column (3)). All regressions include the district court ruling year and circuit fixed effects. The *t*-statistics based on standard errors clustered by circuit court ruling year are reported in the parentheses below the coefficients. The last row reports the sums of *Circuit Outcome GAAP_j × GAAP Case* and *Circuit Outcome GAAP_j*, and the *F*-tests of whether the sums differ significantly from zero. *, **, and *** indicate significance at the 0.1 percent, 0.05 percent, and 0.01 percent levels, respectively. The variable definitions are in [Appendix A](#).

<i>j</i> = Dependent variable	(1) Pending	(2) Post Dismissed	(3) Non-home
<i>Circuit Outcome GAAP_j × GAAP Case</i>	0.022** (2.24)	0.021 (1.36)	0.008 (0.67)
<i>Circuit Outcome GAAP_j</i>	-0.005 (-0.52)	-0.014 (-1.20)	-0.005 (-0.75)
<i>Circuit Outcome Non-GAAP_j × GAAP Case</i>	-0.000 (-0.04)	-0.006 (-0.47)	0.003 (0.28)
<i>Circuit Outcome Non-GAAP_j</i>	0.014 (1.62)	0.007 (0.90)	-0.001 (-0.12)
<i>GAAP Case</i>	-0.156*** (-9.08)	-0.151*** (-12.42)	-0.155*** (-8.35)
<i>Liberal Circuit_{at ruling}</i>	0.043 (0.28)	0.003 (0.02)	0.016 (0.10)
<i>Liberal District Judge</i>	0.025 (1.29)	0.024 (1.30)	0.024 (1.30)
<i>Pending Period Duration</i>	-0.114*** (-23.44)	-0.111*** (-21.95)	-0.111*** (-21.70)
<i>Filing CAR</i>	0.282*** (6.03)	0.274*** (5.74)	0.275*** (5.84)
<i>Intercept</i>	1.023*** (11.67)	1.020*** (11.16)	1.018*** (11.09)
Ruling Year and Circuit FE	Yes	Yes	Yes
Numbers of observations	2,448	2,448	2,448
Adjusted R ² s	0.300	0.299	0.298
<i>F</i> -tests: <i>GAAP Case × Circuit Outcome GAAP_j + Circuit Outcome GAAP_j</i>	0.017**	0.007	0.003

GAAP). We assign each precedent a weight based on its district court citations relative to the citations received by the other precedents in the same circuit to account for cross-sectional and time-series variations in the precedents' importance (Choi and Gulati 2004; Landes, Lessig, and Solimine 1998).⁶ To measure each precedent's importance to current cases, we focus on district court citations in the 5 years before the measurement date. We formally define *Defendant Friendliness GAAP* as follows:

⁶ Our data confirm substantial variation in precedents' importance, with a standard deviation of citations of 27.8, much larger than the mean and the median of citations (20.3 and 11, respectively).

$$Defendant\ Friendliness\ GAAP_{i,t} = \left[\sum_{j \in J_{i,t}} \frac{Citation_{j,t}}{Avg.\ Citation_{j,t}} Outcome_j \right], \quad (3)$$

where i represents the circuit, t represents the date, $J_{i,t}$ represents all GAAP precedents in circuit i prior to date t , j represents a GAAP precedent in circuit i prior to date t , $Citation_{j,t}$ is one plus the number of district court opinions citing precedent j in the 5 years preceding date t , and $Avg.\ Citation_{j,t}$ is the average of $Citation_{j,t}$ for $J_{i,t}$. In [Supplementary Appendix C](#), we illustrate the calculation of *Defendant Friendliness GAAP* for the Ninth Circuit as of December 31, 2005.

To measure each circuit's attitude in non-misreporting cases (e.g., allegations related to management forecasts or omissions of information), we similarly construct a non-GAAP variant of our defendant friendliness measure using non-GAAP precedents (*Defendant Friendliness Non-GAAP*). Because these precedents are less likely to contain principles and rules concerning financial misreporting, they should be less relevant to future lawsuits alleging GAAP violations and firms' financial reporting quality.

Note that both measures are based on cases that end up in each circuit's courts and thus they may be endogenous to characteristics of firms in the circuit. Therefore, we control for firm characteristics and circuit and industry fixed effects in subsequent empirical tests. Furthermore, because differences in firm characteristics across circuits are likely persistent, the issues settled in a circuit court's rulings should be especially relevant for future cases in that circuit, which also motivates the circuit-specific defendant friendliness measure.

[Figure 3](#) depicts each circuit's *Defendant Friendliness GAAP* and *Defendant Friendliness Non-GAAP* over time. Both measures show considerable variation within and across circuits. Most circuits, such as the First, Second, Third, Fifth, Sixth, and Ninth Circuits, exhibit diverging trends in the two measures, resulting in their overall negative correlation on the circuit-month level (-0.091). Several circuits, such as the First, Second, Fifth, Eighth, and Ninth Circuits, show periods of increasing and decreasing defendant friendliness during our sample period.

Importantly, defendant friendliness in relation to GAAP allegations develops differently across circuits. In the first 10 years following the PSLRA, the First, Third, Fourth, Sixth, Eighth, and Tenth Circuits became more friendly toward defendants (positive *Defendant Friendliness GAAP*). In contrast, the Second, Fifth, and Ninth Circuits became less friendly toward defendants (negative *Defendant Friendliness GAAP*). In each year since 2007, when all but the DC Circuit have had at least one precedent, an average of 6.3 of the remaining 11 circuits become more defendant-friendly on GAAP violations, whereas an average of 4.7 circuits become less defendant-friendly. Moreover, in the years surrounding the Ninth Circuit's prominent 1999 non-GAAP ruling in *In re Silicon Graphics Inc.* affirming the district court dismissal decision, the court also affirmed another non-GAAP dismissal decision and reversed a GAAP dismissal decision. These observations highlight that the implicit assumption in single-court ruling studies that the focal ruling is the only source of variation in firms' legal liability is often violated.

4. Securities law precedents and firms' legal liability

If potential plaintiffs and their attorneys understand the implications of defendant-friendly GAAP precedents on case outcomes and anticipate lower settlement amounts, misreporting firms located in more defendant-friendly circuits should be less likely to face SCAs. However, plaintiffs and their attorneys might also ignore courts' attitudes and sue whenever there is evidence of misreporting ([Choi 2007](#)). In this section, we empirically test whether differences in precedents' defendant friendliness across circuits translate into economically meaningful variations in misreporting firms' litigation likelihood.

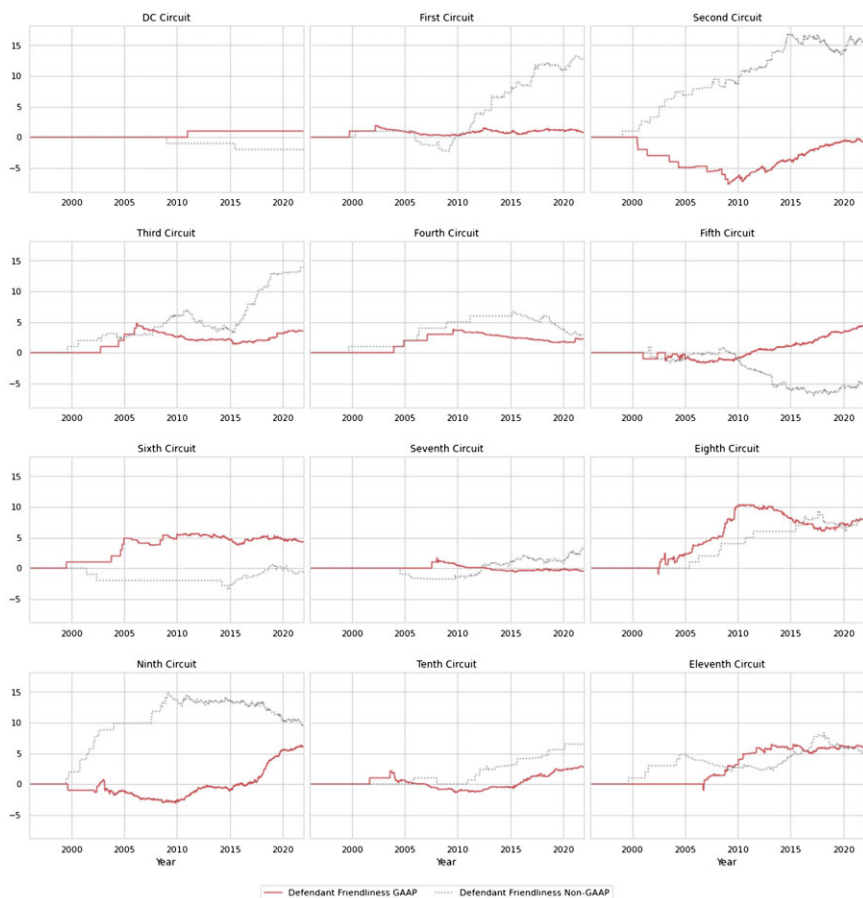


Figure 3. Time series of *Defendant Friendliness GAAP* and *Defendant Friendliness Non-GAAP* by circuit.

4.1 Effect of precedents on lawsuit filings against misreporting firms

We follow the applicable civil procedures (28 U.S. Code §§ 1391; 1404) and prior studies (Cox, Thomas, and Bai 2009; Huang, Hui, and Li 2019) and assume that SCAs are filed in firms’ headquarters circuit.⁷ We assign each firm-year observation a measure of case law defendant friendliness based on the circuit of the firm’s historical headquarters location, which we extract from firms’ 10-K filings in the SEC’s EDGAR database. We then match the SCA data from SCAC with Compustat and CRSP data using tickers and stock names. We define an indicator variable, *Sued*, as one if a firm-year overlaps with the class period of an SCA filed against the firm in its home-circuit, and zero otherwise.

To identify detected financial misreporting firm-years, we use data from the Audit Analytics Non-Reliance Restatement File. For each firm-year, we set an indicator variable,

⁷ In our sample period, 85.2 percent of the cases are filed in home circuits, which is comparable to 85 percent of the cases documented in Cox, Thomas, and Bai (2009). Most non-home-circuit cases either have multiple defendants, such as initial public offering (IPO) cases that usually include the underwriters as co-defendants, or a defendant firm that has moved its headquarters. Although firms can change headquarters, such a move is costly, and circuits’ defendant friendliness is likely to be only one of many factors in the decision. In a sensitivity test, we limit our sample to firms that have not moved their headquarters circuit during our sample period and find similar results (tabulated in Supplementary Appendix Table IA5, Column (1)).

Misreport, that takes a value of one if a firm subsequently restates its financial statements for that year, and zero otherwise. Following prior studies, such as Hennes, Leone, and Miller (2008) and Badertscher, Hribar, and Jenkins (2011), we label financial misreporting as egregious (*Egregious*) if the restatement announcement mentions fraud or an SEC investigation according to Audit Analytics. We label other misreporting as non-egregious (*Non-Egregious*). We estimate the following linear probability model⁸:

$$\begin{aligned} Sued = f(& \text{Misreport} \times \text{Defendant Friendliness GAAP}, \text{Misreport} \\ & \times \text{Defendant Friendliness Non-GAAP}, \text{Misreport}, \text{Defendant Friendliness} \\ & \text{GAAP}, \text{Defendant Friendliness Non-GAAP}, \text{Controls Sued}) + \varepsilon, \end{aligned} \quad (4)$$

where our main variable of interest is *Defendant Friendliness GAAP* and its interaction with *Misreport*. We predict that misreporting firms are less likely to face lawsuits when the home circuit has more defendant-friendly GAAP precedents (i.e., the sum of the two coefficients should be negative). We expect a weaker effect for the *Defendant Friendliness Non-GAAP* and its interaction with *Misreport* because non-GAAP precedents should be less relevant for filing a complaint against a misreporting firm. The coefficient of *Misreport* captures the average effect of misreporting on firms' likelihood of being sued. In the regression, we also include year, circuit, and industry fixed effects.⁹ In all firm-level analyses, we cluster the standard errors by circuit-year.

Following the literature (e.g., Hopkins 2018; Kim and Skinner 2012), we include the following firm characteristics to control for firms' likelihood of facing SCAs: *Size*, *Sales Growth*, *Book-to-Market*, Δ *Return on Assets*, *Buy-and-Hold Return*, *Volatility*, *Skewness*, *Turnover*, *IO*, *Leverage*, and *Financing*. To control for state securities laws that may affect firms' legal liability, we include an indicator variable for the existence of universal demand laws in a firm's state of incorporation (*UD Law*). Following Huang, Hui, and Li (2019), we control for circuit court judge ideology (*Liberal Circuit*), state-level demographic and economic variables, and the state's political leaning (*GDP Growth*, *Unemployment*, *Blue State*).¹⁰ Financial statement data are from Compustat, stock price data are from CRSP, and institutional holdings data are from Thomson Reuters. See Appendix A for detailed variable definitions.

Table 4 provides descriptive statistics for the variables used in the firm-level analyses. Continuous firm-level variables are winsorized at the top and bottom 1 percent levels to mitigate the influence of outliers. Our variable of interest, *Defendant Friendliness GAAP*, shows reasonable variation at the firm-year level, with a standard deviation of 2.541 and an interquartile range between -0.627 and 1.143 . Our sample firm-year observations have a mean market value of US\$2,793.6 million, debt-to-asset ratio of 21.6 percent, and sales

⁸ In Supplementary Appendix Table IA5, Column (2), we present qualitatively similar results using a logit model.

⁹ In sensitivity tests, we use alternative fixed effects (i.e., excluding circuit fixed effects, replacing circuit fixed effects with state fixed effects, and replacing circuit and industry fixed effects with firm fixed effects) and find similar results (tabulated in Supplementary Appendix Table IA5, Columns (3)–(5)).

¹⁰ In sensitivity tests, we further control for district court judge ideology, tabulated in Supplementary Appendix Table IA5, Column (6) and for states' religious culture and political corruption (Parsons, Sulaeman, and Titman 2018), tabulated in Supplementary Appendix Table IA5, Column (7), and we find similar results. We also estimate the scope for omitted variable bias following the coefficient bounding procedure by Oster (2019). Untabulated results indicate that our findings are unlikely driven by endogeneity associated with omitted correlated variables. Specifically, to qualitatively alter our conclusions, selection on omitted variables would have to be more than twenty times larger than selection on the set of controls included in our main tests.

Table 4. Descriptive statistics—firm-level analyses.

This table reports the descriptive statistics for the variables in the firm-level analyses. The variable definitions are in [Appendix A](#).

	N	Mean	SD	p25	Median	p75
Lawsuit likelihood analyses						
<i>Sued</i>	93,954	0.049	0.216	0.000	0.000	0.000
<i>Defendant Friendliness GAAP</i>	93,954	0.394	2.541	-0.627	0.000	1.143
<i>Defendant Friendliness Non-GAAP</i>	93,954	3.523	5.091	0.000	1.241	6.718
<i>Misreport</i>	93,954	0.130	0.336	0.000	0.000	0.000
<i>Non-Egregious</i>	93,954	0.113	0.317	0.000	0.000	0.000
<i>Egregious</i>	93,954	0.016	0.127	0.000	0.000	0.000
<i>Liberal Circuit</i>	93,954	0.397	0.177	0.250	0.388	0.542
<i>Size</i>	93,954	5.703	2.180	4.083	5.629	7.214
<i>Sales Growth</i>	93,954	0.090	0.289	-0.009	0.033	0.157
<i>Book-to-Market</i>	93,954	0.646	0.645	0.279	0.528	0.866
Δ Return on Assets	93,954	0.008	0.220	-0.035	0.000	0.027
<i>Buy-and-Hold Return</i>	93,954	0.125	0.637	-0.249	0.043	0.343
<i>Volatility</i>	93,954	0.037	0.023	0.020	0.030	0.046
<i>Skewness</i>	93,954	0.468	1.254	-0.060	0.348	0.856
<i>Turnover</i>	93,954	1.762	1.853	0.530	1.173	2.295
<i>IO</i>	93,954	0.467	0.323	0.161	0.460	0.752
<i>Leverage</i>	93,954	0.216	0.215	0.028	0.164	0.336
<i>Financing</i>	93,954	0.151	0.269	0.003	0.032	0.172
<i>UD Law</i>	93,954	0.157	0.364	0.000	0.000	0.000
<i>GDP Growth</i>	93,954	0.048	0.025	0.034	0.048	0.063
<i>Unemployment</i>	93,954	0.056	0.018	0.045	0.053	0.064
<i>Blue State</i>	93,954	0.680	0.467	0.000	1.000	1.000
Restatement announcement return analyses						
$CAR_{restatement}$	2,893	-0.016	0.076	-0.037	-0.007	0.016
<i>Overstatement</i>	2,893	0.831	0.375	1.000	1.000	1.000
<i>Analysts</i>	2,893	1.587	1.035	0.693	1.609	2.398
<i>Earnings Persistence</i>	2,893	0.331	0.435	0.037	0.310	0.595
<i>Beta</i>	2,893	1.021	0.572	0.607	1.015	1.398
Investments in internal controls and compliance analyses						
<i>Executive Lawyer</i>	16,380	0.416	0.493	0.000	0.000	1.000
<i>Return on Assets</i>	16,380	0.049	0.093	0.013	0.048	0.093
<i>CEO Chair</i>	16,380	0.598	0.490	0.000	1.000	1.000
<i>Executive Lawyer Pay Ratio</i>	6,347	0.348	0.276	0.215	0.288	0.394
<i>Audit Fee</i>	39,834	13.711	1.259	12.812	13.710	14.564
<i>Current Ratio</i>	39,834	2.967	2.895	1.334	2.049	3.380
<i>Quick Ratio</i>	39,834	2.457	2.755	1.000	1.539	2.706
<i>Segments</i>	39,834	1.001	0.520	0.693	0.693	1.386
<i>Foreign Sales</i>	39,834	0.053	0.156	0.000	0.000	0.000
<i>Loss</i>	39,834	0.344	0.475	0.000	0.000	1.000
<i>December Year End</i>	39,834	0.716	0.451	0.000	1.000	1.000
<i>Going Concern</i>	39,834	0.033	0.177	0.000	0.000	0.000
<i>Independent Board</i>	39,834	3.155	1.432	2.000	3.000	4.000
<i>CEO Chair</i>	39,834	0.471	0.499	0.000	0.000	1.000
<i># Internal Control Weakness</i>	36,833	0.138	0.826	0.000	0.000	0.000
<i>Inventory</i>	36,833	0.082	0.115	0.000	0.026	0.127
<i>Firm Age</i>	36,833	2.736	0.868	2.197	2.833	3.332
<i>M&A</i>	36,833	0.086	0.280	0.000	0.000	0.000
<i>Restructuring</i>	36,833	0.319	0.466	0.000	0.000	1.000
<i>Auditor Resign</i>	36,833	0.008	0.091	0.000	0.000	0.000

(continued)

Table 4. (continued)

	N	Mean	SD	p25	Median	p75
Financial reporting quality analyses						
<i>Discretionary Accruals</i>	26,349	0.034	0.154	-0.033	0.011	0.079
<i>Performance-adjusted Discretionary Accruals</i>	26,349	-0.011	0.218	-0.083	-0.005	0.069
<i>Beat/Meet</i>	26,349	0.012	0.108	0.000	0.000	0.000
<i>Overconfidence</i>	26,349	0.568	0.495	0.000	1.000	1.000
<i>PPS</i>	26,349	0.252	0.222	0.088	0.183	0.349
<i>Pay Slice</i>	26,349	0.383	0.117	0.312	0.386	0.453
<i>Soft Assets</i>	26,349	0.631	0.256	0.443	0.650	0.831
<i>Misreport</i>	19,779	0.165	0.371	0.000	0.000	0.000
<i>Non-Egregious</i>	19,779	0.146	0.353	0.000	0.000	0.000
<i>Egregious</i>	19,779	0.019	0.136	0.000	0.000	0.000
<i>Total Accruals</i>	19,779	0.028	0.129	-0.024	0.025	0.080
Δ Receivable	19,779	0.009	0.035	-0.005	0.006	0.022
Δ Inventory	19,779	0.006	0.027	-0.001	0.001	0.013
Δ Cash Sales	19,779	0.072	0.198	-0.010	0.057	0.151

growth of 9.0 percent. Overall, 12.9 percent of the firm-years are associated with financial misreporting, with 1.6 percent classified as egregious and 11.3 percent as non-egregious.

Table 5 provides the regression results. For brevity, we do not report the coefficients of all controls but report them in [Supplementary Appendix Table IA6](#). In Column (1), the coefficient of *Misreport* is significant and positive. The coefficient's magnitude (0.088) shows that, holding everything else constant, financial misreporting more than triples the firm-year likelihood of being sued—from a 3.7 percent lawsuit likelihood in firm-years without misreporting to 12.5 percent (3.7 percent + 8.8 percent), in line with misreporting triggering shareholder lawsuits ([Johnson, Nelson, and Pritchard 2007](#)). Consistent with our prediction, an *F*-test shows that the sum of the coefficients on *Defendant Friendliness GAAP* and its interaction term with *Misreport* is negative and significant at the 1 percent level. In other words, misreporting firms are less likely to be sued if they are located in a circuit with more defendant-friendly GAAP precedents. The moderating effect of defendant-friendly precedents is economically meaningful. A one-standard-deviation increase in *Defendant Friendliness GAAP* results in a 1.3 percent reduction in lawsuit likelihood ($2.541 \times -0.005 = 0.013$), which is sizable given the misreporting firms' average lawsuit likelihood of 12.6 percent. To illustrate, our results imply that when *Defendant Friendliness GAAP* in the Ninth Circuit decreased from 0.69 to -2.54 between the end of 2002 and 2007, misreporting firms in the circuit should have faced a 1.6 percent ($[(-2.54) - 0.69] \times -0.005$) increase in lawsuit likelihood. We also observe that the sum of the coefficients on *Defendant Friendliness Non-GAAP* and its interaction term with *Misreport* (-0.001) has a significantly smaller magnitude at the 1 percent level than the sum of the coefficients on *Defendant Friendliness GAAP* (-0.005), consistent with non-GAAP precedents being less relevant to misreporting firms' legal liability.

The estimated coefficient of *Liberal Circuit* is positive and significant at the 1 percent level, which is consistent with the role of liberal ideology in increasing firms' lawsuit likelihood ([Huang, Hui, and Li 2019](#)). This evidence, combined with the significant effect of defendant-friendly GAAP precedents, suggests that both judicial precedents and judges' personal preferences affect firms' litigation environment ([Cross 2007](#); [Epstein and Knight 2013](#)).¹¹ The estimated coefficients of other control variables, such as *Size*, *Sales Growth*, *Volatility*, *Skewness*, and *Turnover*, are in line with [Kim and Skinner \(2012\)](#).

¹¹ Untabulated summary statistics show that Liberal Circuit has a negative association with *Defendant Friendliness GAAP* on the circuit-month level (-0.345), which suggests that although circuits with more

Table 5. Defendant friendliness and shareholder litigation against misreporting firms.

This table reports the relation between defendant friendliness in circuit court precedents and SCA occurrences. We estimate the linear probability model of $Sued = \beta(Misreport \times Defendant\ Friendliness\ GAAP + Misreport \times Defendant\ Friendliness\ Non-GAAP + Misreport + Defendant\ Friendliness\ GAAP + Defendant\ Friendliness\ Non-GAAP + Controls\ Sued) + \epsilon$. *Controls Sued* includes *Liberal Circuit*, *Size*, *Sales Growth*, *Book-to-Market*, Δ *Return on Assets*, *Buy-and-Hold Return*, *Volatility*, *Skewness*, *Turnover*, *IO*, *Leverage*, *Financing*, *UD Law*, *GDP Growth*, *Unemployment*, and *Blue State*. Columns (2), (3), and (4) replace *Misreport* with *Non-Egregious*, *Egregious*, and both *Non-Egregious* and *Egregious*, respectively. For brevity, we omit some control variables from the table and report the complete version in [Supplementary Appendix Table IA6](#). All regressions include the year, circuit, and industry fixed effects. The *t*-statistics based on standard errors clustered by circuit-year are reported in the parentheses below the coefficients. The last three rows report the sums (or differences) of the coefficients and *F*-tests of whether they differ significantly from zero. *, **, and *** indicate significance at the 0.1 percent, 0.05 percent, and 0.01 percent levels, respectively. The variable definitions are in [Appendix A](#).

Dependent variable	(1)	(2)	(3)	(4)
			Sued	
<i>Misreport</i> × <i>Defendant Friendliness GAAP</i>	-0.005*** (-4.15)			
<i>Misreport</i> × <i>Defendant Friendliness Non-GAAP</i>	-0.002*** (-3.12)			
<i>Non-Egregious</i> × <i>Defendant Friendliness GAAP</i>		-0.004*** (-3.62)		-0.004*** (-3.87)
<i>Non-Egregious</i> × <i>Defendant Friendliness Non-GAAP</i>		-0.001* (-1.91)		-0.002** (-2.11)
<i>Egregious</i> × <i>Defendant Friendliness GAAP</i>			0.001 (0.14)	0.000 (0.03)
<i>Egregious</i> × <i>Defendant Friendliness Non-GAAP</i>			0.002 (0.63)	0.002 (0.64)
<i>Misreport</i>	0.088*** (17.93)			
<i>Non-Egregious</i>		0.061*** (12.95)		0.066*** (14.09)
<i>Egregious</i>			0.188*** (12.30)	0.197*** (12.88)
<i>Defendant Friendliness GAAP</i>	-0.000 (-0.26)	-0.000 (-0.75)	-0.001 (-1.57)	-0.000 (-0.44)
<i>Defendant Friendliness Non-GAAP</i>	0.001*** (2.66)	0.001** (2.28)	0.001** (2.31)	0.001** (2.53)
<i>Liberal Circuit</i>	0.031*** (3.08)	0.032*** (3.19)	0.031*** (3.21)	0.030*** (3.01)
Other control variables	Y	Y	Y	Y
Year, Circuit, and Industry FE	Y	Y	Y	Y
Number of observations	93,954	93,954	93,954	93,954
Adjusted R ² s	0.097	0.089	0.096	0.103
<i>F</i> -tests	<i>j</i> =	<i>j</i> = Non-	<i>j</i> =	<i>j</i> = Non-
	<i>Misreport</i>	<i>Egregious</i>	<i>Egregious</i>	<i>Egregious</i>
<i>j</i> × <i>Defendant Friendliness GAAP</i> + <i>Defendant Friendliness GAAP</i> = C1	-0.005***	-0.004***	0.000	-0.004***
<i>j</i> × <i>Defendant Friendliness Non-GAAP</i> + <i>Defendant Friendliness Non-GAAP</i> = C2	-0.001*	0.000	0.003	-0.001
C1 - C2	-0.004***	-0.004***	-0.003	-0.003***

Firms' misreporting also varies in severity (Badertscher, Hribar, and Jenkins 2011; Hennes, Leone, and Miller 2008). When financial misreporting is egregious, plaintiffs can more easily establish that managers have willingly defrauded investors. Egregious allegations should therefore be less likely to be dismissed on scienter grounds, even in defendant-friendly courts. In contrast, circuit courts' attitudes should play a more important role in lawsuit filing decisions when a case alleges non-egregious misreporting and for which managers' intentions are more difficult to judge (Donelson, Mcinnis, and Mergenthaler 2013). Thus, conditional on financial misreporting, we expect circuit courts' attitudes to have a stronger influence on lawsuit filing decisions when misreporting is non-egregious than when it is egregious.

In Columns (2) and (3) of Table 5, we separately examine the effects of defendant-friendly GAAP precedents on the firms involved in non-egregious and egregious misreporting and find results consistent with this prediction. First and intuitively, although both misreporting types increase lawsuit likelihood, the effect of egregious misreporting is stronger than that of non-egregious misreporting. *Non-Egregious* and *Egregious* are both significant and positive; the latter (18.8 percent) is more than three times as large as the former (6.1 percent). Second and more importantly, the effect of defendant-friendly GAAP precedents on misreporting firms' likelihood of being sued is stronger when misreporting is non-egregious. In Column (2), the sum of the coefficients on *Defendant Friendliness GAAP* and its interaction with *Non-Egregious* is negative and significant at the 1 percent level, whereas in Column (3), the sum of coefficients on *Defendant Friendliness GAAP* and its interaction with *Egregious* is not significant. Third, the sums of the coefficients on *Defendant Friendliness Non-GAAP* and its interaction with *Non-Egregious* and *Egregious* are not significant in either specification. We observe the same pattern when we consider both types of misreporting in one regression (Column (4)).

In sum, the results in Table 5 show that circuit courts' defendant-friendly precedents on alleged GAAP violations reduce misreporting firms' likelihood of facing lawsuits. This effect is stronger when the misreporting is non-egregious. These findings are consistent with the argument that plaintiffs and their attorneys incorporate the effect of defendant-friendly precedents into their lawsuit filing decisions, especially when managerial intention is more difficult to judge and thus courts' attitudes matter more.

4.2 Effect of precedents on market reaction to restatements

Given that misreporting firms' likelihood of being sued varies with the precedents set in circuit courts, a natural question is whether investors incorporate circuits' defendant-friendly precedents into their valuations when observing a firm restating its financial report. Because defendant-friendly precedents reduce restating firms' potential litigation costs, we conjecture that investors' reactions to restatement announcements are less negative for firms located in more defendant-friendly circuits. To test this conjecture, we estimate the following linear regression model:

$$CAR = f(\text{Defendant Friendliness GAAP}, \text{Defendant Friendliness Non-GAAP}, \text{Controls CAR}), \quad (5)$$

where *CAR* is the market reaction to the restatement announcement, measured by the 3-day market-adjusted return. Following the literature (e.g., Badertscher, Hribar, and Jenkins

liberal judges are less friendly toward defendants with alleged GAAP violations in general (consistent with Huang, Hui, and Li 2019), the two measures do not move synchronously, as the correlation is well above -1 . In additional analyses (tabulated in Supplementary Appendix Table IA7), we also find that circuit precedents and *Liberal Circuit* are incrementally useful for predicting lawsuit likelihood: independently including either of them increases the R^2 (Panel A) and area under the receiver operating characteristic curve (Panel B) of the models (statistically significant at the 1 percent level). In other words, the two measures likely capture different dimensions of courts' attitudes toward defendants.

Table 6. Defendant friendliness and restatement announcement reactions.

This table reports the relation between defendant friendliness in circuit court precedents and market reactions to restatement announcements. We estimate the linear model of $CAR = f(\text{Defendant Friendliness GAAP}, \text{Defendant Friendliness Non-GAAP}, \text{Controls CAR}) + \varepsilon$. Controls CAR includes *Liberal Circuit*, *Overstatement*, *Egregious*, *Size*, *IO*, *Analysts*, *Book-to-Market*, *Leverage*, *Earnings Persistence*, *Beta*, *UD Law*, *GDP Growth*, *Unemployment*, and *Blue State*. For brevity, we omit the control variables from the table and report the complete version in [Supplementary Appendix Table IA8](#). Columns (1), (2), and (3) use the sample of all, non-egregious, and egregious restatements, respectively. The *t*-statistics based on standard errors clustered by circuit-year are reported in parentheses below the coefficients. *, **, and *** indicate significance at the 0.1 percent, 0.05 percent, and 0.01 percent levels, respectively. The variable definitions are in [Appendix A](#).

Dependent variable	(1)	(2)	(3)
	CAR _{restatement}		
<i>Defendant Friendliness GAAP</i>	0.001*** (2.87)	0.002*** (3.36)	-0.002 (-0.72)
<i>Defendant Friendliness Non-GAAP</i>	0.000 (1.05)	0.000 (0.70)	0.002 (0.84)
<i>Intercept</i>	-0.029*** (-2.97)	-0.027*** (-2.67)	-0.054 (-0.84)
<i>Controls CAR</i>	Y	Y	Y
Number of observations	2,893	2,600	293
Adjusted R ² s	0.021	0.008	0.008

2011; Palmrose, Richardson, and Scholz 2004), we control for whether the misstatement overstates net income or net assets (*Overstatement*), for misreporting severity (*Egregious*), and for firm characteristics such as *Size*, *IO*, *Analysts*, *Book-to-Market*, *Leverage*, *Earnings Persistence*, and *Beta*. In addition, we control for circuit- and state-level variables (*Liberal Circuit*, *UD Law*, *GDP Growth*, *Unemployment*, *Blue State*). We obtain analyst following data from I/B/E/S. We exclude restatements announced with earnings announcements (i.e., those occurring within 2 days) to reduce noise in measuring investors' reactions to restatements. Note that this test may suffer from endogeneity because circuit courts' attitudes can change firms' tendency to restate financial reports.

Table 6 reports the results. For brevity, we do not report the coefficients of all controls but report them in [Supplementary Appendix Table IA8](#). Consistent with investors expecting lower litigation costs for misreporting firms in defendant-friendly circuits, *Defendant Friendliness GAAP* is positively associated with CAR in Column (1) at the 1 percent level. In terms of economic magnitude, a one-standard-deviation increase in *Defendant Friendliness GAAP* results in a 30-basis-point (0.001×2.959) increase in the market reaction, which represents a US\$10.9 million smaller loss in shareholder value based on misreporting firms' average market cap of US\$3,648.3 million. Similar to the results in the lawsuit likelihood analysis, the coefficient of *Defendant Friendliness Non-GAAP* is not significant. The restatement-level controls behave as expected: both overstatements and more egregious misreporting are associated with more negative returns.

We then separately examine the market reactions to non-egregious and egregious misreporting. We find that *Defendant Friendliness GAAP* has a significant coefficient for non-egregious misreporting cases (Column (2)). Economically, a one-standard-deviation increase in *Defendant Friendliness GAAP* results in a 60-basis-point (0.002×2.992) increase in market reaction to non-egregious misreporting, representing a US\$21.7 million smaller loss in shareholder value based on non-egregious misreporting firms' average market cap of US\$3,608.5 million. In contrast, the result in Column (3) suggests that when financial misreporting is egregious and plaintiffs can establish managers' willingness to defraud investors

regardless of the courts' attitude, the market reaction does not vary with defendant friendliness. This observation is in line with our results in Table 5, Columns (3) and (4). In sum, these findings suggest that investors understand the implications of defendant-friendly precedents on the expected litigation costs of firms with different severity of financial misreporting.

5. Securities law precedents and financial reporting quality

So far, our results show that firms' expected litigation costs from financial misreporting vary with the defendant friendliness of their home-circuits' GAAP precedents. If managers understand this effect, they should incorporate these lower expected litigation costs into their decision-making and thus invest less in mechanisms that prevent financial misreporting and engage in more aggressive misreporting activities. Specific to misreporting and following our argument that the effect of courts' case-law attitudes depends on the severity of misreporting, defendant friendliness should also affect managers' tendency to engage in non-egregious misreporting more than their tendency to engage in egregious misreporting.

5.1 Effect of precedents on investment in internal controls and compliance

To test whether managers incorporate the moderating effects of defendant-friendly precedents into determining their effort to prevent financial misreporting (i.e., how much to invest in internal controls and compliance), we estimate the following linear and linear probability models:

$$\begin{aligned} \text{Internal Controls/Compliance} = & f(\text{Defendant Friendliness GAAP}, \\ & \text{Defendant Friendliness Non-GAAP}, \text{Controls_Internal/Controls_Compliance}) + \varepsilon. \end{aligned} \quad (6)$$

We use several proxies to measure investments in internal controls and compliance. First, we focus on firms' general counsels because they are among the most important internal governance actors, advising senior management and the board on matters concerning the firm's legal responsibilities and monitoring top management for behavior that is not in the interest of shareholders ([American Bar Association Task Force on Corporate Responsibility 2003](#); [DeMott 2005](#)). Prior studies show that firms with higher paid general counsels are less likely to exhibit GAAP violations, compliance breaches, and monitoring failures ([Hopkins, Maydew, and Venkatachalam 2015](#); [Morse, Wang, and Wu 2016](#)). Following these studies, we measure general counsels' compensation using two variables: an indicator variable that equals one if the general counsel is one of the highest paid executives in the firm (*Executive Lawyer*), and zero otherwise; and these highly paid general counsels' pay, compared with that of the CEO (*Executive Lawyer Pay Ratio*). Second, we use audit effort (*Audit Fee*) to capture firms' investments in financial reporting compliance. Prior studies show that higher audit efforts can reduce misreporting ([Caramanis and Lennox 2008](#); [Lobo and Zhao 2013](#)). Given that misreporting firms in defendant-friendly circuits face lower expected litigation costs, we expect those firms to demand a lower audit effort. We also use firms' number of detected internal control weaknesses (*# Internal Control Weakness*) as an *ex post* measure, with larger numbers indicating lower investment in internal controls that may have prevented misreporting ([Ashbaugh-Skaife, Collins, and Kinney 2007](#); [Masli et al. 2010](#)). Although this measure requires *ex post* detection, it is more directly related to internal controls than measures of compliance efforts.

We control for firm characteristics related to internal controls and compliance, as documented in prior studies, as well as for state-level and circuit-level variables. Specifically, when the dependent variable is general counsels' compensations, firm characteristics include $Size_{t-1}$, $Book-to-Market_{t-1}$, $Buy-and-Hold Return_{t-1}$, $Buy-and-Hold Return_t$, $Return on$

$Assets_{t-1}$, $Return\ on\ Assets_t$, $Volatility_t$, and $CEO\ Chair_{t-1}$ (Graham, Li, and Qiu 2012). When the dependent variable is audit effort, firm characteristics include *Size*, *Leverage*, *Return on Assets*, *Current Ratio*, *Quick Ratio*, *Segments*, *Foreign Sales*, *Loss*, *December Year End*, *Going Concern*, *Independent Board*, and *CEO Chair* (DeFond and Zhang 2014). When the dependent variable is the number of internal control weaknesses, firm characteristics include *Size*, *Sales Growth*, *IO*, *Financing*, *Inventory*, *Firm Age*, *Segments*, *Foreign Sales*, *Loss*, *M&A*, *Restructuring*, *Misreport*, and *Auditor Resign* (Ashbaugh-Skaife, Collins, and Kinney 2007; Doyle, Ge, and McVay 2007). Audit-related data are from Audit Analytics, board composition data are from BoardEx, and M&A data are from SDC Platinum.

Table 7 Columns (1)–(4) report a negative association between *Defendant Friendliness GAAP* and the likelihood of general counsels being among the highest-paid executives, these highly paid general counsels' relative pay, and audit fees at the 5 percent, 1 percent, and 1 percent levels, respectively. For brevity, we do not report the coefficients of all controls but report them in Supplementary Appendix Table IA9. These results are consistent with the prediction that firms in defendant-friendly circuits invest less effort in preventing misreporting. In terms of economic magnitudes, a one-standard-deviation increase in *Defendant Friendliness GAAP* results in a 1.6 percent (-0.005×3.158) reduction in the likelihood of having highly paid general counsels (the average likelihood within the sample firms is 41.6 percent), a 2.0 percent (-0.006×3.245) reduction in their pay relative to the CEOs (the sample average pay ratio is 34.8 percent), and a 2.7 percent (-0.009×3.046) reduction in audit fees. The results in Columns (5) and (6) are also consistent with firms decreasing efforts to prevent misreporting, resulting in more internal control weaknesses being detected subsequently. Specifically, *Defendant Friendliness GAAP* is positively associated with the number of internal control weaknesses at the 5 percent level, with a one-standard-deviation increase in *Defendant Friendliness GAAP* being associated with a 14.5 percent increase in detected internal control weaknesses (an increase of 0.020 [0.006×3.255], relative to the sample average of 0.138). Defendant-friendly non-GAAP precedents have no discernable effect on firms' investments in internal controls or compliance (the only exception being a weakly negative association of *Defendant Friendliness Non-GAAP* and audit fees when the model does not include auditor fixed effects), which is in line with our previous findings.

In sum, our results suggest that managers incorporate the moderating effect of defendant-friendly precedents into expected litigation costs from their misreporting and decrease their prevention efforts by investing less in internal controls and compliance.

5.2 Effect of precedents on financial misreporting activities

Because firms located in more defendant-friendly circuits face lower expected litigation costs associated with financial misreporting, their managers should become more inclined to misreport. To test this prediction, we estimate the following linear model:

$$\text{Misreporting Activities} = f(\text{Defendant Friendliness GAAP}, \text{Defendant Friendliness Non-GAAP}, \text{Controls Misreporting Activities}) + \varepsilon \quad (7)$$

We use both *ex ante* and *ex post* measures of misreporting activities in this analysis. Following the literature, we use three earnings management proxies as *ex ante* measures of misreporting: discretionary accruals, as measured by the modified Jones model (*Discretionary Accruals*, Dechow, Sloan, and Sweeney 1995; Massa, Zhang, and Zhang 2015); performance-adjusted discretionary accruals (*Performance-adjusted Discretionary Accruals*, Fang, Huang, and Karpoff 2016; Kothari, Leone, and Wasley 2005); and an

Table 7. Defendant friendliness and investments in internal controls and compliance.

This table reports the relation between defendant friendliness in circuit court precedents and compensation of general counsel, audit fees, and number of internal control weaknesses. In Columns (1) and (2), we estimate the linear and linear probability models of $Executive\ Lawyer/Executive\ Lawyer\ Pay\ Ratio_t = f(Defendant\ Friendliness\ GAAP_t, Defendant\ Friendliness\ Non-GAAP_t, Controls\ Executive\ Lawyer) + \epsilon$. *Controls Executive Lawyer* includes *Liberal Circuit_t, Size_{t-1}, Book-to-Market_{t-1}, Buy-and-Hold Return_{t-1}, Buy-and-Hold Return_t, Return on Assets_{t-1}, Return on Assets_t, Volatility_t, CEO Chair_{t-1}, UD Law_t, GDP Growth_t, Unemployment_t, and Blue State_t*. In Columns (3) and (4), we estimate the linear model of $Audit\ Fee = f(Defendant\ Friendliness\ GAAP, Defendant\ Friendliness\ Non-GAAP, Controls\ Audit\ Fee) + \epsilon$. *Controls Audit Fee* includes *Liberal Circuit, Size, Leverage, Return on Assets, Current Ratio, Quick Ratio, Segments, Foreign Sales, Loss, December Year End, Going Concern, Independent Board, CEO Chair, UD Law, GDP Growth, Unemployment, and Blue State*. In Columns (5) and (6), we estimate the linear model of $\#Internal\ Controls\ Weakness = f(Defendant\ Friendliness\ GAAP, Defendant\ Friendliness\ Non-GAAP, Controls\ ICW) + \epsilon$. *Controls Internal Control Weakness* includes *Liberal Circuit, Size, Sales Growth, IO, Financing, Inventory, Firm Age, Segments, Foreign Sales, Loss, M&A, Restructuring, Misreport, Auditor Resign, UD Law, GDP Growth, Unemployment, and Blue State*. For brevity, we omit the control variables from the table and report the complete version in [Supplementary Appendix Table IA9](#). All columns include the year, circuit, and industry fixed effects. Columns (4) and (6) add auditor fixed effects. The *t*-statistics based on standard errors clustered by circuit-year are reported in parentheses below the coefficients. *, **, and *** indicate significance at the 0.1 percent, 0.05 percent, and 0.01 percent levels, respectively. The variable definitions are in [Appendix A](#).

Dependent variables	(1) Executive Lawyer _t	(2) Executive Lawyer Pay Ratio _t	(3) Audit Fee	(4) Audit Fee	(5) # Internal Control Weakness	(6) # Internal Control Weakness
<i>Defendant Friendliness GAAP_t</i>	-0.005** (-2.21)	-0.006*** (-3.09)	-0.009*** (-3.14)	-0.008*** (-3.03)	0.006** (2.10)	0.006** (2.18)
<i>Defendant Friendliness Non-GAAP_t</i>	-0.000 (-0.13)	0.001 (0.38)	-0.003* (-1.95)	-0.003 (-1.53)	-0.001 (-0.48)	-0.001 (-0.40)
<i>Intercept</i>	0.517*** (11.18)	0.424*** (7.82)	10.294*** (238.73)	10.802*** (223.44)	0.222*** (5.30)	0.183*** (4.13)
Controls Executive Lawyer	Y	Y	N	N	N	N
Controls Audit Fees	N	N	Y	Y	N	N
Controls Internal Control Weakness	N	N	N	N	Y	Y
Year, Circuit, and Industry FE	Y	Y	Y	Y	Y	Y
Auditor FE	N	N	N	Y	N	Y
Number of observations	16,380	6,347	39,834	39,773	36,833	36,778
Adjusted R ² s	0.079	0.056	0.753	0.788	0.064	0.070

indicator variable (*Beat/Meet*) that equals one if the firm meets or just beats last year's earnings per share, and zero otherwise (Burgstahler and Dichev 1997; DeGeorge, Patel, and Zeckhauser 1999).¹² For *ex post* measures of misreporting, we use firm-years that are subsequently restated, which should have lower Type I errors (false positives) than *ex ante* measures, because these firms disclose that they have misstated their financial statements. However, restatements depend on the detection of misreporting, which can introduce bias to the measure.

We control for firm characteristics related to firms' likelihood of facing SCAs, and state-level and circuit-level variables. In addition, when the dependent variables are *ex ante* measures of misreporting, we use *Overconfidence*, *PPS*, *Pay Slice*, *Independent Board*, and *CEO Chair* to control for managerial compensation characteristics and monitoring (Chu et al. 2019) and *Soft Assets* to control for flexibility in accounting (Barton and Simko 2002). When the dependent variables are *ex post* measures of misreporting, we further control for accrual quality using *Total Accruals*, Δ *Receivable*, Δ *Inventory*, and Δ *Cash Sales* (Dechow et al. 2011).

Columns (1)–(3) of Table 8 tabulate the results using the three *ex ante* measures of misreporting as the dependent variables. For brevity, we do not report the coefficients of all controls but report them in Supplementary Appendix Table IA10. Across all measures, we observe evidence consistent with more defendant-friendly GAAP precedents being associated with more aggressive earnings-management activities, significant at the 5 percent or 10 percent levels. The economic significance is sizable: a one-standard-deviation increase in *Defendant Friendliness GAAP* increases discretionary accruals and performance-adjusted discretionary accruals by 0.6 percent (0.002×3.092) and 0.3 percent (0.001×3.092) of assets, respectively, and increases the likelihood of meet-or-just-beat targets by firms in the circuit by 0.3 percent (0.001×3.092), which is 25.0 percent of the unconditional likelihood of 1.2 percent (0.3 percent / 1.2 percent = 25.0 percent). Similar to Section 5.1, we find no effects for non-GAAP precedents.

Columns (4)–(6) of Table 8 report the results using restatements as the *ex post* measure of misreporting. Also consistent with the intuition, *Defendant Friendliness GAAP* is positively associated with *Misreport* in Column (4) at the 1 percent level. In terms of economic magnitude, a one-standard-deviation increase in *Defendant Friendliness GAAP* increases restatement likelihood by 3.0 percent (0.01×3.026), representing 18.2 percent of the unconditional restatement likelihood of 16.5 percent (3.0 percent / 16.5 percent = 18.2 percent). The control variables behave as expected. For instance, firms with more soft assets or firms led by managers with a higher pay–performance sensitivity have a higher likelihood of restatement.

In Columns (5) and (6), we separate non-egregious and egregious misstatements. Although defendant-friendly GAAP precedents increase firms' tendency to engage in both types of misstatements, significant at the 1 percent level, their influence on non-egregious misstatements is larger than their influence on egregious ones.¹³ Similar to our previous results, managers appear not to consider non-GAAP precedents when deciding whether to misreport as the coefficient of *Defendant Friendliness Non-GAAP* is not significant.

¹² We do not use analyst forecasts as the benchmark for the meet/beat measure because managers can use voluntary disclosure, such as management guidance, to influence analyst forecasts (Richardson, Teoh, and Wysocki 2004). Because these disclosures are less affected by defendant-friendly precedents in GAAP violations, using analyst forecasts as the benchmark introduces noise to the measure.

¹³ Managers who consider misreporting cannot know for certain whether their misreporting will be categorized as egregious *ex post*, which might explain the significant results in Column (6). Note that in the lawsuit likelihood and the restatement market reaction tests in Section 4, plaintiffs and investors observe whether a misstatement is egregious and can act based on that information.

Table 8. Defendant friendliness and misreporting activities.

This table reports the relation between defendant friendliness in circuit court precedents and earnings management and misreporting occurrences. In Columns (1)–(3), we estimate the linear model of *Earnings Management* = $f(\text{Defendant Friendliness GAAP}, \text{Defendant Friendliness Non-GAAP}, \text{Controls Earnings Management}) + \varepsilon$. Columns (1)–(3) use *Discretionary Accruals*, *Performance-adjusted Discretionary Accruals*, and *Beat/Meet* as the dependent variable, respectively. *Controls Earnings Management* includes *Liberal Circuit*, *Size*, *Sales Growth*, *Book-to-Market*, Δ *Return on Assets*, *Buy-and-Hold Return*, *Volatility*, *Skewness*, *Turnover*, *IO*, *Leverage*, *Financing*, *Overconfidence*, *PPS*, *Pay Slice*, *Independent Board*, *CEO Chair*, *Soft Assets*, *UD Law*, *GDP Growth*, *Unemployment*, and *Blue State*. In Columns (4)–(6), we estimate the linear probability model of *Misreport* = $f(\text{Defendant Friendliness GAAP}, \text{Defendant Friendliness Non-GAAP}, \text{Controls Misreport}) + \varepsilon$. Columns (4)–(6) use *Misreport*, *Non-Egregious*, and *Egregious* as the dependent variable, respectively. *Controls Misreport* includes *Controls Earnings Management* (i.e., *Liberal Circuit*, *Size*, *Sales Growth*, *Book-to-Market*, Δ *Return on Assets*, *Buy-and-Hold Return*, *Volatility*, *Skewness*, *Turnover*, *IO*, *Leverage*, *Financing*, *Overconfidence*, *PPS*, *Pay Slice*, *Independent Board*, *CEO Chair*, *Soft Assets*, *UD Law*, *GDP Growth*, *Unemployment*, and *Blue State*), *Total Accruals*, Δ *Receivable*, Δ *Inventory*, and Δ *Cash Sales*. For brevity, we omit the control variables from the table and report the complete version in [Supplementary Appendix Table IA10](#). All regressions include the year, circuit, and industry fixed effects. The *t*-statistics based on standard errors clustered by circuit-year are reported in parentheses below the coefficients. *, **, and *** indicate significance at the 0.1 percent, 0.05 percent, and 0.01 percent levels, respectively. The variable definitions are in [Appendix A](#).

Dependent variables	(1) Discretionary accruals	(2) Performance- adjusted discretionary accruals	(3) Beat/ meet	(4) Misreport	(5) Non- egregious	(6) Egregious
<i>Defendant Friendliness GAAP_t</i>	0.002** (2.20)	0.001* (1.71)	0.001** (2.05)	0.010*** (5.05)	0.008*** (4.36)	0.002*** (2.63)
<i>Defendant Friendliness Non-GAAP_t</i>	0.000 (0.16)	0.001 (1.47)	0.000 (0.52)	−0.000 (−0.12)	0.000 (0.30)	−0.000 (−0.86)
<i>Intercept</i>	0.103*** (7.32)	0.095*** (4.75)	0.048*** (4.88)	0.163*** (3.93)	0.192*** (5.10)	−0.029 (−1.64)
Controls Earnings Management	Y	Y	Y	N	N	N
Controls Misreport	N	N	N	Y	Y	Y
Year, Circuit, and Industry FE	Y	Y	Y	Y	Y	Y
Number of observations	26,349	26,349	26,349	19,779	19,779	19,779
Adjusted R ² s	0.157	0.045	0.002	0.046	0.038	0.024

Overall, our results in this section suggest that more defendant-friendly GAAP precedents increase managers' tendency to engage in financial misreporting, especially misreporting that is non-egregious and for which it is more difficult for potential plaintiffs to judge managerial intent.¹⁴

6. Conclusion

SCAs, among the most significant legal liabilities for firms in the USA, aim to deter managers from providing misleading information to investors. Under common law, their effectiveness critically depends on courts' interpretations of federal securities laws. In this study, we

¹⁴ In an additional test, we examine whether firms located in circuits with more defendant-friendly precedents have less informative stock prices, a likely consequence of more misreporting. Following prior studies (Baik et al. 2022; Fang, Huang, and Karpoff 2016), we measure price informativeness using the relation between returns and future earnings in the subsequent 3 years. We find evidence consistent with this intuition (tabulated in [Supplementary Appendix Table IA11](#)).

introduce a novel measure of US circuit courts' defendant friendliness using 321 circuit court rulings and we provide systematic evidence that it shapes firms' litigation environment. First, case-level analyses confirm the relevance of legal precedents for firms' litigation risk, with district courts heeding their circuit courts' precedents and being more likely to dismiss pending SCA cases when the home circuits have dismissed similar allegations. Second, firm-level analyses reveal that financial misreporting firms located in circuits with more defendant-friendly precedents are less likely to face SCAs, especially for non-egregious misreporting when managers' intentions to mislead investors are more difficult to judge. Moreover, consistent with investors understanding the implications of defendant-friendly precedents, the market reacts less negatively to restatement announcements by firms located in more defendant-friendly circuits. We also find that these firms invest less in internal controls and compliance and engage in more financial misreporting, especially non-egregious misreporting.

By revealing firms' heterogeneous exposure to legal liability under the same statute, our results highlight the under-explored role of the judiciary in financial markets. As political polarization among legislators impedes the passage of new laws, the importance of judicial interpretations of existing statutes may grow even further. Our approach measuring courts' attitudes using a comprehensive collection of relevant precedents is well grounded in legal theory and can be further adapted by future studies to gauge firms' litigation risks in other types of lawsuits.

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Supplementary material

[Supplementary material](#) is available at *Review of Finance* online.

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Conflicts of interest

None declared.

Data availability

The data underlying this article are either derived from a source in the public domain or owned by a third party. Public domain data used in this article are available from the Federal Judicial Center (<https://www.uscourts.gov/topics/federal-judicial-center>), Google

Scholar Case Law Search, the SEC's EDGAR database (<https://www.sec.gov/edgar>), Bureau of Economic Analysis (<http://www.bea.gov/regional>), and Local Area Unemployment Statistics (<https://www.bls.gov/lau/data.htm>). Data owned by third party vendors used in this article are available from Stanford SCAC (<https://securities.stanford.edu/>) and Wharton Research Data Services (<https://wrds-www.wharton.upenn.edu/>).

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Appendix A. Variable definitions.

Variable name	Definition
Variables in district court citation test	
Cited	Indicator variable that equals one if a district court ruling cites a circuit court precedent, and zero otherwise.
GAAP precedent	Indicator variable that equals one if a circuit court precedent involves GAAP violation allegations, and zero otherwise.
GAAP case	Indicator variable that equals one if a district court case involves GAAP violation allegations, and zero otherwise.
Consistent pair	Indicator variable that equals one if the district court case and circuit court precedent are both GAAP or both non-GAAP, and zero otherwise.
Home circuit	Indicator variable that equals one if the district court of the case is under the jurisdiction of the precedent's circuit, and zero otherwise.
Liberal district judge	Indicator variable that equals one if the district court judge presiding over the case was appointed by a Democratic president, and zero otherwise.
Dismissal precedent	Indicator variable that equals one if a circuit court precedent affirms a district court's decision to dismiss the complaint, and zero otherwise.
Consistent ideology	Indicator variable that equals one if the district court judge presiding over the case was appointed by a Democratic president and the circuit court precedent reverses a district court's decision to dismiss the complaint or if the district court judge presiding over the case was appointed by a Republican president and the circuit court precedent affirms a district court's decision to grant a motion to dismiss, and zero otherwise.
Variables in district court decision test	
Dismissed	Indicator variable that equals one if a district court's final decision in a SCA lawsuit is a dismissal without settlement, and zero otherwise.
Circuit outcome (non-)GAAP _{pending}	The sum of the (non-)GAAP ruling outcomes in the circuit court during the pending window of a district court case (i.e., the period between the case filing date and the decision date), where the ruling outcome equals one if a circuit court ruling is defendant-friendly, and negative one otherwise.

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Variable name	Definition
<i>Liberal Circuit</i> _{at ruling}	The probability that a randomly selected three-judge panel in the home-circuit court as of a district court ruling date has at least two judges appointed by a Democratic president.
<i>Pending period duration</i>	The number of years between the ruling date and the filing date of a district court case.
<i>Filing CAR</i>	The three-day market-adjusted return centered on the district court case filing date.
<i>Circuit outcome (non-)GAAP</i> _{post}	The sum of the (non-)GAAP ruling outcomes in the circuit court during a window of 30.8 months (the median length of a district court case pending period in the district court decision test) beginning from 1 year after the ruling date of a district court case, where the ruling outcome equals one if a circuit court ruling is defendant-friendly, and negative one otherwise.
<i>Circuit outcome (Non-)GAAP</i> _{non-home}	The sum of the (non-)GAAP ruling outcomes in the circuit court in a random non-home-circuit court during the pending window of a district court case (i.e., the period between the case filing date and the decision date), where the ruling outcome equals one if a circuit court ruling is defendant-friendly, and negative one otherwise.
Variables in firm-level analyses	
<i>Defendant friendliness (non-)GAAP</i>	Equals $\sum_{j,t} \frac{Citation_{j,t}}{Avg. Citation_{i,t}} Outcome_j$, where i represents the circuit, t represents the date, $J_{i,t}$ represents all (non-)GAAP precedents in circuit i prior to t , j represents a (non-)GAAP precedent in circuit i prior to t , $Citation_{j,t}$ is one plus the number of district court opinions citing precedent j within the last 5 years of t , and $Avg. Citation_{i,t}$ is the average of $Citation_{j,t}$ for $J_{i,t}$.
	We use each firm's historical headquarters location from its 10-K filings to identify its home circuit. In the SCA likelihood test, we take the median value in the window from the fiscal-year start to the lawsuit filing date for the sued firm-years and the median value in the 31-month window (i.e., the average interval between the fiscal-year start and the lawsuit filing date of SCAs) for the not-sued firm-years. In the market reaction to restatement announcement test, we use the value as of the announcement date. For other firm-year level tests, we take the median value during the fiscal year.
<i>Sued</i>	Indicator variable that equals one if a firm-year overlaps with the class period of a SCA filed against the firm in the firm's headquarters circuit, and zero otherwise.
<i>Misreport</i>	Indicator variable that equals one if a firm subsequently restates its financial statement for that fiscal year, and zero otherwise.
<i>Non-Egregious</i>	Indicator variable that equals one if a firm subsequently restates its financial statement for that fiscal year and the restatement announcement mentions neither fraud nor any SEC investigation according to Audit Analytics, and zero otherwise.
<i>Egregious</i>	Indicator variable that equals one if a firm subsequently restates its financial statement for that fiscal year and the restatement announcement mentions either fraud or an SEC investigation according to Audit Analytics, and zero otherwise.

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Variable name	Definition
<i>Liberal Circuit</i>	The probability that a randomly selected three-judge panel from the circuit that has jurisdiction over the firm-year's historical headquarters state has at least two judges appointed by a Democratic president (Huang, Hui, and Li 2019).
<i>Size</i>	The natural logarithm of the market value of equity (CSHO \times PRCC_F) at the end of a fiscal year.
<i>Sales Growth</i>	Change in sales (SALE) from the prior to the current fiscal year, scaled by total assets (AT) at the beginning of the year.
<i>Book-to-Market</i>	The book value of equity scaled by the market value of equity (CEQ/(CSHO \times PRCC_F)) at the end of a fiscal year.
Δ Return on Assets	The change in return on assets from the prior fiscal year to the current fiscal year. Return on assets is calculated as income before extraordinary items (IB) in a year scaled by total assets (AT) at the beginning of the year.
<i>Buy-and-Hold Return</i>	Cumulative daily raw returns (RET) over a fiscal year.
<i>Volatility</i>	Standard deviation of daily raw returns (RET) during a fiscal year.
<i>Skewness</i>	Skewness of daily raw returns (RET) during a fiscal year.
<i>Turnover</i>	Sum of daily trading volume over a fiscal year (VOL), scaled by shares outstanding at the end of the year (SHROUT).
<i>IO</i>	Percentage of institutional holdings as of the firm's most recent 13-F filing before the end of a fiscal year.
<i>Leverage</i>	Sum of long-term debt (DLTT) and short-term debt (DLC) of a firm-year, scaled by total assets (AT) at the end of the fiscal year.
<i>Financing</i>	Sum of equity and debt issuance over a firm-year (SSTK + DLTIS), scaled by total assets (AT) at the end of the fiscal year. Missing values are set to zero.
<i>UD Law</i>	Indicator variable that equals one if the firm's incorporating state enacted universal demand laws prior to the fiscal year end, and zero otherwise.
<i>GDP Growth</i>	The annual percentage change in GDP in the state of a firm-year's historical headquarters during the year.
<i>Unemployment</i>	The average monthly unemployment rate in the state of a firm-year's historical headquarters during the fiscal year.
<i>Blue State</i>	Indicator variable that equals one if the state of the firm's historical headquarters voted for a Democratic candidate in the most recent presidential election prior to the end of the fiscal year, and zero otherwise.
$CAR_{restatement}$	The 3-day market-adjusted return centered on the restatement announcement day.
<i>Overstatement</i>	Indicator variable that equals one if the misstatement associated with the restatement overstates the firm's net income or net assets, and zero otherwise.
<i>Analysts</i>	The natural logarithm of one plus the number of analysts following a firm. Missing values are set to zero.
<i>Persistence</i>	The coefficient estimates from a firm-specific regression of the current year's basic EPS excluding extraordinary items (EPSPX) on its lagged value using the previous 10 years of data. We require at least eight observations to estimate this regression.
<i>Beta</i>	The coefficient estimates from regressing the daily returns for the firm on market returns over the 12 months ending on the fiscal year-end date. We require at least 90 observations to estimate this regression.

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Variable name	Definition
<i>Executive Lawyer</i>	Indicator variable that equals one if the general counsel is one of the highly paid executives in ExecuComp, and zero otherwise.
<i>Executive Lawyer Pay Ratio</i>	The pay ratio of executive general counsel to the CEO. The variable is set to missing for firms in which the general counsel is not one of the highly paid executives in ExecuComp.
<i>Return on Assets</i>	Income before extraordinary items (IB) of the fiscal year, scaled by total assets (AT) at the beginning of the year.
<i>CEO Chair</i>	Indicator variable that equals one if the CEO is also the chairman of the board, and zero otherwise.
<i>Audit Fee</i>	The natural logarithm of audit fees in dollars.
<i>Current Ratio</i>	The ratio of current assets (ACT) to current liabilities (LCT) at the end of the fiscal year.
<i>Quick Ratio</i>	Current assets (ACT) minus inventories (INVT), scaled by current liabilities (LCT) at the end of the fiscal year.
<i>Segments</i>	The natural logarithm of one plus the number of business segments.
<i>Foreign Sales</i>	The sales of foreign segments (SALES) scaled by total sales (SALE), both during the fiscal year.
<i>Loss</i>	Indicator variable that equals one if net income (NI) is less than zero, and zero otherwise.
<i>December Year End</i>	Indicator variable that equals one if the fiscal year-end is December, and zero otherwise.
<i>Going Concern</i>	Indicator variable that equals one if the auditor's opinion for that firm-year contains an explanatory paragraph regarding the going-concern assumption according to Audit Analytics, and zero otherwise.
<i>Independent Board</i>	The annual quintile ranking of the firm in percentage of independent directors, where a rank of five indicates the highest percentage of independent directors.
<i># Internal Control Weakness</i>	The number of internal control weaknesses identified by auditors for the firm-year, according to Audit Analytics.
<i>Inventory</i>	Inventory (INVT) at the end of the fiscal year, scaled by the average total assets of the year.
<i>Firm Age</i>	The natural logarithm of one plus the number of years since the firm's stock data became available on CRSP.
<i>M&A</i>	Indicator variable that equals one if the firm engages in an M&A in the fiscal year according to SDC Platinum, and zero otherwise.
<i>Restructuring</i>	Indicator variable that equals one if the firm's absolute value of pre-tax restructuring costs (RCP) is positive, and zero otherwise.
<i>Auditor Resign</i>	Indicator variable that equals one if the firm's auditor resigns during the fiscal year, and zero otherwise.
<i>Discretionary Accruals</i>	The difference between the firm's total accruals ($\frac{Total\ Accruals_t}{Total\ Asset_{t-1}}$) and normal accruals (NA_t) in a firm-year. For each of the forty-eight Fama–French industry-year, we estimate the modified Jones Model (Dechow, Sloan, and Sweeney 1995) as follows: $\frac{Total\ Accruals_t}{Total\ Asset_{t-1}} = \beta_1 \frac{1}{Total\ Asset_{t-1}} + \beta_2 \frac{\Delta Revenue_t}{Total\ Asset_{t-1}} + \beta_3 \frac{PPE_t}{Total\ Asset_{t-1}} + \varepsilon$ and use the estimated coefficients to calculate a firm-year's normal accruals as $NA_t = \hat{\beta}_1 \frac{1}{Total\ Asset_{t-1}} + \hat{\beta}_2 \frac{\Delta Revenue_t - \Delta Receivable_t}{Total\ Asset_{t-1}} + \hat{\beta}_3 \frac{PPE_t}{Total\ Asset_{t-1}}$.

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Variable name	Definition
<i>Performance-adjusted Discretionary Accruals</i>	We require at least eight observations to estimate each regression. A firm's discretionary accruals minus a matched firm's discretionary accruals (Kothari, Leone, and Wasley 2005). For each firm-year, we match it with another firm in the same Fama–French industry and with the closest return on assets in the previous year.
<i>Beat/Meet</i>	Indicator that equals one if the firm's annual EPS meets or just beats (by up to one cent) the prior year's EPS, and zero otherwise.
<i>Overconfidence</i>	Indicator variable that equals one if the firm's CEO held options that are at least 67 percent in the money in this year or any previous year, and zero otherwise (Hirshleifer, Low, and Teoh 2012). For each CEO-year, the moneyness of options is calculated as the fiscal year-end stock price divided by the estimated strike price minus one. The estimated strike price is calculated as the fiscal year-end stock price minus the average realizable value per vested option. The average realizable value per vested option equals the total realizable value of vested options divided by the number of vested options held by the CEO.
<i>PPS</i>	The CEO's pay-for-performance sensitivity calculated as $\text{ONEPCT}/(\text{ONEPCT} + \text{Salary} + \text{Bonus})$ following Feng et al. (2011), with ONEPCT being the total change in the value of the executive's stock and stock option portfolio in response to a 1 percent change in the stock price.
<i>Pay Slice</i>	The CEO's total compensation (TDC1) as a percentage of the total compensation of the top five executives in ExecuComp.
<i>Soft Assets</i>	Total assets (AT) minus cash (CHE) and net PPE (PPENT) at the end of the fiscal year, scaled by the average total assets of the year.
<i>Total Accruals</i>	Total accruals following Richardson et al. (2005), calculated as the sum of changes in net working capital ($\text{ACT} - \text{CHE} - \text{LCT} + \text{DLC}$), changes in net non-current operating assets ($\text{AT} - \text{ACT} - \text{IVAO} - \text{LT} + \text{LCT} + \text{DLTT}$), and changes in net financial assets ($\text{IVST} + \text{IVAO} - \text{DLTT} - \text{DLC} - \text{PSTK}$), all relative to the prior year, scaled by the average total assets of the current year.
<i>ΔReceivable</i>	Change in accounts receivable (RECT) from the prior to the current fiscal year, scaled by the average total assets of the current year.
<i>ΔInventory</i>	Change in inventory (INVT) from the prior to the current fiscal year, scaled by the average total assets of the current year.
<i>ΔCash Sales</i>	Change in cash sales (SALE – RECCH) from the prior to the current fiscal year, scaled by the average total assets of the current year.