

# THE IMPACT OF LITIGATION RISK ON CORPORATE PROSPECTIVE DISCLOSURE: A REVIEW OF THE EMPIRICAL LITERATURE

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## Abstract

We review the literature on the impact of litigation risk (a form of external governance) on corporate prospective disclosure decisions as reflected in management earnings forecasts. From this analysis we identify four key areas for future research. First, litigation risk warrants more attention from researchers; currently it tends to be treated as a secondary factor impacting MEF decisions. Second, it would be informative from a governance perspective for researchers to explore why litigation risk has a differential impact on MEF decisions across countries. Third, understanding the interaction between litigation risk and forecast/firm-specific characteristics is important from management, investor and regulatory perspectives but is currently under-explored. Last, research on the litigation risk and MEF attributes link is piecemeal and incomplete, requiring more integrated and expanded analysis.

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## I. Introduction

The literature on corporate disclosure is vast (see Healy and Palepu, 2001; Beyer et al., 2010 for previous reviews). In this literature corporate disclosure is examined from many perspectives, e.g. disclosure type (voluntary and mandatory disclosure, narrative and quantitative disclosures, environmental disclosure, and strategic disclosure), disclosure antecedents, incentives and consequences, and retrospective and prospective (forward-looking) disclosure. Of all these areas there has been a paucity of research on the consequences of corporate disclosure where the disclosure is misleading or fails to comply with regulations. The consequences are likely to vary across countries and across time because of (1) the extent of enforcement of statutory and common law, (2) the increase in more onerous corporate disclosure regulation, and (3) the increasing growth in litigation action evident in many countries.

The objective of this review is to provide an overview of the current state of research that examines the impact of litigation risk on prospective disclosures and provide suggestions for future research. Because corporate disclosure can take many forms, in this review we focus our attention on a frequent form of prospective

disclosure: *management earnings forecasts* (MEFs). This form of prospective disclosure has universal applicability and the underlying disclosure attributes can be readily examined in a litigation context.

Prospective disclosures in the form of *management earnings forecasts*, commonly referred to as *management earnings guidance*<sup>6</sup> in the business media, have become increasingly common in many countries. MEFs are traditionally considered to be a form of voluntary disclosure (Hirst et al., 2008). As with other forms of voluntary disclosure, managers have much discretion over their disclosure decisions. For example, managers choose whether to disclose or not, whether to update an earnings forecast, when to disclose a forecast, how precise the forecast information should be, and whether to bundle the forecast with other information. In some situations, managers may intentionally bias or delay their earnings forecasts and subsequently face the consequences of litigation action.

Hirst et al. (2008) review different types of factors influencing MEF decisions, among which litigation risk is one factor reviewed. They argue

<sup>6</sup>The terms *management earnings guidance* and *management earnings forecasts* are used interchangeably in this thesis.

that litigation risk is an important factor influencing managers' information disclosure behavior. However, most of the studies they review are U.S.-based and related to whether or not preemptive disclosures triggers litigation action. While they note the importance of the legal and regulatory environment in influencing the disclosure decisions they do not consider research beyond the U.S. institutional setting.<sup>7</sup>

Following prominent corporate failures and concerns over corporate disclosure behaviour during the recent global financial crisis, market participants and regulators have begun to pay more attention to corporate disclosure transparency (see Freixas and Laux, 2012). As a consequence there have been regulatory reforms related to information disclosure in a number of jurisdictions (e.g. the U.K, Europe, Australia, New Zealand, Hong Kong, etc.). Following these reforms, litigation risk arising from misleading disclosure has become an increasingly important factor impacting on their earnings guidance behavior. Correspondingly, research on the impact of litigation risk on MEF disclosure behavior in countries outside the U.S. has also emerged in recent years. Given the important role this research can play in assessing transparency and governance and in providing guidance to market participant and regulators, it is an opportune time to offer some direction to researchers in this field.

With this motivation in mind, this review paper organizes prior studies of the impact of litigation risk on MEF decisions, and identifies a number of potential areas for future research. First, given the importance of timely and complete prospective disclosure in capital markets, researchers need to pay more attention to litigation risk in non-U.S. markets, and not merely dismiss this factor as one that is applicable only to the U.S. setting. Second, by examining how litigation risk influences MEF decisions outside the U.S, researchers may reach different conclusions from those that have been reported in U.S. studies due to differences in regulations, legal culture, and other institutional factors. Third, it is likely to be productive for researchers to pay more attention to the interactions of litigation risk and forecast specific factors or firm specific factors. Fourth, besides the MEF characteristics that has received much attention, the impact of litigation risk on other MEF attributes, such as MEF venue and attributions, are also likely to be rewarding areas for future research.

This study is organized as follows. First, litigation risk and different types of MEF decisions are explained. Then in the research review section, studies of how MEF decisions are influenced by litigation risk are reviewed. Finally a summary and suggestions for future research are provided in the last section.

## II. Explanations of Litigation Risk and MEF Decisions

Prior disclosure research generally measures litigation risk in two ways: the first is the probability of being sued, which is commonly used in U.S. studies primarily because of the large amount of disclosure-related shareholder lawsuits. The second involves the broader combination of both the legal and regulatory environment (the more common approach in non-U.S.-based research). The second approach can be attributed to the traditionally lower level of private shareholder lawsuits and greater reliance on enforcement action by regulators in those countries compared to the U.S.

The impact of both private and public enforcement action have not gone unnoticed in the MEF literature. Notably in the MEF research classification framework of Hirst *et al.* (2008), two categories of forecast antecedents are identified: the *forecast environment* and the *forecaster environment*. The legal and regulatory environment is classified under the forecast environment, and the risk of shareholder lawsuits (firm-specific litigation risk) is classified under the forecaster environment. These two measures are both related to litigation risk faced by firms, and it is difficult to clearly differentiate between them. Further, prior studies show the two measures often influence firms' disclosure decisions in the same direction. Therefore, in this study, the two measures are pooled under our broader definition of litigation risk.<sup>8</sup>

### Management Earnings Forecast Decisions

According to King *et al.* (1990), management earnings forecast decision is a sequential approach that involves two steps. First, managers decide whether to disclose an earnings forecast, and related to that decision, they decide on disclosure frequency, and subsequently, whether to update a forecast. Second, after deciding to issue a forecast,

<sup>7</sup> Hirst *et al.* (2008, footnote 6, p. 321) recognize that research could be extended to other jurisdictions: "We focus on the U.S. environment. However, the framework could be expanded to cover cross-border issues in other legal and regulatory regimes." They provide an example of a U.S. – Canadian study (by Baginski *et al.*, 2002).

<sup>8</sup> Our definition is consistent with the common definition of litigation risk: "The possibility that legal action will be taken because of an individual's or corporation's actions, inactions, products, services or other events" (Investopedia, 2012, available at: <http://www.investopedia.com/terms/l/litigation-risk.asp#ixzz25YfoRUaz>)

managers need to decide the properties (or attributes or characteristics) of their forecasts. These include forecast bias (or level of accuracy), horizon, precision, attributions, etc. As an antecedent to the disclosure decisions, the presence of litigation risk is likely to influence those decisions to varying degrees. The following provides an overview of the main MEF characteristics that are likely to be considered in the MEF framing decision.

**Forecast news type.** In prior research (Skinner, 1994; Soffer *et al.*, 2000) MEFs are usually classified as bad, neutral and good news, depending on whether they reveal unfavorable/neutral/favorable information compared to the current market earning expectation. In most U.S. studies the current market earnings expectation is measured relative to consensus analysts' earnings forecasts.

**Forecast accuracy.** In prior research (Dunstan *et al.*, 2011; Karamanou and Vafeas, 2005), the level of MEF accuracy usually includes directional forecast error (or bias) and non-directional forecast error (the magnitude of the error). The former tests whether MEFs are pessimistic or optimistic compared to the actual earnings and the latter tests the absolute forecast error. MEF accuracy is one of the forecast attributes that is of most concern to investors, because investors need to evaluate the credibility of the forecast in their investment decisions. While this can only occur *ex post* (i.e. after the realization of the forecasted earnings), prior evidence of accuracy is likely to impact on the credibility of an MEF when it is released. Some evidence supports this expectation (Rogers and Stocken, 2003).

**Forecast horizon.** MEF horizon commonly refers to the time between MEF issuance date and the end of the fiscal year (Ajinkya *et al.*, 2005; Baginski *et al.*, 2002). Those MEFs issued earlier are considered as timelier.

**Forecast precision.** Like MEF credibility, more precise MEFs can allow investors to be better informed about companies' future earnings (Karamanou and Vafeas, 2005). They enable investors to more accurately verify MEFs following future earnings realizations (Lev, 1992). Moreover, more precise MEFs indicate management is more certain about future earnings (Baginski *et al.*, 1993; Choiet *et al.*, 2010). MEFs are always classified in increasing precision or specificity levels as: qualitative, open-ended, range and point forecasts (Baginski *et al.*, 2002; Dunstan *et al.*, 2011).

**Routine and non-routine forecasts.** Following Gallery *et al.* (2003), Chan *et al.* (2007) and Dunstan *et al.* (2011), MEFs are classified as routine and non-routine MEFs. Routine MEFs are forecasts disclosed in periodic financial reports and other recurring events such as at the company's annual general meeting (AGM), letters to

shareholders, etc. MEFs issued in other announcements are classified as non-routine.

**Forecast venue.** Related to routine/non-routine classification, Bamber and Cheon (1998) classified MEFs as forecasts issued in special press releases, and forecasts issued in meetings with analysts and reporters. The former is more proactive and received by a larger audience, and the latter is more reactive with a restricted immediate audience.

### III. Review of the Key MEF Literature

#### *U.S –based MEF Research*

##### Forecast Likelihood/Frequency

There is a paucity of research directly focusing on the impact of litigation risk on MEF likelihood/frequency, and the mixed relationship between litigation risk and MEF likelihood/frequency is often included in the MEF likelihood/frequency models where litigation risk is only used as a control variable.

There are two types of contrary explanations for the impact of litigation risk on MEF likelihood/frequency: managers may be more likely to disclose earnings forecasts to avoid or reduce the litigation risk of withholding material earnings information, especially future earnings declines. On the other hand, managers may be less likely to disclose earnings predictions to avoid or reduce litigation risk that could arise from missing their forecasts, especially missing bad news forecasts. The research is inconclusive on which explanation dominates in managers' decisions.

Some studies (Ajinkya *et al.*, 2005; Brown *et al.*, 2005; Chen, 2004; Dai *et al.*, 2009; Hribar and Yang, 2010; Larocque, 2011) document companies with higher litigation risk are more likely to issue MEFs. Stoumbos and Tanlu (2009) find companies with higher litigation risk issue more MEF revisions. Additionally, Ajinkya *et al.* (2005) find managers are more likely to issue earnings forecasts in the U.S. after the issue of Reg. FD.<sup>9</sup> Also, Anilowski *et al.* (2007) find that earnings guidance and forecasting firms show a general increasing trend from 1994 to 2003, and they state that one reason may be the Reg. FD. Houston *et al.* (2008) document companies with higher litigation risk are more likely to cease quarterly earnings guidance, indicating that managers curtail short-term earnings forecasts to lower litigation risk. Lee (2009) finds a significantly negative relationship between litigation risk and MEF disclosure likelihood/frequency. Further, Rogers and Van

<sup>9</sup> Regulation FD (Regulation Fair Disclosure) was implemented by SEC (U.S. Securities and Exchange Commission) in August 2000. It mandated that all publicly traded companies must disclose material information to all investors at the same time.

Buskirk (2009) examine how management earnings forecast behavior change after being sued. They find the probability of a firm hosting an earnings-related conference call or disclosing MEFs decline following lawsuits, which is contrary to the full disclosure preferences of regulators or private litigants.

The influence of litigation risk on forecast likelihood/frequency is shown to vary between good and bad MEF news. There is much U.S. research focusing on the impact of litigation risk on bad news MEF disclosure, and the results are quite consistent. In the high litigious U.S. environment, firms are more likely to disclose bad news earnings predictions to avoid shareholder lawsuits for withholding bad news.

Skinner (1994) finds that because of an asymmetric loss (litigation and reputational costs) that arises in negative versus positive earnings surprises, managers in the U.S tend to disclose bad news MEFs more frequently to avoid negative earnings surprises. Similarly in more recent U.S. studies, Brown *et al.* (2005) find firms with higher litigation risk issue a larger proportion of bad news MEFs. Likewise, Field *et al.* (2005) document that firms with higher litigation risk are more likely to release earnings warnings. Additionally, Brown *et al.* (2005) find firms facing higher litigation risk are more likely to disclose forecasts when the market's expectations are unduly optimistic. Cao and Narayanamoorthy (2010) also argue that firms are more likely to be sued for withholding bad news, and firms may incur lawsuits if they announce good news MEFs but fail to achieve them. Accordingly, Cao and Narayanamoorthy find that firms with higher litigation risk are more likely to release bad news MEFs, and such firms release less news in good news periods.

### **MEF Accuracy**

Shareholders are more likely to be disappointed and sue companies when they find companies' actual earnings is lower than what they expect. Therefore, prior U.S research finds companies facing higher litigation risk are more likely to issue conservative MEFs. Skinner (1994) argues firms are more likely to be sued when there are negative earnings surprises at the earnings announcement date. Accordingly, Soffer *et al.* (2000) find U.S. firms in high-litigation industries are more likely to have positive earnings surprises at the earnings announcement date. This result indicates that firms facing higher litigation risk tend to be more conservatively biased when releasing MEFs. Further, Rogers and Stocken (2005) find weak evidence that managers who are more likely to face litigation, issue less optimistic forecasts. They also observe that managers' incentives to misrepresent information caused by the threat of litigation are

influenced by the difficulty market participants face in detecting the misrepresentation.

In a more recent study focusing on MEF bias, Ciconteet *al.* (2012) examine the forecast bias of range MEFs (whether the midpoint is a good proxy for management earnings expectations in range forecasts), and whether forecast bias of range forecasts changed after Reg. FD. They argue that after Reg. FD managers are not allowed to communicate with analysts privately, so they can only influence analyst earnings forecasts through public guidance. Therefore, they find an increased strategic use of range forecasts to walk down analysts' earnings expectations after Reg. FD, that is, managers are more pessimistic and true earnings expectations are more likely to be close to the upper bound of range forecasts after Reg. FD. These findings open up a new avenue for further MEF/litigation risk research.

There is little research directly examining the impact of litigation risk on absolute MEF error and the inconsistent results are only found when testing MEF accuracy models where litigation risk is used as a control variable. Companies facing higher litigation risk may issue more accurate MEFs to avoid the litigation risk of missing MEFs. However, the results regarding the relationship between litigation risk and MEF accuracy is inconsistent. Fang (2009) and Stoumbos and Tanlu (2009) find firms facing higher litigation risk issue earnings forecasts with larger forecast errors. Similarly, Hribar and Yang (2010) find companies with higher litigation risk are more likely to miss their MEFs. In contrast, Baik *et al.* (2010) document companies with higher litigation risk issue more accurate MEFs. Consistent with the asymmetric loss function, the impact of litigation risk on forecast accuracy varies between good and bad news forecasts. Brown *et al.* (2005) find firms with higher litigation risk release a larger proportion of the total news when preempting negative earnings surprises than when preempting positive earnings surprises. They attribute this behaviour to a desire to decrease the probability of shareholder lawsuits that are more likely to arise following negative earnings surprises.

### **MEF Horizon**

MEF horizon is related to the timeliness of MEFs (those disclosed earlier are regarded as more timely). Timely forecasts are considered desirable in capital markets, because manager have less information and face more uncertainty with earlier forecasts. However, those that are issued earlier (i.e. with a longer horizon) are more likely to be proven inaccurate *ex post*. As a consequence, companies are more likely to be sued when they miss a forecast issued earlier in the forecast horizon. On the other hand, disclosing bad news

forecasts earlier can help firms defend the charges that they failed to disclose earnings warnings in a timely manner. Also, issuing MEFs earlier can mitigate the potential liability as the class period typically ends on the MEF release date (Francis *et al.*, 1994; Skinner, 1994, 1997). Therefore, it is difficult to reach a conclusion regarding how litigation risk impacts on MEF horizon.

In the empirical studies, Brown *et al.* (2005) find that companies with higher litigation risk issue their MEFs earlier for both good and bad news. Cao and Narayanamoorthy (2010) document firms with higher litigation risk release bad news MEFs earlier. However, when examining changes in disclosure behaviour of firms involved in disclosure related class-actions, Rogers and Van Buskirk (2009) find after being sued, firms tend to disclose less timely MEFs, which is contrary to the goals of regulators or private litigants.

### **MEF Precision**

There are two contrary explanations regarding the impact of litigation risk on MEF precision. On one hand, companies with higher litigation risk may issue less precise MEFs to reduce the litigation risk of missing forecasts, especially bad news forecasts. On the other hand, companies with higher litigation risk may issue more precise MEFs to avoid subsequent accusations of providing insufficiently precise information about firms' future earnings expectations.

Inconsistent results regarding the relationship between litigation risk and MEF precision are found in prior research. From a forecast precision (or specificity) perspective, Bamber and Cheon (1998) argue less precise MEFs are more likely to be proven accurate *ex post*. Accordingly, they find that the greater the exposure to legal liability, the less likely managers issue precise earnings forecasts. In contrast, Brown *et al.* (2005) document companies with higher litigation risk tend to issue more point MEFs (precise forecasts) relative to range forecasts.

Consistent with the Bamber and Cheon's argument more recent studies support the inverse relation between litigation risk and forecast precision. For example, Dai *et al.* (2009) find companies with a higher likelihood of exposure to shareholder lawsuits are more likely to disclose qualitative MEFs. Similarly, Rogers and Van Buskirk (2009) find firms move towards less precise MEFs after being sued. Consistent with litigation risk concerns, Choi *et al.* (2010) also find that when forecast uncertainty is greater, managers issue less precise earnings forecasts. Likewise, Hribar and Yang (2010) find companies with higher litigation risk issue less precise MEFs.

It is important to note that the impact of litigation risk on MEF precision varies between

good and bad news forecasts, but the results are inconsistent. On one hand, Skinner (1994) finds that among the MEFs examined in his study, good news forecasts tend to be point or range forecasts, and bad news forecasts tend to be qualitative forecasts. That is probably because bad news forecasts are considered as more credible by the markets. Therefore, firms obtain no additional benefits from issuing more precise MEFs, and also because they may face higher litigation costs if they issue more precise MEFs which are more likely to be proven inaccurate *ex-post* (Brown *et al.*, 2005). However, on the other hand, Brown *et al.* (2005) also argue firms with higher litigation risk may issue more precise bad news MEFs to bolster their defence against the charges that they deliberately withheld material information. Cao and Narayanamoorthy (2010) state that firms with higher litigation risk release less precise good news forecasts to avoid or mitigate shareholder lawsuits related to negative earnings surprises. Accordingly, Cao and Narayanamoorthy (2010) find that firms with higher litigation risk tend to issue more precise MEFs when they have bad news, but issue less precise good news forecasts.

### **Forecast Venue**

Bamber and Cheon (1998) examine forecast venue and specificity for a sample of U.S. firms. They use the trend of firms' earnings performance as one of the measures of firm's legal liability costs, and they argue firms with declining earnings are exposed to more legal liability. Accordingly, they find companies with declining earnings are more likely to issue MEFs in special press releases, suggesting companies with higher litigation risk tend to proactively issue forecasts in more open contexts to reduce potential litigation costs.

### **Non-U.S.-based MEF Research**

Although most MEF studies are U.S.-based, there is an emerging body of MEF research based in non-U.S. settings. Because of the lower levels of shareholder lawsuits in those countries, most of the non-U.S. research examines the impact of the domestic public regulatory environment on MEF disclosure behavior.

In an early study comparing differences in legal regimes, Baginski *et al.* (2002) contrast earnings forecasts issued by Canadian managers with those issued by their U.S. counterparts. They find that Canadian managers issue more frequent, more precise and timelier earnings forecasts as Canadian managers face lower legal penalties related to inaccurate forecasts. They also find Canadian managers issue more forecasts when earnings increase; a result that Baginski *et al.* also

attribute to lower litigation risk faced by Canadian managers following earnings disappointments.

Extending Baginski *et al.* (2002), Tinaikar (2008) compares MEF characteristics of Canadian and U.S. firms, and finds that Canadian firms' MEFs are more precise. He also finds Canadian firms' MEFs are more optimistic compared to those of U.S. firms. Consistent with Baginski *et al.*, Tinaikar attributes the difference to the higher litigation risk in the U.S. than in Canada.

Similar to Canada, the U.K. has traditionally been a less litigious country than the U.S. Prior to 1994 U.K. regulations did have specifically restrict private disclosure of corporate information. However, the situation changed in 1994 when the London Stock Exchange introduced new guidance regarding the immediate public disclosure of price sensitive information. In a study of corporate earnings warnings (bad news MEFs) before and after the 1994 regulatory change, Helbok and Walker (2003) find the frequency, precision and timeliness improved in the recent regulated period.

Jong *et al.* (2012) examine the impact of cross-listings in the US or UK on the attributes of MEFs by Dutch firms. Listed firms are exposed to a stricter legal environment, greater disclosure requirements and additional scrutiny. Consistent with litigation risk arguments, they find the cross-listed firms disclose forecasts that are less specific, more accurate and more conservative.

In Japan disclosure of MEFs is effectively mandated by the Securities Listing Regulations of the Tokyo Stock Exchange (TSE) (Kato *et al.*, 2009). Although there is no statutory backing to the TSE's continuous disclosure rules, the listing rules encourage companies to disclose sales and earnings forecasts regularly at the beginning of each financial reporting year, and according to *Rule 405 of Securities Listing Regulations*, a listed company must immediately disclose details of any material variation from forecasts. Their evidence suggests that most companies comply with continuous disclosure rules (Kato *et al.*, 2009). Nevertheless Kato *et al.* (2009) note that the Japanese setting is one in which litigation risk associated with providing biased forecasts is relatively low. Consistent with this low level of litigation risk, they find the initial MEFs are systematically optimistic, but interestingly, managers revise their forecasts downward across the fiscal year to avoid negative earnings surprises at the end of the financial year.

Over the past two decades Australia and New Zealand have undergone a series of regulatory reforms related to continuous disclosure. As a result, both jurisdictions have provided fruitful environments for observing the impact of the regulatory reforms on corporate disclosure behaviour. In one early study, Brown *et al.* (1999) examine the effect of statutory sanctions on companies' voluntary disclosures issued by ASX-

listed companies from 1992 to 1996. Their results indicate that any increase in voluntary disclosure from the introduction of statutory sanctions had little impact as most of the improvement was confined to smaller firms and firms that performed relatively poorly.

In a later study Chan *et al.* (2007) examine MEFs issued by ASX-listed companies from 1994 to 2001 to test the impact of the 2000 legislative changes and increased enforcement action introduced to strengthen the continuous disclosure regime. In contrast to Brown *et al.* (1999) they find after 2000, there was an increase in the disclosure of non-routine MEFs consisting largely of increases in bad news forecasts. In other words, after the regulatory reforms, companies were more likely to disclose material changes in earnings expectations in non-routine announcements, rather than waiting to release the information at a routine event such as an AGM. Consistent with the findings of Skinner (1994) they attribute this change in behavior to the increase in litigation risk arising from the regulatory reforms. Interestingly, Chan *et al.* (2007) also find MEF precision has improved after the regulatory reform.

The regulatory reforms associated with the continuous disclosure regime in New Zealand are similar to the reforms in Australia, but comparatively later. These reforms introduced in 2002 are not as onerous as those observed in Australia, and in contrast with the Australian reforms, were not accompanied by an increase in private class actions. In a key study, Dunstan *et al.* (2011) explore the MEF impact of the New Zealand's continuous disclosure regulatory reforms for a sample of most of the NZX-listed companies over the 1999 to 2005 period. They find MEF frequency, accuracy, non-routine MEF disclosure, and precision have improved after the reforms. From these findings they infer that public regulatory reforms may have a greater benefit in a low private litigation environment like New Zealand.

#### IV. Summaries and Conclusions

Litigation risk is an important factor influencing MEF decisions, and there are numerous U.S. studies related to this topic. In recent years non-U.S. studies have emerged following regulatory reforms which aim to enhance corporations' disclosure transparency. As the number of disclosure studies on this topic in other countries increases they provide new insights into the impact of litigation risk on the behavior of managers in their disclosure of prospective information. These new insights offer a number of potential productive topics for future research.

First, from the studies reviewed it is obvious that litigation risk is an important factor influencing

MEF decisions. However, except for Skinner (1994), and Cao and Narayanamoorthy (2010), most studies reviewed take litigation risk as an afterthought (i.e. as a control variable in a prediction regression model). Thus the impact of litigation risk on MEFs has not been explored and explained comprehensively beyond the initial decision to disclose or not to disclose. Therefore, it is likely to be productive for researchers to focus more effort on understanding how litigation risk shapes MEF characteristics.

Second, much research on the impact of litigation risk on MEF decisions is U.S.-based. However, from the small amount of related research in other countries (such as the Australia and New Zealand studies), it seems that the impact of litigation risk in similar MEF decisions differs from those encountered in U.S. research. Therefore, it would be useful to explore why an increase in litigation risk does not lead to similar outcomes across jurisdictions. Also, a related and potential fruitful area of research would be to investigate how regulatory enforcement by the public regulatory authorities differs and interacts with the growth in private litigation action.

Further, all the studies reviewed here are based on companies in developed countries, and there is a dearth of research in developing countries (or emerging markets). In many developing countries, disclosure transparency and the related legal environment are not as advanced as those of developed countries. However, due to growing demands of investors, listed companies are under increasing pressure to provide more transparent disclosure of prospects when raising funds in international capital markets. Therefore, it is likely that companies, market participants and governments in developing countries will increasingly pay more attention to global developments in information disclosure and its associated governance.

For example, in most countries MEFs are voluntary disclosures, but in China a part of earnings pre-announcements are compulsory. From 2002, Chinese stock exchanges require companies which turn a loss (profit) to profit (loss), and with earnings decreasing/increasing by more than 50 per cent issue to earnings pre-announcements in routine or non-routine reports. However, there is still no statutory support for such rules, and related shareholder lawsuits are very rare. Therefore, there is a pressing need to strengthen the legal environment for disclosure in developing countries, such as China, to improve the quality of prospective disclosure, including MEFs. As these changes emerge they offer interesting avenues for disclosure research in developing countries.

Third, a potential productive area for future research is the interaction between litigation risk and forecast specific characteristics or firm specific

characteristics. Some researchers (Baginski *et al.*, 2002; Brown *et al.*, 2005; Rogers and Stocken, 2005) have done some work in this area. For example, Rogers and Stocken (2005) find managers' incentives to bias their earnings forecasts due to litigation risk are affected by the difficulty the market has when assessing forecast credibility. Therefore, researchers should exploit the opportunity to examine whether the impact of litigation risk on management forecast behavior is affected by forecast or firm specific characteristics.

Fourth, much research on the impact of litigation risk on MEF decisions focuses on forecast frequency/likelihood, forecast news type, forecast bias, horizon and precision. However, the influence of litigation risk on other characteristics (e.g. absolute forecast error, forecast venue, forecast attributions, etc.) has not received much attention. It would be useful for future research to explore a broader range of MEF attributes when examining the impact of litigation risk on corporate disclosure behaviour.

With the rapid adoption of new technologies and internationalization of capital markets, market participants and corporate regulators will increasingly demand timelier and more frequent prospective disclosures. A pervasive example is management earnings guidance. As managers attempt to meet these demands they will increasingly face private and public litigation risk. However, as this review has revealed, the research on the link between prospective disclosure and litigation risk is still in its infancy. In this review we have suggested number areas where this link can be productively investigated to better inform the governance of capital markets.

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