

Do False Financial Statements Distort Peer Firms' Decisions?



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The Accounting Review (2016) 91 (1): 251–278.

<https://doi.org/10.2308/accr-51096>

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ABSTRACT

Beatty, Liao, and Wu (2013) document that financial misreporting by prominent firms distorts peer firms' capital investment decisions. Using a large sample of firms subject to SEC and DOJ enforcement actions for accounting misstatements, I establish three important generalizations. First, the adverse effect of financial misstatements documented by **Beatty et al. (2013)** is not limited to high-profile scandals and can be generalized to a larger population. Second, the distortions are not confined to capital investments; they also extend to choices peer firms make with respect to R&D, advertising, and pricing policies—decisions with immediate bottom-line impact. Third, I document that the magnitude of the distortion varies predictably with peer firms' characteristics, the misstating firms' external information environment, and the industry-specific information environment within which the misstatement occurs. Specifically, I find smaller distortions for larger peers and peers managed by more able managers, and larger distortions for more widely followed misstating firms and in the industries in which more firms misstate. Collectively, my results suggest that the distortive effect of financial misstatements is larger and more pervasive than documented in prior research.

Keywords: peer firms, financial misstatements, financial misreporting, operating decisions

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