Judicial Precedents on GAAP Violations, Litigation Risk and Misreporting*

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Abstract

We study judicial precedents on accounting violations and examine its effects on firms' litigation risk and financial misreporting. Using a sample of 119 circuit court rulings on alleged violations of Generally Accepted Accounting Principles (GAAP) from 1996 to 2018, we document that court variations in their standard to dismiss such cases, i.e., their leniency toward GAAP violations, affect decisions in district courts under their jurisdiction. Specifically, district courts are more likely to dismiss pending cases when circuit courts set a lenient precedent. Furthermore, we find that shareholders are less likely to sue misstating firms that reside in more lenient circuits and that firms in these circuits have a higher tendency to misreport. These findings are consistent with a weaker deterrence effect of securities litigation in lenient circuits. We conclude that circuit court precedents induce within-country heterogeneity in private enforcement of securities laws and affect firms' financial reporting quality.

JEL-Classification: K22, K40, M41
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1 Introduction

Capital markets cannot function without the support from the underlying legal system. Effective legal protection of outside investors limits expropriation by corporate insiders, reduces incentives for financial misreporting and facilitates the development of capital markets (La Porta et al., 1997, 1998; Leuz et al., 2003; La Porta et al., 2008). In the case law tradition, the ability of securities litigation to protect investors depends critically on judicial precedents. Following the doctrine of stare decisis, which means "to stand by decided matters," courts have to apply the principles and rules established in prior rulings (Shapiro, 1972; Landes and Posner, 1976; Aldisert, 1989; Niblett et al., 2010).[1] Thus, precedents are part of the law. In case law countries with multiple jurisdictions, each court builds precedents based on its own cases, creating divergent judicial interpretations of the same law (Landes and Posner, 1976; Gennaioli and Shleifer, 2007; Niblett et al., 2010). In this paper, we exploit the variation in U.S. circuit court rulings to study how case-law precedents affect shareholder litigation and financial misreporting.

Securities class action lawsuits are an important means for outside investors to discipline managers for financial misreporting (Coffee Jr., 2006; Mahoney, 2009; Bai et al., 2010; Cheng et al., 2010). However, their well-functioning depends critically on how courts define meritorious lawsuits in the past, especially in cases alleging violations of Generally Accepted Accounting Principles (GAAP, hereafter) (Choi, 2007). When courts have been too lenient on defendant firms' misreporting practices, i.e., courts easily dismiss cases, shareholder litigation can become inconsequential and loses its ability to deter misreporting (Pritchard and Sale, 2005; Choi, 2007; Choi et al., 2009). In contrast, when courts have been too hostile to defendant firms, i.e., courts hardly dismiss cases, frivolous lawsuits can prevail and solicit monetary settlements from potentially innocent firms (Bernstein, 2015). As cases have different factual dimensions, and random factors such as the case sequence affect case outcomes (Leibovitch, 2016), the collection of prior rulings differs across jurisdictions in a country. Each jurisdiction's precedents undergo an idiosyncratic and path-dependent

[1] As explained by a circuit court, "[a] judicial precedent attaches a specific legal consequence to a detailed set of facts in an adjudged case or judicial decision, which is then considered as furnishing the rule for the determination of a subsequent case involving identical or similar material facts and arising in the same court or a lower court in the judicial hierarchy. " (Allegheny County Gen. Hosp. v. NLRB, 608 F.2d 965, 969-70, 3rd Cir. 1979).

evolution (Gennaioli and Shleifer, 2007).[2] This implies that courts from different jurisdictions may rule differently in cases with similar alleged misconduct.

We exploit both the cross-sectional and time-series variations in precedents on GAAP violations and analyze their impact on litigation risk and firms' financial reporting. Our paper joins recent research in accounting and finance that study the consequence of court rulings. These studies typically examine only a single court ruling in the Supreme court or circuit courts, such as In re Dura Pharmaceuticals or In re Silicon Graphics (Bliss et al., 2018; Hopkins, 2018; Huang et al., 2020; Houston et al., 2019).[3] While some rulings are undeniably influential, it is the collection of precedents that defines firms' litigation risk. In addition, findings based on one ruling may not be generalizable because each ruling covers specific facts that may not apply to other cases. Whether the collection of accounting-related precedents as an important part of the case law system affects firms' litigation environment and financial reporting remains unanswered.

The U.S. federal court jurisdictions are divided geographically into 12 circuits, with 94 districts residing underneath them. We therefore begin with collecting circuit and district court rulings on securities litigation and case citations between 1996 and 2018 from the Google Scholar Case Law Search.[4] We first confirm that circuit court precedents affect firms' expected litigation risk. Following the doctrine of hierarchical precedents (Caminker, 1993, 1994), a circuit court's precedents are binding for itself and its lower district courts and thus, shape firms' litigation risk in its jurisdiction (Shapiro, 1972; Perino, 2006). To demonstrate the effect, we examine district court citation patterns of circuit court precedents and the effect of such precedents on case outcomes.

We document that district courts are around five times more likely to cite precedents from their home circuits than from other circuits, and that district court rulings in GAAP violation cases are more than twice as likely to cite GAAP precedents than non-GAAP precedents. We also examine how precedents affect district court decisions. To address the endogeneity concern, i.e., existing circuit court precedents may affect plaintiffs' decision to file a new lawsuit, we test how circuit court precedents that arrive after the lawsuit filing affect the outcome at the district court. We

[2]See Section 2.2 for examples of diverging precedents in securities class action lawsuits.

[3]Other studies have also used Supreme Court rulings such as Tellabs, and Australia National Bank (Huang et al., 2019; Licht et al., 2018).

[4]See Appendix C for a detailed description of the data collection of court rulings from Google Scholar.

find that a district court is 3.04% more (3.03% less) likely to dismiss a lawsuit when its circuit court establishing new precedents by affirming (reversing) one more dismissal decision during the lawsuit's pending period. These findings provide direct evidence that district court judges refer to relevant precedents in their deliberation and adhere to the precedents when deciding cases, consistent with circuit court precedents determining firms' litigation risk.

Next, we measure each circuit court's leniency toward misreporting at a point in time by the proportion of the most recent five[5] shareholder lawsuits on GAAP violations that are dismissed (*Lenient GAAP Precedents*) and examine how it affects firms' litigation risk. We find that while restating firms are sued more often, consistent with restatements being hard evidence of securities fraud (Choi, 2007; Johnson et al., 2007), this association is significantly weaker in circuits with more lenient GAAP precedents, i.e., dismissing more GAAP violation cases in the past. A one standard deviation increase in *Lenient GAAP Precedents* results in a 13.6% reduction in the odds of litigation against a restating firm, with the probability of litigation conditional on restatement declining from 16.53% to 14.29%. There is no such moderating effect of non-GAAP precedents, which mitigates concerns that our results are driven by a general trend in court rulings.

We conduct three cross-sectional tests to provide additional evidence for when precedents are more important. We find that the effect is stronger when potential lead plaintiffs are more sophisticated and are thus more capable to incorporate court precedents in their filing decisions. Moreover, precedents' affect plaintiffs' filings decisions more when expected lawsuit payoffs from potential lawsuits are higher, e.g., when potential defendants carry a higher ex-ante litigation risk or exhibit more incentives to intentionally misreport.

Precedents might affect firms' incentive to misstate not only through their own litigation risk but also through auditors' litigation exposure. Plaintiffs can name auditors as co-defendants in shareholder lawsuits, which makes them exposed to the effect of precedents. We therefore investigate whether GAAP precedents change auditors' litigation risk when firms misstated. We find that conditional on shareholder lawsuits associated with restatements, plaintiffs are less likely to name

[5]Our results are not dependent on this design choice of our measure. In robustness tests, we alternatively use the full history of rulings after the PSLRA in each circuit and find similar results (see Internet Appendix Tables IA1, IA2, and IA3).

the auditor as a co-defendant in circuits with more lenient GAAP precedents. Overall, our results suggest that GAAP precedents affect both firms' and auditors' litigation risk.

Last, we investigate how the variation in litigation risk induced by court precedents affect firms' likelihood of a misstatement. We conjecture and find that the diminished deterrence of securities litigation resulting from lenient GAAP precedents emboldens companies to misreport. In terms of economic magnitude, a one-standard-deviation increase in *Lenient GAAP Precedents* in a circuit increases the odds of restatement by an average firm in the circuit by 3.2%, with the unconditional probability increasing from 9.66% to 9.97%. Again, non-GAAP precedents do not affect misreporting.

Our paper makes several contributions to the literature. First, it adds to the law and finance literature on how the common law tradition facilitates capital market development through its effect on private litigation and financial reporting quality (La Porta et al., 1997; Leuz et al., 2003; Srinivasan et al., 2015). Prior studies mostly rely on cross-country differences to identify how legal origins and private enforcement affect capital markets and firm behavior.[6] We show that even within one country and under the same statutory law, variations in judicial precedents across geographic jurisdictions can lead to differences in private enforcement of securities laws and financial reporting.

Second, our work extends accounting research on the impact of court rulings on financial reporting. Prior literature uses single court rulings, such as In re Silicon Graphics in the Ninth Circuit, and Tellabs Inc. in the Supreme Court, as an instrument to study the effect of litigation risk (Crane and Koch, 2016; Cazier et al., 2017; Hopkins, 2018; Huang et al., 2020; Houston et al., 2019). However, single rulings may not be representative and empirical results using one case may be confounded by contemporaneous events (Markham, 2015). For example, Hopkins (2018) admits that the In re Silicon Graphics ruling by the Ninth Circuit "came at a time (1999) and place (western United States) at the center of the internet bubble that was about to face a significant economic decline." Moreover, an implicit assumption in single-circuit-ruling studies is that other circuits do not experience any concurrent change in litigation risk during the same period, which

[6]One exception is Filip et al. (2015) who use a Canadian setting and study within-country variation of common law — civil law tradition, and find that French civil law environment appears to encourage firms to publish accounting data of better quality due to the higher legal liability of directors and auditors in that regime.

usually does not hold in reality.[7] Our results are more generalizable because we do not rely on this assumption and instead measure relevant precedents in each circuit throughout a period of about two decades. Our study, which uses aggregated precedents relevant to financial reporting, provides a comprehensive picture of how courts diverge in their leniency toward accounting violations over time and its implications on firms' misreporting.

Last, our study contributes to the understanding of the legal environment following the Private Securities Litigation Reform Act (PSLRA, hereafter) in 1995 (Choi, 2007; Johnson et al., 2007). Since its passage, researchers have evaluated its economic consequences using market reactions to legislative events (Johnson et al., 2000; Ali and Kallapur, 2001), changes in firms' forward-looking disclosure (Johnson et al., 2001), allegations in lawsuit complaints (Johnson et al., 2007), and litigation outcomes (Choi, 2007). We add to this strand of literature by highlighting that a law's effect depends critically on its subsequent judicial interpretations, which has implications for investors and regulators because courts' diverging precedents results in firms having different litigation risks and likelihoods of misreporting across circuits even under the same statutory law.

2 Background and hypotheses development

2.1 The role of judicial precedents under case law

Under the case law, judicial precedents set by prior rulings are a main source of the law. The doctrine of *stare decisis* commands judges to apply the law as in previous cases (Shapiro, 1972; Landes and Posner, 1976; Aldisert, 1989; Niblett et al., 2010). Specifically, when judges interpret applicable statutes and decide a case, they draw an analogy between the current case and relevant precedents, following the same principles and rules as established in prior rulings (Carpenter, 1917; Schauer, 1987; Che and Yi, 1993; Cross, 2003; Lamond, 2006).[8] Although non-legal factors, such as judges' political ideology (Epstein and Knight, 1998; Zorn and Bowie, 2010; Huang et al., 2019)

[7] For instance, in 1999, the year of In re Silicon Graphics Inc. in the 9th Circuit, other circuits also ruled on several significant accounting cases. The 1st Circuit ruled on Greebel v. FTP Software, Inc., the 2nd Circuit Stevelman v. Alias Research Inc., and the 6th Cir. In re Comshare Inc. Securities Litigation. Also, see our discussion of court precedents in Section 3.

[8] When there are multiple precedents, courts should refer to the ones they deem most relevant to the case (Lindquist and Cross, 2005).

and pragmatism (Cardozo and Kaufman, 2010; Posner, 2008), can also affect judicial decision-making, very few legal scholars would question the significant role of judicial precedents (Cross, 2003; Lindquist and Klein, 2006; Epstein and Knight, 2013). Indeed, deviating from existing precedents imposes costs on judges, such as reputation cost or a reversal by a higher court (Miceli and Coşgel, 1994; Shapiro and Levy, 1994; Gulati and McCauliff, 1998). Landes and Posner (1976) further argue that when judges refuse to follow existing precedents, they undermine the precedential weight of their own decisions.

In a country with multiple territorial jurisdictions, courts in each jurisdiction develop precedents based on the cases arriving at their benches. As facts are different in each case and random factors, such as case sequences or even judges' emotional state, affect case outcomes (Leibovitch, 2016; Eren and Mocan, 2018), precedents can diverge toward different equilibria across jurisdictions over time. Numerous legal studies have therefore argued that judicial precedents develop in an idiosyncratic and path-dependent fashion (Holmes Jr, 1987; Easterbrook, 1988; Kornhauser, 1992; Hathaway, 2003; Niblett et al., 2010; Niblett, 2013).

The U.S. federal court jurisdictions consist of three levels. At the lowest level, there are 94 districts divided geographically, each with a United States District Court (USDC), i.e., the trial court, that exercises original (first instance) jurisdiction. The second level include the 12 United States Court of Appeals (the circuit courts) that exercise appellate jurisdiction, i.e., to review, amend, and overrule decisions of the district courts. At the top is the Supreme Court of the United States (SCOTUS) that exercises discretionary jurisdiction. Following the doctrine of hierarchical precedents (Caminker, 1993, 1994), a circuit court's precedents are binding for both itself and the district courts under its jurisdiction (Shapiro, 1972; Perino, 2006). As a result, in addition to the statutory law and Supreme Court decisions, each circuit has its own set of binding precedents that its district courts need to follow in subsequent cases.[9]

[9] Although the Supreme Court can, to some extent, harmonize circuit splits (Bruhl, 2014), it does not eliminate them. As an example, after the Supreme Court ruled on Tellabs and directed all federal courts to apply a holistic approach to review all the facts collectively when testing allegations for scienter, circuit courts only superficially adopted the Tellabs decision, and disguised their pre-Tellabs tests within the holistic review (Gorman, 2009; Su, 2011).

2.2 Judicial precedents and securities class action lawsuits

Securities class action lawsuits are a major enforcement mechanism of securities laws and play a crucial role in deterring misreporting in the U.S. (Mahoney, 2009; Hopkins, 2018). The Securities and Exchange Commission (SEC) views private litigation as "a necessary supplement to the Commission's own enforcement efforts, act as a deterrent against securities fraud, and provide a mechanism for defrauded investors to obtain damages" (Walker and Seymour, 1998). The Supreme Court notes that "[j]udicial interpretations and application, legislative acquiescence, and the passage of time has removed any doubt that a private cause of action [...] constitutes an essential tool for enforcement of the 1934 Act's requirements"(Basic, Inc. v. Levinson, 1988).[10] Like other types of enforcement, the deterrence of securities class action litigation varies with its punishment (Becker, 1968). Thus, its well-functioning critically depends on the existing precedents that define the financial reporting practices that are unlawful and allow for lawsuits to recover damages.

In 1995, the 104th U.S. Congress passed the Private Securities Litigation Reform Act (PSLRA), which introduces a new pleading standard for shareholder litigation (e.g., (Choi, 2007; Johnson et al., 2007). Under the new regime, for a lawsuit to survive a motion to dismiss—the most important procedural hurdle—plaintiffs must adequately allege that the defendant acted with "scienter," i.e., the intent to deceive. [11] However, Congress did not specifically define what constitutes scienter and left it to the courts to develop their own pleading standards Walker and Seymour (1998). As a result, the outcomes of securities class action lawsuits depend critically on how courts define scienter after the PSLRA (Pritchard and Sale, 2005).

Some plaintiff lawyers attempt to satisfy the new pleading standard by alleging a violation of accounting principles (Thompson and Sale, 2003; Pritchard and Sale, 2005). Specifically, plaintiffs claim that the firm and its management have intentionally misled the market when providing a financial report that violated GAAP. Indeed, legal scholars argue that the misstatement of a finan-

[10]The Supreme Court repeats similar words in more recent rulings, such as Dura Pharmaceuticals, Inc. v. Broudo (2005) and Tellabs, Inc. v. Makor Issues & Rights, Ltd. (2007).

[11]Lawsuits that are not dismissed invariably settle before trial (Pritchard and Sale, 2005). Prior studies usually define a case as successful for the plaintiffs if it is not dismissed (Johnson et al., 2007; Kempf and Spalt, 2019). Dismissal decisions are important because the PSLRA's stay on discovery provision prevents plaintiffs from engaging in discovery, the costliest part of litigation for defendants (Choi and Pritchard, 2012), until after the case survives the motion to dismiss (Sale, 1998).

cial report constitutes "hard evidence" and meets the standards for securities fraud of misleading investors (Pritchard and Sale, 2005; Choi, 2007; Choi et al., 2009). However, some circuit courts disagree with this argument and have regularly dismissed cases against misstating defendant firms.[12] In effect, these circuits have established precedents that are more lenient on GAAP violations. We expect that investors understand the implications of judicial precedents and sue misstating firms less often when the circuit court with jurisdiction has set more lenient precedents.

However, each securities lawsuit can be different and include case-specific facts that affect courts' judgment of whether they pass the pleading standard. Just because a circuit court has dismissed some cases alleging financial misstatements in the past does not necessarily mean it will do the same in all future financial misstatement cases. While deviating from existing precedents imposes costs on judges, they can still choose not to follow the precedents, arguing that the facts are not similar and have to be ruled differently as a result. Moreover, it is possible that plaintiffs always sue when there is hard evidence such as misstatements Choi (2007), and thus precedents would not affect firms' litigation likelihood. Therefore, whether the differences in dismissal rates in prior court rulings across circuits translate into economically meaningful variation in litigation risk is an empirical question we test in this paper. We formally state our hypothesis as follows:

Hypothesis 1: *Firms with financial misstatements are less likely to be sued when the Court of Appeals in the firm's headquarter circuit builds judicial precedent more lenient on GAAP violations.*

Our first hypothesis implies that firms can expect lower litigation costs of financial misreporting in circuits with histories more lenient on GAAP violations. Precedents may not only affect firms' incentive to misstate via investors' lawsuit filing decisions against a firm but also through auditors' litigation exposure by being named co-defendants in securities class action lawsuits. In lenient circuits, courts are less likely to accept GAAP violations as sufficient grounds for scienter, which also makes it more difficult for plaintiffs to argue for auditor liability. In response, auditors have

[12] In Appendix D, we provide the excerpt of two court rulings, Greebel v. FTP Software Inc. (1st Cir., 1999) and In re Comshare Inc. Securities Litigation (6th Cir., 1999). In both cases, the circuit court ruled that investors did not meet the pleading standard of the PSLRA and failed to plead securities fraud claims based on GAAP violation allegations. The courts do not always rule against accounting claims. In the same Appendix D, we also provide the excerpt of a court ruling, Novak v. Kasaks (2nd Cir., 2000), where the Second Circuit ruled that investors successfully alleged GAAP violation claims against defendant firms.

fewer incentives to exercise due care when checking firms' financial reports. Assuming that firms understand the effect of lenient precedents on their own and the auditors' litigation risk, they should be more willing to commit financial misreporting when their circuit has a more lenient precedent, all else equal. Our second hypothesis is:

Hypothesis 2: *A firm is more likely to commit financial misreporting when the Court of Appeals in the firm's headquarter circuit builds judicial precedent more lenient on GAAP violations.*

3 Empirical measurement of circuit court precedents and their effect on district court rulings

3.1 Circuit court rulings data

We obtain the full text of relevant circuit court rulings between January 1996 and May 2018 from Google Scholar Case Law Search. Our sample starts with 1996 because Congress passed the PSLRA, which codifies the new pleading standard, in November 1995.[13]

As summarized by Panel A of Table 1, we first search for keywords related to securities class action lawsuits, including "In re securities litigation," "securities litigation GAAP," and "securities litigation PSLRA," in the Circuit Court of Appeals rulings provided by Google Scholar. From the initial 2,024 circuit court rulings, we remove 975 rulings that do not involve Rule 10b(5) securities fraud and 211 rulings that are non-class-action.[14] To focus on rulings where the circuit courts interpret the pleading standard, we keep cases in which the original district court decision was a dismissal and that the circuit court decision is either to affirm or to reverse the district court decision, removing 226 cases.[15] For cases with more than one ruling, we keep the one with the highest citation and delete 133 duplicates. Lastly, we exclude 47 circuit court rulings that have no

[13]Two other databases we require in our main tests, namely the Securities Class Action Clearinghouse and Audit Analytics, also start their coverage in 1996.

[14]Certain non-class-action securities fraud cases could involve the SEC suing the corporate and/or its executives or the DOJ indictment.

[15]The majority of appeals to the circuit courts in securities class action lawsuits are related to dismissal decisions. In rare cases, certain individuals or a group of investors appeal to the circuit court to challenge the district court's settlement approval decision. We do not include these cases because they do not involve the pleading standards.

citations because they have little impact on subsequent case.[16] Details of our procedure, including the list of keywords, case selection criteria, and processing, are provided in Appendix C. Our final sample includes 432 circuit court rulings.

[Insert Table 1 Around Here]

Next, to identify the relevant precedents for firms' financial reporting practices, we separate circuit court rulings into two groups based on whether or not the underlying case alleges a GAAP violation. We classify a circuit court ruling as involving a GAAP violation if the decision mentions a GAAP violation or a financial misstatement. Of the 432 circuit court precedents, about a quarter (119) include GAAP violation allegations (Panel B of Table 1).[17] We also tabulate GAAP violation allegations by the type of misstated accounts in Panel C. Most of the allegations concern misstated income statement items, with 64 cases (54%) involving revenues. Another 24 cases (20%) refer to misstatements outside the income statement, most of which in the balance sheet. There is no clear pattern on how the type of misstated accounts affect dismissal rates. For example, circuit courts dismiss 46 of 79 (58.2%) cases with misstated revenue allegations, not significantly different from the dismissal rate of the non-revenue misreporting cases (59.1%). The finding is consistent with the empirical observation in Pritchard and Sale (2005) that allegations on revenue manipulations do not predict circuit court decisions.

[Insert Table 2 Panel A Around Here]

Table 2 presents the distribution of the circuit court rulings by year and circuits. Panel A shows that there are between 6 to 30 rulings each year (an average of 19.6), with the post-internet bubble period (2002, 2004–05) and the financial-crisis period (2008–09) witnessing an unusually high number of rulings. More than half of the decisions (59.7%) affirm district court dismissals. The period of 1997–99 experiences elevated dismissal rates, with around 67% (31 out of 46) of the circuit rulings affirming district court decisions. The high dismissal rate is consistent with the anecdotal evidence that the pleading standards were higher in the years immediately following the

[16] Including these rulings does not change our results.

[17] We provide the full list of the circuit court rulings on shareholder class action involving GAAP violations in our sample in Appendix B.

PSLRA when circuit courts started to develop new case law precedents (Thurm, 1999). Moreover, we do not see differential dismissal rates cases that involve GAAP violation and those that do not, echoing the results in Pritchard and Sale (2005) that the presence of GAAP violation allegations does not predict circuit court rulings.

[Insert Table 2 Panel B Around Here]

Panel B of Table 2 breaks down the number of rulings by circuits. The 2nd and 9th Circuits have the most rulings (84 and 82, respectively), whereas the DC Circuit is the least active with only three rulings, likely due to the number of firms residing in these circuits. The remaining circuits show case numbers between 16 and 43. Dismissal rates vary significantly across circuits. The three overall most stringent circuits are the 1st, 4th, and 10th Circuits, with more than 75% cases dismissed. Pleading standards also differ for a given circuit depending on the type of allegation. For example, the 1st Circuit's high overall dismissal rate is driven by Non-GAAP allegations (87.5%), while it only dismissed 37.5% of GAAP allegations. Interestingly, the 9th Circuit exhibits comparably low overall dismissal rates in our sample period (overall 47.6% compared to the average overall dismissal rate of 62.6% for the other circuits). A closer look at the GAAP rulings by the 9th Circuit reveals several streaks of reversals, decreasing its dismissal rate (see a list of all GAAP rulings in Appendix B). For instance, the court at least partially reversed all five GAAP cases between 2003 and 2006, and again all four GAAP cases between 2009 October and 2014 July. This observation highlights the importance of considering the time-series of decisions and is consistent with prior studies arguing that 9th Circuit does not always adhere to a stringent pleading standard (Hart, 2002; Mulreed, 2005).[18] The 7th Circuit has a relatively low dismissal rate of 33.3% for GAAP violation cases, consistent with Choi and Pritchard (2012) that the pleading standards in that circuit are less stringent than many of the other circuits.

[18]Prior studies argue whether the 9th Circuit holds the most stringent pleading standard post-PSLRA. While its ruling In re Silicon Graphics Inc. (SGI) clearly established the strictest pleading standard (Moss, 1999; Hopkins, 2018), the circuit appears to have not always applied that standard in subsequent cases (Hart, 2002; Mulreed, 2005).

3.2 Empirical measure of judicial precedents

Figure 1 depicts the geographical boundaries of the twelve circuit court jurisdictions. Each circuit court cover at least one state and states have between one to four district courts.

[Insert Figure 1 Around Here]

A circuit court's leniency toward GAAP violations depends on the pleading standards it has established in its precedents. A court that has regularly dismissed GAAP violation cases in the past, is more likely to have a stringent pleading standard and follow principles and rules that are more lenient toward GAAP violations.[19] Therefore, we use the percentage of GAAP violation cases that a circuit has dismissed in the past to measure its leniency at each point in time (*Lenient GAAP Precedents*). To account for precedents' losing importance when newer rulings arrive (see Section 3.3; Landes and Posner (1976)), we focus on the most recent five rulings in each circuit.[20] The measure is defined as:

$$\text{Lenient GAAP Precedents} = \frac{\sum \text{Dismissed GAAP Allegation Rulings}}{\sum \text{GAAP Allegation Rulings}}. \tag{1}$$

Similarly, we construct a measure for non-GAAP precedents (*Lenient non-GAAP Precedents*) using the percentage of non-GAAP-violation cases that a circuit has dismissed in the past. We use this variable in robustness tests (see Section 4.6) to investigate whether our results are driven by a general trend in circuit court precedents on securities class actions.

[Insert Figure 2 Around Here]

Figure 2, which depicts the time-series of our measure, *Lenient GAAP Precedents*, for each circuit since 1996, shows that there are significant variations in the leniency towards GAAP violation

[19] The first circuit court ruling covering GAAP violation in our data set that applies the PSLRA is on 1997 June (In re Burlington Coat Factory in the 3rd Circuit). For the period before in each circuit's first ruling, we assume that the pre-PSLRA pleading standard prevailed in all circuits and use all circuit GAAP violation rulings during the 1990-1995 period to calculate the dismissal rate. There are five such rulings (one in the 1st, 5th, and 9th Circuits, and two in the 2nd Circuit), all of which reversed district courts' dismissal decisions.

[20] When there are less than five past rulings, we use all existing rulings. In robustness tests, we alternatively use the full history of rulings after the PSLRA in each circuit. We find similar results (see Internet Appendix Table IA1, IA2, and IA3).

cases across circuits and time. Importantly, court leniency does not always move in tandem. For example, during 2002 to 2005, the 3rd, 4th, and 8th Circuits become significantly more stringent (dismissal rates increases from 50% to 80%, 0% to 100%, and 26% to 78%) while the 6th, and 9th Circuits appear to soften their pleading standard during the same period (dismissal rates decreases from 100% to 43%, and 52% to 23%). Furthermore, several circuits, including the 1st, 2nd, 3rd, 5th, 6th, and 9th Circuits, show a pattern of fluctuating leniency during our sample period.

Overall, there is no common time trend among the different circuits, and precedents exhibits considerable variation within and across circuits.

3.3 Circuit court precedents and the lower district courts

In the previous sections, we argue that circuit court rulings become binding constraints on future decisions of district courts under its jurisdiction and that related precedents are more relevant for future case outcomes than unrelated precedents (Hellman, 1989; Hinkle, 2015). In this section, we provide empirical evidence to corroborate these assertions and measure the importance of circuit court precedents on district courts. Specifically, we examine whether district courts are more likely to cite precedents from its corresponding circuit in rulings than those from other circuits, whether district courts are more likely to cite GAAP violation precedents than non-GAAP violation precedents if the case on hand also alleges GAAP violation, and whether circuit court decisions directly affect those of district courts.

We start by analyzing the district courts' patterns of circuit court ruling citations. We obtain 5,251 district court rulings on securities class action cases from Google Scholar Search and search within them for citations of the 432 circuit court rulings we collect (as discussed in Section 3.1). There is a total of 28,842 citations of circuit court precedents in the district court rulings.[21] Table 3 Panel A presents the citations of circuit court precedents by circuits. We find that circuit court precedents are relevant for district court rulings, with average citations per precedent ranging from 19.7 for precedents from the DC circuit to 112.5 those from the 2nd circuit. The difference in the number of citations each circuits' precedent receive is consistent with the differences in the

[21] When a district court ruling cites a circuit court precedent multiple times, we only count it as one citation.

number of cases in circuits, and that district courts are more likely to cite precedents from their own circuits. To provide more direct evidence on jurisdiction's effect on district court citations, we separately tabulate the within-circuit and across-circuit citations of precedents and find that circuit court precedents are cited much more frequently by district courts under the jurisdiction (48.6 citations) than those not outside (18.1).

[Insert Table 3 Panels A and B Around Here]

Next, we separately tabulate citations for precedents with and without GAAP violations (in rows, refer to as GAAP precedents and non-GAAP precedents respectively) by district court cases with and without GAAP violations (in columns) in Panel B. We find that first, GAAP precedents have a higher citation rate than non-GAAP precedents (109.1 vs. 50.7 citations), indicating that GAAP precedents have larger influence on future securities class action cases than non-GAAP precedents. Second, GAAP precedents are three times more likely to be cited by district court cases alleging GAAP violations (51.1 citations) than are non-GAAP precedents (17.5 citations). The difference is statistically significant at the 1% level. This confirms that GAAP precedents are more relevant for accounting-related cases than non-GAAP precedents, a notion which we rely on in our later tests.

[Insert Table 3 Panels C and D Around Here]

Panel C offers a closer look at how citations vary with the age of precedents. The results show that district courts cite circuit precedents less often as they age, consistent with the importance of precedents decreasing gradually over time Landes and Posner (1976). For example, a newly published ruling has a citation of 9.8 in its first year compared to only 7.6 (4.3) citations for a ruling from 10 (20) years ago.

To control for precedent age and judge ideology, and examine how jurisdiction and precedent relevancy affect case citation simultaneously, we use a regression analysis at the district court case-precedent level. Specifically, we match each district court ruling with all circuit court precedents decided prior to the district court ruling date, resulting in 1,309,759 ruling-precedent pairs, and

estimate the following linear probability regression model:[22]

$$\begin{aligned} Prob(\text{Citation}) = \beta_0 + \beta_1 \text{ Home Circuit} + \beta_2 \text{ GAAP Precedent } \times \text{GAAP Case} \\ + \beta_3 \text{ GAAP Precedent} + \beta_4 \text{ GAAP Case} + \beta_5 \text{ Precedent Age} \\ + \beta_6 \text{ Consistent Precedent} + \beta_7 \text{ Liberal District Judge} + \varepsilon. \end{aligned} \tag{2}$$

where Citation is an indicator variable that equals one if the district court ruling cites the circuit court precedent, and zero otherwise. Variables of interest include an indicator variable for the home-circuit (*Home Circuit*) that equals one if the precedent is from the same circuit as the district court, an indicator variable for GAAP precedents (*GAAP Precedent*), an indicator variable for the district court case involving GAAP allegations (*GAAP Case*), and an interaction term of GAAP Precedent and GAAP Case. Control variables include the length of the period between the precedent's publication date and the district court ruling date in years (*Precedent Age*), whether the precedent is consistent with the district court judge's ideology (*Consistent Precedent*), i.e., a reversal (affirming) precedent for a Democratic (Republican) district judge (*Consistent Precedent*), to control for a Democratic (Republican) appointee' preference to cite reversed (dismissed) precedents to give plaintiffs (defendant firms) an advantage (Niblett and Yoon, 2015), and whether the district court judge presiding over the case is liberal (*Liberal District Judge*). Appendix A provides detailed definitions of the variables used in our analysis.

[Insert Table 4 Around Here]

Table 4 presents the results. The coefficient of Home Circuit is 0.104 and significant at the 1% level. In terms of the economic magnitude, a district court is 17 times more likely to cite a precedent from the home circuit (11.0%) than from the outside (at a probability of 0.6%). The coefficient for GAAP Precedent is 0.010, and that for the interaction term *GAAP Precedent* · *GAAP Case* 0.022 (both significant at the 1% level). That is, a district court ruling in a GAAP case is 166% more

[22]We present results based on linear probability models in the main text to account for a potential incidental parameters problem in alternative logit models (Lancaster, 2000; Hsiao, 2003). Caudill (1987, 1988) points out that linear probability models provide reliable coefficient estimates, especially when outcomes for a subject are identical in all time periods, e.g., a firm is never sued during our sample period. Results for the logit models are in the Internet Appendix Table IA4 and are qualitatively similar.

likely to cite a GAAP precedent than a non-GAAP one (at a probability of 1.97%). The estimated coefficients on the control variables are consistent with the general intuition. For example, we expect and find that older precedents are cited less. In addition, precedents consistent with the district court judge's ideology are cited more often. In other words, a Democratic (Republican) appointee cites reversed (dismissed) precedents more often.

Our citation analyses provide indirect evidence on the importance of precedents as judges may use citations to justify their decisions after they made up their mind. To directly test the circuit court precedent's effect on district court rulings, we examine whether district courts are more likely to dismiss GAAP violation cases when its home circuit dismisses such cases and vice versa. Since circuit court precedents can affect plaintiffs' lawsuit filing decisions Field et al. (2005),[23] introducing an endogeneity problem, we focus on the effect of home-circuit decisions on district court cases that have already been filed.

We merge district court decisions on the "motion to dismiss" and decision dates from Google Scholar Search with Stanford's Securities Class Action Clearinghouse (SCAC) dataset using the defendant's company name to obtain the complaint filing dates. We then match the district court cases with the circuit court rulings based on the jurisdiction and the case pending window, i.e., between the complaint filing date and the decision date. The final sample includes 439 district court decisions with home-circuit decisions during the case pending period.[24] We estimate the following linear probability regression model:[25]

$$\begin{aligned} Prob(\text{Dismissal}) = \beta_0 + \beta_1 \ \#\text{Affirmed}_{(\text{filing, ruling})} + \beta_2 \ \#\text{Reversed}_{(\text{filing, ruling})} \\ + \boldsymbol{\beta} \cdot \boldsymbol{X} + \boldsymbol{\gamma} \cdot \boldsymbol{Y} + \varepsilon. \end{aligned} \tag{3}$$

The dependent variable, *Dismissal*, is an indicator variable that equals one if the district court dismisses the case, and zero otherwise. The independent variables of interest are the number of home-circuit dismissal affirmations ($\#Affirmed_{(filing,\ ruling)}$) and reversals ($\#Reversed_{(filing,\ ruling)}$)

[23] Cotropia et al. (2017) show that plaintiffs are are more likely to file a lawsuit when they expect a lower chance of dismissal.

[24] In the Internet Appendix Table IA5, we provide the descriptive statistics of the district court rulings sample.

[25] In the Internet Appendix Table IA6, we present results using logit models, which are qualitatively similar to using linear probability regression model.

during the case pending period. We expect that district courts are more (less) likely to dismiss a case if its home circuit affirms (reverses) dismissal decisions, which translates into a positive (negative) coefficient on $\#Affirmed_{(filing,\ ruling)}$ ($\#Reversed_{(filing,\ ruling)}$). We include the percentage of cases dismissed in the circuit prior to the pending lawsuit's filing date to control for existing precedents (*Existing GAAP Precedents*). We also control for judge ideology using circuit court ideology (*Liberal Circuit*) and the ideology of the individual district court judge assigned to the case (*Liberal District Judge*), and case merit using the cumulative abnormal return when a lawsuit has been filed (*CAR filing*) and an indicator variable whether the case is a GAAP case (*GAAP Case*). We further include circuit and year fixed-effects to control for macroeconomic trends and geographical differences that may affect case outcomes.

[Insert Table 5 Around Here]

Table 5 column (1) presents the results. As expected, the coefficient on $\#Affirmed_{(filing,\ ruling)}$ ($\#Reversed_{(filing,\ ruling)}$) is positive (negative) and significant at least at the 5% level, consistent with the development in the circuit precedent affecting district case outcomes. The economic magnitude of the precedents' effect is sizable. When there is one more dismissal affirmation (reversal) at the circuit court during the post-filing window, the district court is 3.04% more (3.03% less) likely to dismiss the case at hand (relative to the unconditional likelihood of dismissal of 80.5%).

We conduct two placebo tests to ensure robustness of the results. First, we use the home-circuit decisions arriving during the window three years after the actual case pending window to mitigate the concern that our results are driven by cross-circuit differences affecting both district and circuit court decisions. Second, we use circuit court rulings from non-home circuits during the case pending window to ascertain whether our results merely capture the overall time trend in securities class action lawsuits. The results of the placebo tests (tabulated in columns (2) and (3) of Table 5) show that neither home-circuit precedents developed outside the case pending window nor precedents developed in other circuits during the pending window influence district court outcomes. Specifically, while the estimated coefficients on $\#Affirmed_{(filing,\ ruling)}$ ($\#Reversed_{(filing,\ ruling)}$) are positive (negative) in the placebo tests, none of them are statistically significant.

Taken together, both citation analyses and district court decision tests confirm that circuit court precedents, especially those from the home circuits, those that are more recent, and those that allege similar violations, affect district court rulings.

4 The relation between circuit court precedents, firm litigation risk and financial reporting

4.1 Securities class action lawsuit and firm financial data

After establishing the importance of circuit court precedents, we next turn to the impact of the precedents on firms' litigation and reporting behavior. For the firm-level tests, we match the securities class action lawsuit data from SCAC with financial statement data from Compustat using ticker and defendant company names. Stock price data is from CRSP. To identify firm-years with financial misstatements, we use data from the Audit Analytics Non-Reliance Restatement File. For each firm-year, we define an indicator variable Misstatement for any involvement of financial misstatement. In addition, we follow Hennes, Leone, and Miller (2008) and define Fraud Misst. for misstatements that mentioned fraud or a SEC investigation when the restatement was announced, and Non-fraud Misst. for misstatements that does not. Note that we only observe misstatements that have subsequently been restated. In other words, our Misstatement variable is subject to endogeneity if precedents affect firms' likelihood of restatements conditional on misstatements. More specifically, if firms change the type of misstatements to avoid detection or if firms choose not to restate when precedents are less lenient on GAAP violations, it biases towards finding that firms are more likely to misstate when precedents are more lenient. Thus, our empirical results concerning H2 could be driven by precedents' effect on both misreporting or restating conditional on misreporting.

[Insert Table 6 Around Here]

Panel A of Table 6 provides descriptive statistics for the sample containing 65,154 firm-year observations. The mean (median) value of our main variable of interest, *Lenient GAAP Precedents*,

is 0.400 (0.400). The standard deviation and the inter-quartile range are 0.339 and 0.600, respectively, suggesting reasonable variation on the firm-year level. The average firm-year observation has a size equivalent to $230.7 million, a leverage ratio of 21.8%, and sales growth of 27.7%. Moreover, 9.7% of the observations are related to financial misstatements, with 1.3% classified as fraud related restatements and the rest (8.4%) as non-fraud related. As expected, the majority (86%) of misstatements involve an overstatement of net income.

Panel B of Table 6 shows the correlations among main variables used in our tests. Our precedent variable *Lenient GAAP Precedents* and *Lenient non-GAAP Precedents* are positively but only weakly correlated. Our variables of interest behave as expected. For instance, Firm Sued is positively correlated with Misstatement, suggesting that firms are more likely sued when the financial report is restated.

4.2 Circuit court precedents' effect on litigation risk of accounting misstatement

Hypothesis 1 predicts that firms with financial misstatements are less likely to be sued when the home-circuit has more lenient precedents on securities lawsuits with GAAP violations. To test H1, we estimate the following linear probability model:[26]

$$\begin{aligned} Prob(\text{Sued}) = \beta_0 &+ \beta_1 \text{ Lenient GAAP Precedents} + \beta_2 \text{ Misstatement} \\ &+ \beta_3 \text{ Misstatement} \cdot \text{Lenient GAAP Precedents} \\ &+ \boldsymbol{\beta} \cdot \boldsymbol{LitiCirl} + \varepsilon. \end{aligned} \tag{4}$$

where *Sued* is an indicator variable that equals one if a firm–year overlaps with the class period of a securities class action lawsuit, and zero otherwise. As such, β_2 captures the effect of misstatement on the likelihood of getting sued by shareholders and β_3 captures circuit precedents' effect on litigation likelihood. Hypothesis 1 predicts a negative coefficient on interaction term of Misstatement and *Lenient GAAP Precedents* (β_1) as lenient judicial precedents on GAAP violations reduces the

[26] In the Internet Appendix Table IA7, we present results using logit models, which are qualitatively similar to using linear probability regression model.

likelihood of being sued for firms with financial misreporting.

Following prior literature, such as Kim and Skinner (2012) and Hopkins (2018), we include the following firm characteristics to control for firm litigation risk and propensity to misstate: *Size*, *FPS*, *Sales Growth*, *Buy-and-Hold Return*, *Daily Return Volatility*, *Daily Return Skewness*, and *Share Turnover*, *Leverage*, *Big Auditors*, *Log(#Analysts)*, *Institutional Holdings*, Δ*Return on Assets*, and *Financing*.[27] Following Huang et al. (2019), we also control for judge ideology (*Liberal Circuit*) and state-level demographic and economic variables, including the political leaning of the states (*Blue State*), *State Unemployment*, and *State GDP*. We report t-statistics based on standard-errors clustered by circuit-year in parenthesis.

[Insert Table 7 Around Here]

Table 7 provides the empirical results for the model in Equation (4). The coefficient of Misstatement in column (1) is significantly positive (0.138, significant at the 1% level), suggesting that misstated financial reports trigger shareholder lawsuits Johnson et al. (2007). Economically, firm-years with misstatements are sued more than twice as likely as those without (from 6.3% for average firms to 16.5% for firm-years with misstatements). Importantly, consistent with H1, the estimated coefficient on the interaction term between Misstatement and *Lenient GAAP Precedents* is negative (-0.074, significant at the 1% level). That is, misstating firms are significantly less likely to be sued if they reside in a circuit with precedents more lenient on GAAP violations. The effect of lenient circuit precedents is economically meaningful. A one-standard-deviation increase in precedent leniency results in a 13.6% reduction in the litigation probability for misstating firms (from 16.53% to 14.29%). For example, as the Lenient GAAP Precedent decreases from 0.6 to 0 in the Ninth Circuit during 2002 to 2007 period, misstating firms in the circuit face a 18.9% increase in litigation risk (from 21.05% to 25.02%).

The estimated coefficients on the control variables, such as *Size*, *FPS*, or *Daily Return Volatility*, are in general consistent with prior literature, such as Kim and Skinner (2012). Note that the estimated coefficient on Liberal Circuit, which measures circuit court judge ideology, is positive and

[27] We do not control for some determinants of misstatement, such as accruals, soft assets or change in cash sales, as these variables may capture the "symptom" of accounting misstatement.

significant, consistent with liberal ideology increasing litigation risk (Huang et al., 2019). Taken together with earlier discussion, our finding confirms that judicial precedents and judge ideology independently affect firms' litigation environment, echoing Epstein and Knight (2013)'s argument that both are important in judicial decision-making.

In columns (2) and (3), we separately examine judicial precedents' effect on litigation risk conditional on fraud and non-fraud related misstatements. Compared to non-fraud related misstatements, fraud-related ones likely provide more direct proof that managers act with an intention to defraud investors. Thus, potential plaintiffs should have a stronger case when suing firms that engage in these misstatements. In such strong cases, courts have less discretion and thus, precedents should matter less. In contrast, courts' attitude towards misstatements could have a larger influence when cases only have non-fraud related misstatement and are more ambiguous (Donelson et al., 2013). We expect the effect of *Lenient GAAP Precedents* on firm litigation risk to be stronger for non-fraud related misstatements than for fraud-related ones.

The results are consistent with this intuition. First, while non-fraud related misstatements increase litigation risk (estimated coefficients on *Non-fraud Misst.* is positive and significant at the 1% level), *Fraud Misst.* are significantly more likely to result in litigations (the difference between *Fraud Misst.* and *Non-fraud Misst.* are statistically significant at the 1% level). Second, the effect of lenient precedent on litigation that we document earlier are driven primarily by non-fraud related misstatements (the interaction between *Non-fraud Misst.* and *Lenient GAAP Precedents* in column (3) is negative and significant at the 1% level). On the other hand, column (2) shows that conditional on firms having fraud-related misstatements, shareholders do not appear to take judicial precedents into account when making lawsuit filing decisions (the interaction between *Fraud Misst.* and *Lenient GAAP Precedents* is insignificantly different from zero). In terms of economic magnitude, for non-fraud related misstatements, a one-standard-deviation increase in precedent leniency results in a 13.5% reduction in the litigation probability for non-fraud misstating firms (from 13.96% to 12.08%). In column (4), we include both fraud and non-fraud misstatement in the same regression and find similar results.

In sum, results in Table 7 show that circuit court leniency on GAAP violation reduces firms'

likelihood of being sued, especially when the potential cases may have weaker merits, consistent with plaintiffs anticipating lenient precedents' effect on lawsuit success rates and making lawsuit filing decisions accordingly.

4.3 Judicial precedents' effect on litigation cost – cross-sectional analyses

We conduct three cross-sectional tests to investigate when judicial precedents are more important for litigation risk. Because the effect of precedents on lawsuit filing decisions should depend on the potential plaintiffs' ability and incentive to consider precedents' implications for lawsuit outcomes, we expect precedents to matter more when expected payoffs from the lawsuits are higher and when potential plaintiffs are more sophisticated.

We first examine how precedents' effect on lawsuit filings vary with expected lawsuit payoffs and expect that the higher the expected lawsuit payoffs, the more likely plaintiffs consider precedents in their filing decisions. We use two measures of expected lawsuit payoffs, firms ex-ante litigation risk and their economic performance. Prior studies show that investors expect higher payoffs from lawsuits against firms with higher predicted litigation risk (Finnerty and Pushner, 2002), which we measure following Kim and Skinner (2012). In addition, misstatements of firms with low economic performance are more likely to concern income-increasing accruals (Schrand and Zechman, 2012; Gerakos and Kovrijnykh, 2013), and thus, plaintiffs are more likely to prevail in lawsuits against these firms, increasing the expected payoff of such lawsuits. We use cash flows from operations scaled by total assets to capture a firm's economic performance.

Next, we focus on potential plaintiffs' sophistication level, measured with institutional ownership. Consistent with institutional investors having greater sophistication and resources to monitor a case and more experience in securities litigation (Weiss and Beckerman, 1994; Perino, 2003, 2012), prior studies find that cases with an institutional lead plaintiff are less likely to be dismissed and have significantly larger settlements (Cox et al., 2006; Cheng et al., 2010). Similarly, we expect institutional investors to be better equipped to incorporate precedents into their filing decisions than individual investors. Since firms with higher institutional investors are more likely to be lead plaintiffs in lawsuits involving high institutional ownership firms, we expect precedents to have a

stronger influence on litigation risk for these firms. [28]

[Insert Table 8 Around Here]

We estimate Equation (4) separately for subsamples based on the median value of the above-mentioned variables. Table 8 reports the results. When partitioning on firms' ex-ante litigation risk, the coefficient on Misstatement is larger for firms with high compared to low litigation risk (0.076 in column (1) versus 0.179 in column (2)), suggesting that misstatements by those firms carry higher expected lawsuit payoffs. As expected, the interaction term between Misstatement and *Lenient GAAP Precedents* is insignificant for firms with low litigation risk (-0.018 in column (1)), but negative and highly significant for firms with high litigation risk (-0.105 in column (2)). The Chi-square test shows that the difference is significant at the 1% level. We obtain similar results when we partition on firms' economic performance. The coefficient on *Misstatement* · *Lenient GAAP Precedents* is more negative for firms with low economic performance than for those with high performance (-0.118 and -0.025 respectively, difference significant at the 1% level). When partitioning on firms' institutional ownership, the coefficient on the interaction term of Misstatement and Lenient GAAP Precedent is more negative for high institutional ownership firms (-0.097 in column (6)) than for low institutional ownership firms (-0.063 in column (5)), with the difference being significant at the 10% level. The effect of precedents varies with potential plaintiffs' capabilities and is stronger when sophisticated investors are more likely to direct the lawsuit filing decisions.

Overall, our cross-sectional results show that judicial precedents' effect on litigation risk is stronger when expected lawsuit payoffs are higher and when plaintiffs are more sophisticated.

4.4 The effect of GAAP precedents on auditor litigation

Precedents may not only affect firms' incentive to misstate through firms' own litigation risk but also through auditors' litigation exposure. While the extent to which an auditor is liable for a firm's misstatement is debatable, i.e., whether auditors' responsibility only covers technical compliance

[28] The PSLRA's lead plaintiff provision dictates that the adequate plaintiff, i.e., the one with the largest financial interest, shall be assigned as the lead plaintiff and retain counsel to represent the class (Choi and Pritchard, 2012).

with GAAP or that it also includes the fair presentation of a firm's underlying economics (see Ball, 2009; Palmrose and Kinney Jr, 2018; DeFond et al., 2018), investors can name auditor as co-defendants in securities class action lawsuits.

In ex-ante, it is not clear how lenient precedents affect auditor litigation risk. On the one hand, courts in lenient circuits are less inclined to accept GAAP violations as sufficient grounds for scienter, which would make it more difficult for plaintiffs to argue that auditors are liable. This implies that plaintiffs are less likely to include auditors in lawsuits when precedents are more lenient. On the other hand, investors in more lenient circuits may strategically include auditors as co-defendants to signal case merit and solicit settlements from auditors (Donelson and Prentice, 2012). As such, auditors would be named co-defendants more often to overcome the heightened pleading hurdle in lenient circuits.

Following Park (2017), we use securities class actions lawsuits in which the defendant restated financial statements as a sample and examine the effect of precedent on whether investors include auditors as co-defendants. To correct for the non-random sample selection bias, we use a two-stage approach. In the first stage, we estimate the probability of a misstating firm being sued by investors. We then estimate the following linear probability model in the second stage concerning the conditional probability of an auditor being co-defendant in such cases:[29]

$$Prob(\text{Auditor Sued}|Z=1) = \beta_0 + \beta_1 \cdot \text{Lenient GAAP Precedents} + \boldsymbol{\beta} \cdot \boldsymbol{LitiCirl} + \lambda + \varepsilon, \quad (5)$$

where Z represents the first-stage sample selection event, which is the condition that a misstating firm is part of a shareholder lawsuit. λ is the inverse Mills ratio from the first-stage probit regression to correct for sample selection bias in the second-stage. Auditor Sued is an indicator variable that equals one if an auditor is named co-defendant in a securities class action lawsuit, and zero otherwise. The set of controls are the same as in the firm litigation test.

[29]The first-stage probit model is:

$$Prob(Z) = \alpha \cdot LitiCir + \beta \cdot \text{IV}$$

where IV is set of instruments used in the first-stage, including ΔCash Sales, ΔEmployees, and Lenient non-GAAP Precedents. Table IA8 of the Internet Appendix provides the first-stage results, and Table IA9 provides the second-stage results using a logit model.

[Insert Table 9 Around Here]

Table 9 provides the results. In column (1), the coefficient of Lenient GAAP Precedents is significantly negative at -0.136 when focusing on misstating firms, suggesting that lenient precedents result in auditors being named co-defendant less often. This is in line with a raised pleading standard making it more difficult for plaintiffs to argue for auditor liability. Auditor liability seems to be weakened by lenient precedents.

In columns (2) and (3), we separate the lawsuits in cases in which the firm being sued shows a fraudulent or non-fraudulent misstatement, respectively. Similar to our previous results, only non-fraud-related misstatements show a significant effect as judicial precedents are more likely to play a significant role in such cases. The coefficient on *Lenient GAAP Precedents* is -0.145 and significant at the 1% level. We do not find a significant effect on fraud-related misreporting cases.

Results in Table 9 suggest that lenient GAAP precedents reduces litigation risk not only for firms but also for auditors. Specifically, auditors are less likely to be named co-defendants in shareholder class action lawsuits in more lenient circuits, which implies a weaker incentive to prevent financial misreporting.

4.5 Judicial precedents' effect financial misreporting

We next turn to firms' misreporting behavior and empirically test H2. If firms understand the effects of lenient precedents on their litigation risk that we have documented so far, firms in a more lenient circuits should commit more financial misreporting as their expected litigation costs are lower. We estimate the following linear probability model:[30]

$$Prob(\text{Misstatement}) = \beta_0 + \beta_1 \cdot \text{Lenient GAAP Precedents} + \boldsymbol{\beta} \cdot \boldsymbol{MisreportCirl} + \varepsilon \qquad (6)$$

The coefficient β_1 captures the effect of a circuit court's leniency in GAAP violations on accounting misstatements of firms under its jurisdiction. H2 predicts a positive β_1. Following Chu et al. (2019), we control for determinants of financial misreporting, including pressure

[30] In the Internet Appendix Table IA10, we present results using logit models, which are qualitatively similar to using linear probability regression model.

from analysts (Long-Term Growth, Buy, Strong-buy), pressure from investors (PE Ratio , Institutional Holdings, Beat Consensus), and executive and governance factors (*Overconfidence*, *Pay Slice*, *Independent Board*, *CEO Chair*). In addition, we control for firm characteristics related to litigation risk (*Size*, *Sales Growth*, *Buy-and-Hold Return*, *Daily Return Volatility*, *Daily Return Skewness*, and *Share Turnover*, *Leverage*, *Big Auditors*, *Log(#Analysts)*, Δ*Return on Assets*, *Financing*), and state-level and circuit-level variables (*Liberal Circuit*, *Blue State*, *State Unemployment*, *State GDP*). We report t-statistics based on standard-errors clustered at the circuit-year level in parenthesis.

[Insert Table 10 Around Here]

Table 10 reports the results. Consistent with H2, Lenient GAAP Precedents is positively associated with Misstatement in column (1) (significant at the 5% level). The magnitude of the estimated coefficient (0.009) shows that the economic significance is sizable: when a circuit's precedents become one-standard-deviation more lenient on GAAP violations, an average firm in the circuit is 3.4% more likely to misstate the financial reports (from an unconditional misstatement likelihood of 9.66% to 9.97%).

In columns (2) and (3), we again differentiate between fraud and non-fraud related misstatements. We find that Lenient GAAP Precedents only affects the tendency of non-fraudulent misstatements, but not fraudulent ones. This finding is consistent with the results in Tables 8 and 9. Judicial precedents mainly lower expected litigation cost of firms and auditors for non-fraud related misstatement, likely because cases without hard evidence are more ambiguous and other factors, such as judge ideology, can play a more significant role.

4.6 Non-GAAP precedents' effect on litigation risk and financial misreporting

Our identification relies on the cross-sectional and time-series variations in GAAP precedents. To ensure that our results are not driven by differences in a general trend of litigation across circuits, we provide robustness tests using circuits' non-GAAP precedents.

Judges do not need to follow precedents from the same circuit if there is a lack of relevance, i.e., the case on hand is different from the one in the precedents. Because non-GAAP precedents are

less relevant for future accounting allegations, judicial precedents on non-GAAP cases should have a weaker or no effect on shareholders' lawsuit filing decisions concerning accounting allegations and thus, on the deterrence effect on financial misreporting. Note that the correlation between *Lenient GAAP Precedents* and *Lenient GAAP Precedents* is positive and below 20% (see Panel B of Table 6). This suggests that circuits have different stringency for GAAP related and non-GAAP related cases.

[Insert Table 11 Around Here]

Table 11 reports results of the first set of firm-level tests concerning H1. As expected, the coefficient on the interaction term with *Lenient non-GAAP Precedents* shows no moderating effect, compared to the significant and negative of GAAP-related precedents in our main tests. Similarly, Table 12 shows that the indirect effect through auditor litigation is not driven by a general trend.

[Insert Table 12 Around Here]

Finally, we obtain a similar picture when repeating our reporting outcome tests. The coefficient on *Lenient non-GAAP Precedents* remains insignificant in all specifications in Table 13.

[Insert Table 13 Around Here]

We find no significant effect of non-accounting precedents in the test for H1 and H2. This confirms that our main findings are not driven by the difference in the build-up of court rulings after the PSLRA, but precedents concerning GAAP violations. The tests also highlight the importance of accounting-related court rulings when measuring precedents.

5 Conclusion

In this paper, we shed light on the effects of judicial precedents on shareholder litigation and financial misreporting. Judicial precedents are prior court rulings that become judge-made law, constraining a court's future decision making. As such, they define an essential part of firms' litigation environment.

We use court rulings in the U.S. Court of Appeals on cases alleging GAAP violations to measure relevant circuit court precedents on firms' misreporting. We document that circuit court precedents differ significantly in their level of accepting GAAP violation as sufficient for pleading securities fraud. We conjecture and find that the deterrence effect of private litigation weakens in circuits with more lenient precedents on GAAP violations. Firms residing in these circuits are less likely to be sued for misstated accounting numbers, lowering their expected litigation cost. As a result, firms in these circuits are significantly more likely to engage in financial misreporting.

Our study suggests that judicial precedents induce within-country heterogeneity in firms' litigation environment, and firms adapt their reporting behavior accordingly. Our results also indicate that circuit courts have raised the procedural hurdles for shareholder litigation, which may have pushed some meritorious cases out of court and increased financial misreporting.

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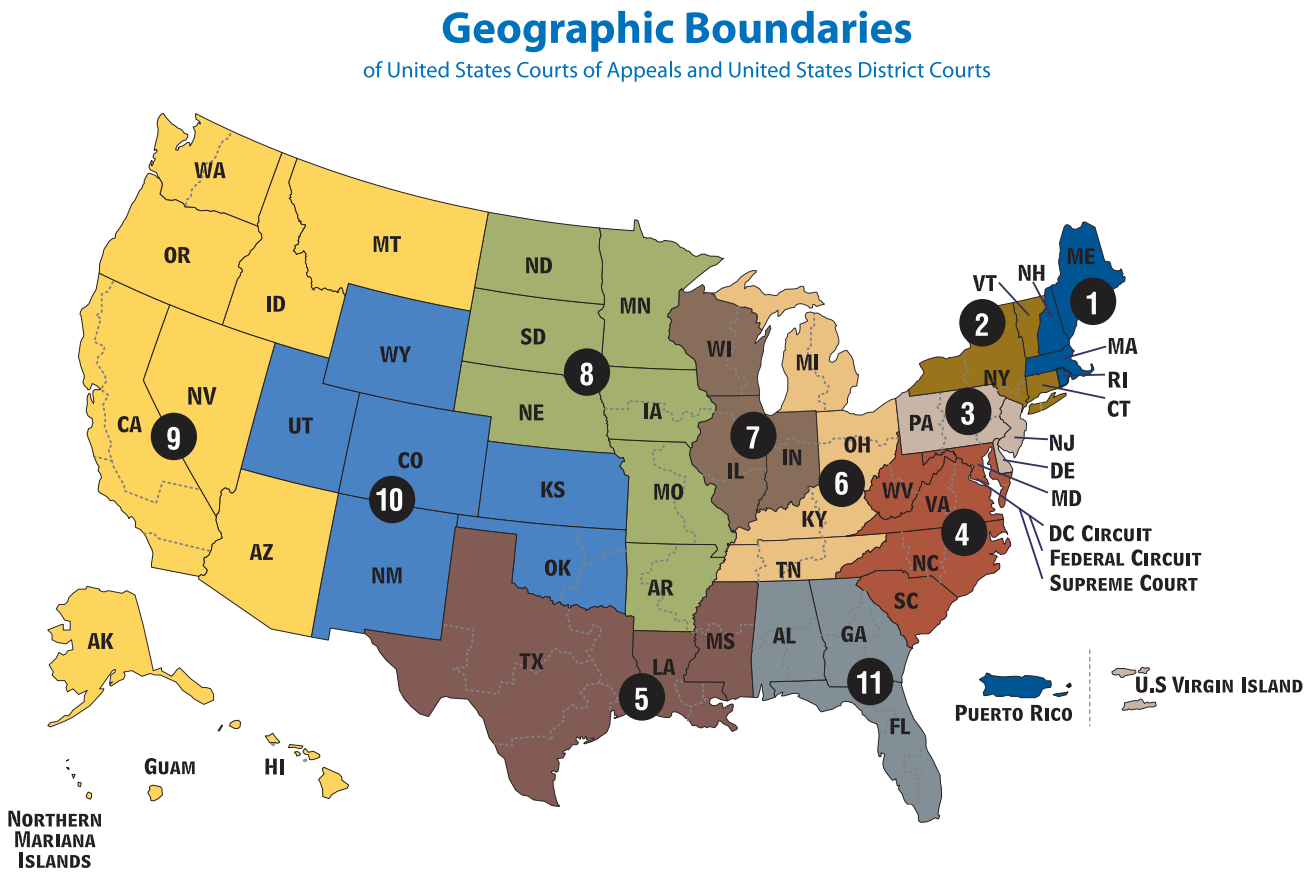
Figure 1: *Time Series of Circuit Court Precedents on GAAP Violations*



Source: The official website of U.S. Courts
(https://www.uscourts.gov/sites/default/files/u.s._federal_courts_circuit_map_1.pdf)

Figure 2: *Time Series of Circuit Court Precedents on GAAP Violations*

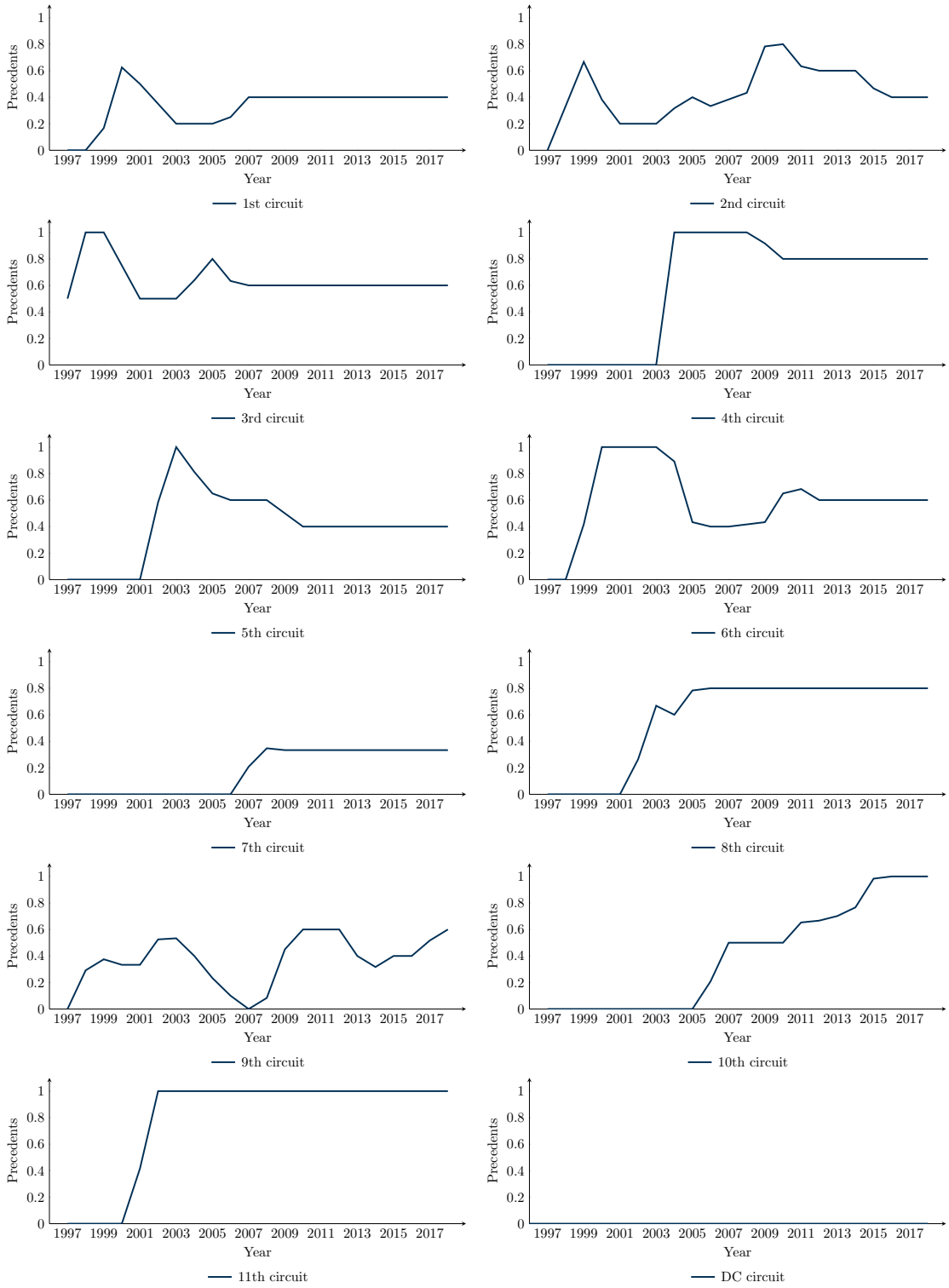
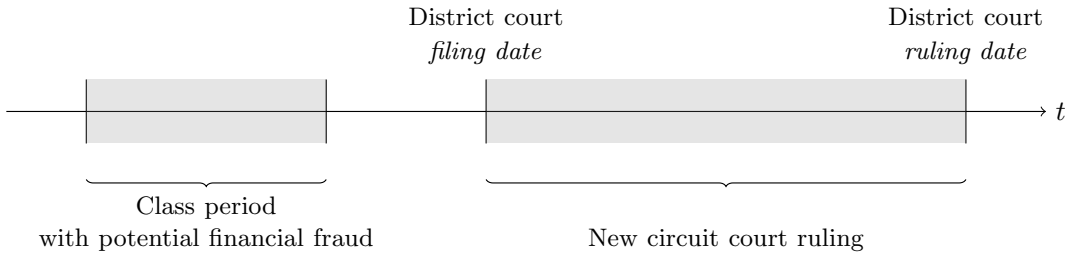


Figure 3: *Timeline: District Court Ruling Test*



Appendix A: *Variable Definitions*

Circuit Court Precedent Variables	
Lenient GAAP Precedents	The percentage of shareholder class action lawsuits that are dismissed by the circuit court in the five most recent lawsuits with GAAP-violation allegations from after 1996 till each current year.*
Lenient non-GAAP Precedents	The percentage of shareholder class action lawsuits that are dismissed by the circuit court in the five most recent lawsuits with other-than-GAAP-violation allegations from after 1996 till each current year.*
$\#\text{Affirmed}_{(\text{filing, ruling})}$	The number of circuit dismissal affirmations in the circuit with jurisdiction over the district court case during the post-filing window. The post-filing window is after the lawsuits are filed at the district court but before the district court makes its decision.*
$\#\text{Reversed}_{(\text{filing, ruling})}$	The number of circuit dismissal reversals in the circuit with jurisdiction over the district court case during the post-filing window. The post-filing window is after the lawsuits are filed at the district court but before the district court makes its decision.*
$\#\text{Affirmed}_{(\text{filing+3y, ruling+3y})}$	The number of circuit dismissal affirmations in the circuit with jurisdiction over the district court case during the post-filing window plus three years. The post-filing window is after the lawsuits are filed at the district court but before the district court makes its decision.*
$\#\text{Reversed}_{(\text{filing+3y, ruling+3y})}$	The number of circuit dismissal reversals in the circuit with jurisdiction over the district court case during the post-filing window plus three years. The post-filing window is after the lawsuits are filed at the district court but before the district court makes its decision.*
$\#\text{Affirmed}_{pseudo}$	The number of dismissal affirmations in the pseudo circuit during the post-filing window. The post-filing window is after the lawsuits are filed at the district court but before the district court makes its decision. The pseudo circuit is the circuit of the lagged case observation in the SCAC dataset.*
$\#\text{Reversed}_{pseudo}$	The number of dismissal reversals in the pseudo circuit during the post-filing window. The post-filing window is after the lawsuits are filed at the district court but before the district court makes its decision. The pseudo circuit is the circuit of the lagged case observation in the SCAC dataset.*
Existing GAAP Precedents	The percentage of precedents being dismissal affirmations in the circuit prior to lawsuit filing at the district court.*
Home Circuit	An indicator variable that takes value 1 if the precedent and the case in a possible precedent–citation pair come from the same circuit, and 0 otherwise.*
GAAP Precedent	An indicator variable that takes value 1 if a precedent involves GAAP violation allegations, and 0 otherwise.*
Precedent Age	The number of years between the circuit precedent and the case in a possible precedent–citation pair.*
District Court Variables	
Dismissal	An indicator variable that equals 1 if the district court dismisses the case, and 0 otherwise..*
Liberal District Judge	An indicator variable that equals 1 if the district judge in charge of the lawsuit is appointed by a Democrat president, and 0 otherwise..*
GAAP Case	An indicator variable that takes value 1 if a citing case involves GAAP violation allegations, and 0 otherwise.*

* Circuit court rulings are from Google Scholar Case Law Search, district court ruling and citation from Google Scholar Case Law Search, and district court case filing date from Securities Class Action Clearinghouse (SCAC).

Litigation Variables	
Sued	An indicator variable that equals 1 if the firm–year overlaps with the class period of a securities class action lawsuit, and 0 otherwise; securities class action lawsuits are obtained from the website of Securities Class Action Clearinghouse.
Financial Misreporting Variables	
Misstatement	An indicator variable that equals 1 if the firm–year involves accounting misstatement as revealed in a later restatement, and 0 otherwise; restatement data are from Audit Analytics Non-reliance restatement file.
Fraud Misst.	An indicator variable that equals 1 if the firm–year involves fraudulent accounting misstatement as revealed in a later restatement in association with fraud or SEC investigations, and 0 otherwise; restatement data are from Audit Analytics Non—reliance restatement file.
Non-fraud Misst.	An indicator variable that equals 1 if the firm–year involves non-fraudulent accounting misstatement as revealed in a later restatement not in association with fraud or SEC investigations, and 0 otherwise; restatement data are from Audit Analytics Non-reliance restatement file.
Overstatement	An indicator variable that equals 1 if the firm–year involves net-income-increasing accounting misstatement as revealed in a later restatement, and 0 otherwise; restatement data are from Audit Analytics Non-reliance restatement file.
Understatement	An indicator variable that equals 1 if the firm–year involves net-income-decreasing accounting restatement as revealed in a later restatement, and 0 otherwise; restatement data are from Audit Analytics Non-reliance restatement file.
Control Variables – Litigation Risk	
FPS	An indicator variable that equals 1 if the firm's historical SIC code in the year belongs to one of the following groups: biotech (2833–36, 8731–34), computer (3570–77, 7370–74), electronics (3670–74), or retail (5200–5961), and 0 otherwise.
Size	The natural log of 1 plus total assets (AT).
Sales Growth	The change in sales (SALE) from the prior year to the current year, scaled by lagged total assets (AT).
Buy-and-Hold Return	The buy-and-hold return for the fiscal year.
Daily Return Volatility	The standard deviation of daily raw return (RET) in the fiscal year.
Daily Return Skewness	The skewness of daily raw return (RET) in the fiscal year.
Share Turnover	The sum of daily trading volume (VOL) scaled by shares outstanding (SHROUT).
Blue State	An indicator variable that equals 1 if the most recent Presidential election in the state level was won by a candidate from the Democratic Party.
State GDP	The yearly percentage change in GDP of the firm's headquarter state.
State Unemployment	The unemployment rate of the firm's headquarter state.
Liberal Circuit	The circuit-court ideology variable from Huang et al. (2019), the probability that a three-judge panel in a circuit would be dominated by at least two judges appointed by Precedents from the Democratic party.
Leverage	The sum of long-term debt (DLTT) and short-term debt (DLC) scaled by the total assets (AT).
Big Auditors	An indicator variable that equals 1 if the firm's auditor is from one of the top eight auditing firms, and 0 otherwise.

Control Variables – Misstatement related variables	
Log(#Analysts)	The natural log of 1 plus the number of analysts following the firm.
Institutional Holdings	The annual quintile rank of the percentage of institutional holdings, measured as the number of shares held by 13-F institutional investors scaled by the number of shares outstanding.
Financing	The sum of equity and debt issuance (SSTK + DLTIS) scaled by the total assets (AT).
ΔReturn on Assets	Year-over-year change in return on assets (IB/AT).
Long-Term Growth	An indicator variable that equals 1 if the median analyst consensus long-term growth forecast is in the highest annual quintile, and 0 otherwise; long-term growth forecast is measured as the most recent consensus forecast after the end of fiscal year t-1 and before the earnings announcement of year t.
Buy	An indicator variable that equals 1 if the percentage of analyst recommendation being buy or strong buy is in the highest annual quintile, and 0 otherwise; analyst recommendation is the most recent consensus recommendation after the end of fiscal year t-1 and before the earnings announcement of year t.
Strong-buy	An indicator variable that equals 1 if the consensus analyst recommendation is strong buy, and 0 otherwise; analyst recommendation is the most recent consensus recommendation after the end of fiscal year t-1 and before the earnings announcement of year t.
PE Ratio	An indicator variable that equals 1 if the forward price-to-earnings ratio as forecasted by analyst in the highest annual quintile, and 0 otherwise ; forward price-to-earnings is the stock price at the beginning of year t divided by the most recent consensus median EPS forecast for year t after the earnings announcement of year t-1.
Beat Consensus	The percent of quarters that a firm beats the median analyst EPS forecast in the prior three years.
Overconfidence	An indicator variable that equals 1 if the CEO's sum in-the-money unexercised exercisable options is greater than the three-digit SIC industry median.
Sensitivity	CEO pay-for-performance sensitivity, measured ONEPCT scaled by the sum of ONEPCT and salary and bonus. ONEPCT is the change in executive's stock and option portfolio in response to one-percent change in the stock method as in Core and Guay (2002).
Pay Slice	CEO's total pay (TDC1) as a percentage to the top five executives' total pay (TDC1).
Independent Board	Annual quintile rank of the percentage of independent directors from RiskMetrics.
CEO Chair	An indicator variable that equals 1 if the CEO is also the chairman of the board, and 0 otherwise.

Appendix B: *List of Circuit Court Rulings Involving Alleged GAAP Violations*

Circuit	Case Title	Ruling Date	Decision
1st	Greebel v. FTP Software, Inc.	08OCT1999	affirmed
1st	Waste Management Holdings, Inc. v. Mowbray	31MAR2000	reversed
1st	Aldridge v. AT Cross Corp.	20MAR2002	reversed
1st	Young v. Lepone	10SEP2002	reversed
1st	In re Cabletron Systems, Inc.	12NOV2002	reversed
1st	Baron v. Smith	18AUG2004	affirmed
1st	In re Stone & Webster, Inc., Securities Litigation	14JUL2005	reversed (in−part)
1st	Ezra Charitable Trust v. Tyco International, Ltd.	27SEP2006	affirmed
2nd	Wright v. Ernst & Young LLP	06AUG1998	affirmed
2nd	Stevelman v. Alias Research Inc.	05APR1999	reversed
2nd	Novak v. Kasaks	21JUN2000	reversed
2nd	Rothman v. Gregor	11JUL2000	reversed (in−part)
2nd	In re Carter−Wallace, Inc., Securities Litigation	07AUG2000	affirmed
2nd	Ganino v. Citizens Utilities Co.	06SEP2000	reversed
2nd	DiRienzo v. Philip Services Corp.	08NOV2000	reversed
2nd	In re Scholastic Corp. Securities Litigation	01JUN2001	reversed
2nd	ONTARIO PUBLIC SERVICE EMP. v. NORTEL NETWORKS	19MAY2004	affirmed
2nd	Slayton v. American Exp. Co.	07AUG2006	reversed
2nd	Lattanzio v. Deloitte & Touche LLP	31JAN2007	affirmed
2nd	Morrison v. National Australia Bank Ltd.	23OCT2008	affirmed
2nd	ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.	21JAN2009	affirmed
2nd	PONTIAC GENERAL EMPLOYEES'RETIREMENT v. MBIA	28FEB2011	reversed
2nd	ACTICON AG v. China North East Petroleum Holdings	01AUG2012	reversed
2nd	In re Advanced Battery Technologies, Inc.	25MAR2015	affirmed
2nd	In re Kingate Management Ltd. Litigation	23APR2015	reversed
3rd	In re Burlington Coat Factory Securities Litigation	10JUN1997	affirmed
3rd	Semerenko v. Cendant Corp.	16JUN2000	reversed
3rd	GSC Partners CDO Fund v. Washington	17MAY2004	affirmed
3rd	In re Alpharma Inc. Securities Litigation	15JUN2004	affirmed
3rd	CA PUBLIC EMPLOYEES'RETIREMENT SYSTEM v. Chubb	30DEC2004	affirmed
3rd	IN RE SUPREMA SPECIALTIES, INC. SECURITIES LIT.	23FEB2006	reversed
3rd	McCabe v. Ernst & Young, LLP	23JUL2007	reversed
4th	Ottmann v. Hanger Orthopedic Group, Inc.	22DEC2003	affirmed
4th	Nolte v. Capital One Financial Corp.	02DEC2004	affirmed
4th	In re PEC Solutions, Inc. Securities Litigation	18MAR2005	affirmed
4th	TEACHERS'RETIREMENT SYSTEM OF LA v. Hunter	20FEB2007	affirmed
4th	PUBLIC EMPLOYEES'RETIREMENT v. Deloitte & Touche LLP	05JAN2009	affirmed
4th	Matrix Capital Management Fund, LP v. BearingPoint	31JUL2009	reversed
4th	Yates v. Municipal Mortg. & Equity, LLC	07MAR2014	affirmed
5th	ABC ARBITRAGE PLAINTIFFS GROUP v. Tchuruk	13MAY2002	affirmed
5th	Abrams v. Baker Hughes Inc.	21MAY2002	affirmed
5th	Goldstein v. MCI WorldCom	28JUL2003	affirmed
5th	Southland Securities v. INSpire Ins. Solutions Inc.	31MAR2004	reversed (in−part)
5th	Plotkin v. IP Axess Inc.	21APR2005	reversed (in−part)
5th	CENTRAL LABORERS'PENSION FUND v. Integrated Elec. Serv., Inc.	21AUG2007	affirmed
5th	Alaska Elec. Pension Fund v. Flowserve Corp.	19JUN2009	reversed
5th	Owens v. Jastrow	12JUN2015	affirmed
6th	In re Comshare Inc. Securities Litigation	08JUL1999	affirmed
6th	New England Health Care Pension v. Ernst & Young	09JUL2003	affirmed
6th	PR Diamonds, Inc. v. Chandler	03MAR2004	affirmed
6th	IN RE FORD MOTOR CO. SECURITIES LIT.	23AUG2004	reversed
6th	MONROE EMPLOYEES RETIREMENT v. Bridgestone	22OCT2004	reversed (in−part)
6th	Fidel v. Farley	16DEC2004	affirmed
6th	City of Monroe Employees v. Bridgestone	04FEB2005	reversed (in−part)
6th	Wyser−Pratte Management Co. v. Telxon Corp.	28JUN2005	affirmed
6th	Zaluski v. United American Healthcare Corp.	27MAY2008	reversed
6th	Ley v. Visteon Corp.	06OCT2008	affirmed
6th	Frank v. Dana Corp.	19NOV2008	reversed
6th	INDIANA STATE DIST. COUNCIL OF LABORER v. Omnicare	21OCT2009	affirmed
6th	Konkol v. Diebold, Inc.	22DEC2009	affirmed

6th	LOUISIANA SCHOOL RET. SYSTEM v. Ernst & Young, LLP	22SEP2010	affirmed
6th	Frank v. Dana Corp.	25MAY2011	reversed
6th	IND. DIST. COUNCIL v. Omnicare	23MAY2013	reversed (in−part)
6th	Doshi v. General Cable Corp.	24MAY2016	affirmed
7th	Makor Issues & Rights, Ltd. v. Tellabs, Inc.	25JAN2006	reversed (in−part)
7th	Higginbotham v. Baxter Intern., Inc.	27JUL2007	affirmed
7th	Makor Issues & Rights, Ltd. v. Tellabs Inc.	17JAN2008	reversed
8th	Florida State Bd. of Admin. v. Green Tree Financial Corporation	25OCT2001	reversed
8th	In re Navarre Corp. Securities Litigation	01JUL2002	affirmed
8th	In re K−tel Intern., Inc. Securities Litigation	07AUG2002	affirmed
8th	Kushner v. Beverly Enterprises, Inc.	23JAN2003	affirmed
8th	Gebhardt v. ConAgra Foods, Inc.	30JUN2003	reversed
8th	FERRIS, BAKER WATTS v. Ernst & Young, LLP	21JAN2005	affirmed
8th	IN RE ACCEPTANCE INS. COMPANIES SECURITIES	29AUG2005	affirmed
8th	In re Cerner Corp. Securities Litigation	06OCT2005	affirmed
8th	In re Ceridian Corp. Securities Litigation	11SEP2008	affirmed
8th	Horizon Asset Management Inc. v. H & R BLOCK, INC.	09SEP2009	reversed (in−part)
8th	McAdams v. McCord	20OCT2009	affirmed
8th	Podraza v. Whiting	22JUN2015	affirmed
9th	Cooper v. Pickett	08AUG1997	reversed
9th	Steckman v. Hart Brewing, Inc.	14MAY1998	affirmed
9th	Griggs v. Pace American Group, Inc.	12MAR1999	reversed
9th	In re Vantive Corp. Securities Litigation	15MAR2002	affirmed
9th	DSAM Global Value Fund v. Altris Software, Inc.	19APR2002	affirmed
9th	Eminence Capital, LLC v. Aspeon, Inc.	21JAN2003	reversed
9th	Broudo v. Dura Pharmaceuticals, Inc.	05AUG2003	reversed
9th	Nursing Home Pension v. Oracle Corp.	01SEP2004	reversed
9th	In re Daou Systems, Inc.	02FEB2005	reversed (in−part)
9th	Simpson v. AOL Time Warner Inc.	30JUN2006	reversed (in−part)
9th	Metzler Inv. GmbH v. Corinthian Colleges, Inc.	25JUL2008	affirmed
9th	Zucco Partners, LLC v. Digimarc Corp.	12JAN2009	affirmed
9th	Dreiling v. America Online Inc.	19AUG2009	affirmed
9th	Siracusano v. Matrixx Initiatives, Inc.	28OCT2009	reversed
9th	New Mexico Investment Council v. Ernst & Young	14APR2011	reversed
9th	In re VeriFone Holdings, Inc. Securities Litig.	21DEC2012	reversed (in−part)
9th	Petrie v. Electronic Game Card, Inc.	30JUL2014	reversed
9th	Loos v. Immersion Corp.	07AUG2014	affirmed
9th	OREGON PUBLIC EMPLOYEES RET. FUND v. Apollo Group	16DEC2014	affirmed
9th	Lloyd v. CVB Financial Corp.	01FEB2016	reversed (in−part)
9th	City of Dearborn Heights v. Align Technology	05MAY2017	affirmed
9th	In re Quality Systems, Inc. Securities Litigation	28JUL2017	reversed
9th	Webb v. Solarcity Corp.	08MAR2018	affirmed
10th	Adams v. Kinder−Morgan, Inc.	11AUG2003	reversed
10th	Deephaven Private Placement Trading, LTD v. Grant Thornton & Co.	21JUL2006	affirmed
10th	Dronsejko v. Thornton	20JAN2011	affirmed
10th	b"Slater v. AG Edwards & Sons, Inc.	09JUL2013	affirmed
10th	MHC MUT. CONVERSION v. SANDLER O'NEILL & PARTNERS	01AUG2014	affirmed
10th	IN RE GOLD RESOURCE CORPORATION SECURITIES LITIGATION	16JAN2015	affirmed
10th	Anderson v. Spirit Aerosystems Holdings, Inc.	05JUL2016	affirmed
11th	Ziemba v. Cascade Intern., Inc.	11JUL2001	affirmed
11th	Garfield v. NDC Health Corporation	12OCT2006	affirmed
11th	Mizzaro v. Home Depot, Inc.	08OCT2008	affirmed
11th	Rosenberg v. Gould	09JAN2009	affirmed
11th	Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.	19JAN2010	affirmed
11th	Thompson v. RelationServe Media, Inc.	30JUN2010	affirmed
11th	Meyer v. Greene	25FEB2013	affirmed
11th	Brophy v. Jiangbo Pharmaceuticals, Inc.	25MAR2015	affirmed
DC	Belizan v. Hershon	17JAN2006	reversed
DC	Belizan v. Hershon	27JUL2007	reversed

Appendix C: *Data Collection of Court Rulings*

Downloading circuit court rulings As the initial step, we search for securities class action lawsuits in the 12 federal circuit courts in the Google Scholar Case Law Search (`https://scholar.google.com/scholar_courts`). We restrict the time period to between January, 1996 and May, 2018. We search the following phrases related to shareholder lawsuits:

- In re "securities litigation",
- securities litigation GAAP,
- securities litigation PSLRA,
- securities litigation GAAS auditor auditing audit,
- "securities litigation" and "Safe Harbor".

We modify the Python script *scholar.py* from GitHub (`https://github.com/ckreibich/scholar.py`) and use it to conduct the search and data collection. The Python script downloads the full-text of every court ruling in the Google Scholar search result. As Panel A of **??** shows, this initial step yields 2,024 circuit court rulings from January 1996 and May 2018.

Processing court rulings Next, we use our customised Python script to search keywords in the court rulings to ensure that the rulings involve Rule 10b(5) securities fraud class-action and have identifiable rulings. We use Python's RegEx to allow for variations of mentioning Rule 10b(5) and other phrases. In particular, we implement the criteria through the following steps:

1. Keep rulings that mention either "Rule 10b(5)", "Section 10 (b)", "Securities Exchange Act", or "Securities Fraud". This step drops 975 rulings;
2. To ensure that the rulings are about shareholder class action, we require rulings mention either "PSLRA", "Private Securities Litigation Reform Act", "Class Action", "Class Period", "Class Member", "Class of individual", "Class of Investor". We drop rulings if the title mentions either "SEC", "US", or "USA"; this step drops 211 rulings;
3. Keep rulings if and only if we are able to identify the ruling as either affirmed, reversed, or affirmed in-part and reversed in-part. To ensure that our rulings identification have clear and unambiguous interpretations, we require the circuit ruling mentioning district ruling being dismissed rather than being settled; this step drops 226 rulings;
4. For duplicate circuit rulings on the same date in the same circuit, we keep one with the largest citation. These duplications could arise from court opinion updates for the same ruling. After this step, there are 479 rulings left;

5. Finally, we drop 47 circuit court rulings with no citations because they are unlikely to have effects on future rulings.

There are 432 rulings left (**??**), in which we look for GAAP violation cases in the next step.

Identifying precedents related to GAAP violations We use another customised Python script to search keywords in the court rulings to identify if a ruling involves GAAP violations. A circuit court ruling is coded as related to GAAP violation if it satisfies at least one of the following conditions:

- it mentions GAAP related keywords and GAAP violation related keywords within a sentence for at least once;

  GAAP related keywords (matching at least one of the following):

  - "generally accepted accounting principles", or "accounting principle",
  - "financial accounting standards", or "accounting standard"
  - GAAP, GAAS, AICPA, FAS, FASB, SFAS, IFRS, or PCAOB,
  - "revenue recognition", "revenue principle", or "channel stuffing."[31]

  GAAP violation related keywords (matching at least one of the following):

  - alleg*, conceal, disguise, exaggerat*, inflat*, fabricat*, failure, failed, false, falsi*, fraud*, fictitious, improper, inadequate, incorrect, investigat*, irregular, inappropriate, lied, lying, manipulat*, mislead, misled, mistak*, premature, questionable, untrue, violat*,
  - over-, under- mis- re-, in combination with: stating, stated, states, statement, represent, or report,
  - 'contrary to", "cosmetically improv*", "not proper", "not comport*",

- it mentions GAAP related keywords defined above, and misstatement related verbs together with at least two different types of specific accounting misstatement;

  Misstatement related verbs (matching at least one of the following):

  - delay, exaggerat*, fabricat, false, falsi*, fictitious, fraud, lied, lying, inappropriate, incorrect, inflat*, improper, irregular, mistak*, misrepresented, premature, questionable, untrue,
  - over-, under-, mis-, re-, in combination with: stating, stated, states, represent, report ,

[31] We include "channel stuffing" because the Tellabs case in the 7th circuit involves GAAP violation but it did mention anything other than "channel stuffing".

  - "contrary to", "cosmetically improv*", "not proper", "notcomport*",

  We search the following types of specific accounting misstatement:

  - revenue, sales, "channel stuffing", "recogni* loss", "loss recogni*"
  - "costs of goods", "costs of product", "costs of sales", "costs of selling", "costs of service", expense, expensing, capitaliz*, depreciat*
  - "net income", profit,
  - asset, liabilibit, equity, "intangible asset", reserve, provision, allowance, depreciation,
  - goodwill, impair*
  - receivable, payable, inventory

- it mentions restatement verb keywords and restatement object keywords within a sentence for at least once.

  Restatement verb keywords (matching at least one of the following):

  - restate, restates, restating, restated, restatement

  Restatement object keywords (matching at least one of the following):

  - sales, revenue, cost, expense, earning, profit, income, asset, liabilibit, equity, goodwill, receivable, payable,
  - "financial report", "annual report", "quarterly report", "financial statement", 10-K, 10-Q

We then manually check for the rulings that mention GAAP but our Python script cannot determine if they involve GAAP violations. We read the rulings and manually classify 7 rulings as involving GAAP violations, as these ruling discuss certain accounting treatments in question in terms of GAAP compliance/violation. As a result, we classify the 432 circuit rulings into 119 ones involving GAAP violations, and 313 not involving GAAP violations (Panel B, **??**). In addition, we also read through all 119 rulings that involve GAAP violations to determine the specific types of GAAP violations, and report the alleged GAAP violation types in Panel C, **??**.

Downloading and processing district court rulings We use steps similar to those described above to search, download, and process, district court rulings in the 94 districts below the 12 circuits. We first search in the Google Scholar Case Law Search for district court rulings since

1996 using the shareholder lawsuits keywords described above. This step yields 5,244 rulings. We then search keywords inside court rulings to require that rulings involve Rule 10b(5) securities fraud class-action, and that rulings have identifiable ruling directions on the motions-to-dismiss decision, leaving 1,079 rulings. For each ruling, we then merge with the Securities Class Action Clearinghouse data for class-period information. After this step, there are 439 rulings remaining in the sample. Finally, we merge the dataset with the circuit court precedents. The description of district court ruling sample selection is available in the **??** of the Internet Appendix.

Appendix D: *Example Court Ruling Excerpts*

In this Appendix, we provide the excerpts of court ruling that involve GAAP violation allegations. The first ruling is In re Comshare Inc. Securities Litigation (6th Cir., 1999) and the second ruling is Greebel v. FTP Software, Inc. (1st Cir, 1999). In both cases, the court ruled against investors. The third ruling is Novak v. Kasaks (2nd Cir., 2000), and the court ruled in favor of investors.

In re Comshare Inc. Securities Litigation (183 F. 3d 542)
United States Court of Appeals, Sixth Circuit.
July 8, 1999

Plaintiffs, shareholders of Comshare, Inc. ("Comshare"), appeal an order entered by the district court dismissing pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure their class action complaint against Comshare and several of its officers and directors alleging securities fraud in violation of the Securities and Exchange Act of 1934, 15 U.S.C. §78j(b) & 78t(a) (1998). Specifically, the parties ask us to decide an issue of first impression for this Court—whether, under the heightened pleading standards set forth in the Private Securities Litigation Reform Act of 1995, 15 U.S.C. §78u-4(b)(2) (1998), a plaintiff alleging securities fraud in violation of the Securities and Exchange Act may survive a motion to dismiss by alleging facts giving rise to a strong inference of recklessness or of motive and opportunity. For the reasons set forth below, we AFFIRM, on different grounds, the judgment of the district court.

...

Comshare's revenue generally consists of software license fees, software maintenance service fees, and other consulting and service fees. With regard to license fees in particular, Comshare's policy is that it will not recognize revenue in such business until a customer contract is fully executed and the software has been shipped—in other words, the sale must be final before Comshare will recognize its revenue from the transaction. **According to Plaintiffs, recognition of the revenue from sales before payment of the purchase prices is reasonably assured violates not only Comshare's own revenue recognition policy, but also violates Generally Accepted Accounting Principles ("GAAP").**

... On August 6, 1996, after the market closed, Comshare issued a press release stating it was delaying release of the results for the fourth quarter and year ending June 30, 1996 pending completion of its year-end audit, which Comshare had expanded to include a detailed review of orders in the UK and other foreign countries. Specifically, Comshare disclosed that it initiated a detailed review "after discovery of letters setting forth conditions to certain orders in the United Kingdom, which the Company had not been made aware of at the time the revenue was recognized," and disclosed that Comshare was aware of approximately $4 million in such orders. (J.A. at 172.) ...

In its Form 10-K for 1996, Comshare stated: In connection with the Company's fiscal 1996 year end audit, the Company discovered side letters setting forth conditions to **certain foreign orders in violation of the Company's revenue recognition policies.** No violations were found in U.S. orders. The growth in software license revenue in fiscal 1996 for all the Company's products was negatively impacted by these violations, although it is difficult to estimate what license growth would have been in fiscal 1996 without the violation of Company policies.... Corrective actions have been taken, including management changes, personnel terminations and other disciplinary actions and the establishment of new orders procedures.

... Generally, Plaintiffs claim that Defendants' actions in improperly recognizing revenue for conditional sales and in thereby misstating its revenue amount to securities fraud. ...

... **While the allegations set forth in the Complaint may give rise to a strong inference that individual Defendants had a motive and the opportunity to commit securities fraud and may be relevant on the issue of recklessness, see In re Baesa, 969 F.Supp. at 242, in this case they do not, in our view, give rise to a strong inference that Defendants acted with recklessness, or that the revenue recognition errors at the heart of this case were "so obvious that any reasonable man would have known of [them]." Mansbach, 598 F.2d at 1025.** Accordingly, we find that Plaintiffs failed to adequately plead scienter and that, in the final analysis, the district court properly dismissed the Complaint.

The failure to follow GAAP is, by itself, insufficient to state a securities fraud claim. See, e.g., Serabian v. Amoskeag Bank Shares, Inc., 24 F.3d 357, 362 (1st Cir.1994); Fine v. American Solar King Corp., 919 F.2d 290, 297-98 (5th Cir.1990). While Plaintiffs claim Defendants "were aware of, or were recklessly indifferent to" the revenue recognition errors, they allege no facts to show that Defendants knew or could have known of the errors, or that their regular procedures should have alerted them to the errors sooner than they actually did. (Complaint ¶¶ 82, 93.) Rather, their allegations rest on mere "information and belief," and cannot support a strong inference of scienter. See 15 U.S.C. § 78u-4(b)(1) (1998) ("[I]f an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."); see also Maldonado v. Dominguez, 137 F.3d 1, 9 (1st Cir. 1998); Luce v. Edelstein, 802 F.2d 49, 54 n. 1 (2d Cir.1986). Indeed, Plaintiffs have not alleged specific facts that illustrate "red flags" that should have put Defendants on notice of the revenue recognition errors, or that demonstrate reasons for Defendants to have questioned the revenue reporting of its UK subsidiary. Cf. In re Health Management Sec. Litig., 970 F.Supp. 192, 203 (E.D.N.Y.1997) (finding strong inference of recklessness where defendant allegedly failed to follow proper audit procedures, that GAAP violations led to material misstatements, and that defendant ignored numerous "red flags").

Although Plaintiffs speculate that it is likely that Defendants knew of the GAAP violations because they occurred over a long period of time, claims of securities fraud cannot rest "on speculation and conclusory allegations." San Leandro Emergency Med. Plan v. Philip Morris Cos., 75 F.3d 801, 813

(2d Cir. 1996). Similarly, Plaintiffs' claim that a subsequent revelation of the falsehood of previous statements implies scienter lacks merit, since "[m]ere allegations that statements in one report should have been made in earlier reports do not make out a claim of securities fraud." Stevelman, 174 F.3d at 84 (quoting Acito, 47 F.3d at 53). Moreover, the mere lack of records documenting the finality of sales in Comshare's UK subsidiary could not, without a showing that Comshare normally expected to see such documents from its subsidiaries, imply recklessness. See Chill, 101 F.3d at 270. Indeed, this Court should not presume recklessness or intentional misconduct from a parent corporation's reliance on its subsidiary's internal controls. See id. at 271; In re Baesa, 969 F.Supp. at 242 (observing that "a subsidiary's fraud cannot be automatically imputed to its corporate parent (Baesa), let alone to the parent's principal officer (Beach)").

Because Plaintiffs have failed to plead facts that show that the revenue recognition errors at Comshare's UK subsidiary should have been obvious to Comshare or that Comshare consciously disregarded "red flags" that would have revealed the errors prior to their inclusion in public statements, we conclude the Complaint fails to allege facts that give rise to a strong inference of scienter under § 10(b) and Rule 10b-5. We observe that in their brief, Plaintiffs sought an opportunity to replead on the grounds that when they filed the Complaint, very few courts had interpreted the pleading standards of the PSLRA. (Appellants' Br. at 49.) While we agree that the PSLRA pleading standards were not well-defined at the time Plaintiffs filed their complaint and note that numerous courts have granted the opportunity to replead on those grounds, see, e.g., In re Baesa, 969 F.Supp. at 243, counsel stated unequivocally at oral argument that Plaintiffs did not wish to replead their case. Accordingly, we do not disturb the district court's dismissal with prejudice of Plaintiffs' complaint for failure to state a claim. For the reasons set forth above, we AFFIRM the judgment of the district court.

Greebel v. FTP Software, Inc. (194 F. 3d 185)
United States Court of Appeals, First Circuit.
October 8, 1999

This case requires us for the first time to interpret the provisions of the Private Securities Litigation Reform Act of 1995.

. . .

FTP Software, Inc. develops, markets, and supports Internet and Intranet software for personal computers and networks.

. . .

Plaintiffs allege that FTP failed to disclose the threats to its continued success, as well as several **"questionable" sales practices**. These included the making of "warehouse shipments"—that is, **booking a fictitious sale of a product to a non-existent buyer**, shipping that product to a

warehouse for storage, and then eventually returning it to FTP. According to plaintiffs, one FTP employee who complained about these shipments, and who refused (in at least one instance) to sign for the product return, was dismissed as a result of his protest, all before the Class Period. Other objectionable sales practices included excessively discounted sales (as high as 90%) and **"channel stuffing"** activity that compressed sales and orders into the final weeks of a fiscal quarter, with the intention of "cosmetically" improving the reported results for that quarter. Finally, plaintiffs say that FTP failed to disclose its practice of inducing distributors to purchase more product than they needed by promising that the distributors could return the unsold product. Distributors would send their orders to FTP with a notation that they were entitled to return any unsold product. FTP then booked these sales as revenue, but because FTP understood that recognizing such sales as revenue was improper (because of a right of return existed), it allegedly instructed the sales force to white-out these right-of-return notations on the distributors' order forms.

. . .

At the heart of plaintiffs' case is the allegation that defendants consistently overstated the earnings of the company by improperly booking as revenue (and inadequately reserving) "sales" that were actually contingent transactions. This was improper, plaintiffs say, under generally accepted accounting principles ("GAAP"), specifically Statement of Financial Accounting Standards No. 48 ("FAS 48"). Plaintiffs claim that the sales were contingent because there were unlimited return rights. Plaintiffs say that they have evidence both tending directly to show conscious wrongdoing on the part of defendants and circumstantial evidence from which such wrongdoing may be inferred, including that the defendants had both motive and opportunity.

. . .

Plaintiffs allege that the financial statements included in FTP's Form 10-Q report for the third quarter of 1995 were prepared in violation of GAAP and contained improperly inflated revenues and earnings. Specifically, plaintiffs claim that FTP recognized revenues from sales that included a right of return, which did not meet the requirements for revenue recognition set forth in FAS 48. When a buyer has the right to return a product, FAS 48 prohibits the seller from recognizing income from the sale unless six conditions are met.

. . .

Violations of GAAP standards such as FAS 48 could provide evidence of scienter. See Malone v. Microdyne Corp., 26 F.3d 471, 478-79 (4th Cir.1994). **To support even a reasonable inference of scienter, however, the complaint must describe the violations with sufficient particularity; "a general allegation that the practices at issue resulted in a false report of company earnings is not a sufficiently particular claim of misrepresentation." Gross v. Summa Four, Inc., 93 F.3d 987, 996 (1st 204*204 Cir.1996) (quoting Serabian v. Amoskeag Bank Shares, Inc., 24 F.3d 357, 362 n. 5 (1st Cir.1994)).**

Here, as the district court correctly concluded, the complaint clearly falls short. The allegations in the complaint do not include such basic details as the approximate amount by which revenues and earnings were overstated, see Gross, 93 F.3d at 996; the products involved in the contingent transactions, cf. Malone, 26 F.3d at 476-77 (products that were "sold" with rights of return specifically identified); the dates of any of the transactions; or the identities of any of the customers or FTP employees involved in the transactions. We do not say that each of these particulars must appear in a complaint, but their complete absence in this case is indicative of the excessive generality of these allegations. ... Plaintiffs identify four sets of transactions from the third quarter of 1995 that allegedly involve improperly booked revenue. Plaintiffs present invoices, purchase orders, and other documentation that show, they contend: (a) a set of transactions totaling $678,000 with a distributor, Merisel, in which Merisel was not obliged to pay for the product; (b) a $705,250 transaction with reseller CC-OPS in which CC-OPS was given an unlimited right to return the product; (c) a $1.14 million transaction with reseller Afina Sistemas that involved the "sale" of an FTP product that did not yet exist; and (d) a $416,325 transaction with reseller Force 3 that was contingent upon Force 3 receiving a government contract. ... At best, plaintiffs' additional evidence supports an inference that FTP improperly recognized from $416,000 to $1.55 million in revenue in the third quarter of 1995. Because FTP reported overall revenue during the quarter of $37.1 million, **these transactions do not support a strong inference of scienter.** It is equally possible to conclude that FTP made some incorrect accounting decisions regarding a limited number of transactions. Seeing fraud, however, requires too great of an inferential leap. In short, even when viewed in combination with plaintiffs' other allegations, plaintiffs' additional evidence does not support a strong inference of scienter, and thus the district court's decision not to consider the evidence could not have affected the outcome of the motion to dismiss. ... The district court correctly refused to dismiss the complaint originally and was well within its discretion in limiting the discovery it afforded. The difficult and different balance the Act now requires—testing allegations before little or no discovery, but holding plaintiffs to a strong inference of scienter standard—has been honored in this case. Plaintiffs did not have enough weight on their side of the balance to meet the requirements of the Act, and so we affirm the dismissal. Costs to appellants.

Novak v. Kasaks (216 F. 3d 300)
Court of Appeals, Second Circuit
June 21, 2000

In 1996, plaintiffs-appellants filed this securities fraud class action, alleging violations of sections 10(b) and 20(a) of the Securities Exchange Act ("the 1934 Act") and Rule 10b-5 promulgated thereunder. In two opinions issued in 1998, the district court dismissed both the original complaint and the plaintiffs' amended complaint pursuant to Fed.R.Civ.P. 12(b)(6) and 15 U.S.C. § 78u-4(b)(3)(A) for failure to plead with sufficient particularity facts supporting a strong inference that

the defendants had acted fraudulently.

. . .

On April 25, 1996, plaintiffs Carol Novak and Robert Nieman brought this action on behalf of all purchasers of the common stock of the AnnTaylor Stores Corporation between February 3, 1994, and May 4, 1995 (the "Class Period"). In their complaint, the plaintiffs named two groups of defendants: (1) the AnnTaylor defendants, both the corporation itself—which, through its wholly-owned subsidiary, defendant AnnTaylor, Inc., is a specialty retailer of women's clothing, shoes, and accessories—and several officers at the highest level of management; and (2) the Merrill Lynch defendants, a group of entities and individuals that collectively held a dominant share of AnnTaylor stock and sold a significant fraction of their holdings during the Class Period. . .

The plaintiffs' specific allegations focus on AnnTaylor's so-called "Box and Hold" practice, whereby a substantial and growing quantity of out-of-date inventory was stored in several warehouses during the Class Period without being marked down. Internal Company documents ("Weekly Reports")—distributed at regular Monday morning merchandise meetings in which the AnnTaylor defendants participated—distinguished between regular inventory and "Box and Hold" inventory. According to the complaint, these reports demonstrated that: (1) much of the "Box and Hold" inventory was several years old and thus unlikely to be sold at full price, if at all; and (2) the levels of such inventory grew significantly during the Class Period, from about 10% to about 34% of total inventory. However, AnnTaylor's public financial statements did not distinguish between types of inventory, nor did AnnTaylor write off any of the "Box and Hold" inventory during the Class Period, allegedly in violation of Generally Accepted Accounting Principles ("GAAP") that required markdowns under these circumstances. Instead, the defendants made or caused to be made a series of positive statements to the public about the status of AnnTaylor's inventories, describing them at various points during the Class Period as "under control," "in good shape," and at "reasonable" or "expected" levels; stating that "no major or unusual markdowns were anticipated"; and attributing rising levels of inventory to growth, expansion, and planned future sales.

The plaintiffs contend that this course of conduct amounts to securities fraud. Had AnnTaylor taken appropriate write-downs, they argue, the Company's earnings would have been substantially lower than reported. Thus, the AnnTaylor defendants' alleged deception painted too rosy a picture of the Company's current performance and future prospects and kept the company's stock price at an artificially high level during the Class Period. . . .

. . . The landscape of securities fraud litigation has been transformed in recent years by the passage of the PSLRA. This case requires us to determine the impact of two provisions in this legislation on the pleading standard for scienter and the required degree of particularity in pleading in this circuit.

. . .

Finally, allegations of GAAP violations or accounting irregularities, standing alone, are insufficient

to state a securities fraud claim. See Stevelman, 174 F.3d at 84; Chill, 101 F.3d at 270. Only where such allegations are coupled with evidence of "corresponding fraudulent intent," Chill, 101 F.3d at 270, might they be sufficient.

. . .

According to the complaint, the AnnTaylor defendants knew at all relevant times that the Company had serious inventory problems that they sought to disguise by adopting the "Box and Hold" scheme. By refusing to mark down inventory they knew to be "worthless," "obsolete," and "unsalable," the defendants acted "intentionally and deliberately" to artificially inflate AnnTaylor's reported financial results. They discussed the need to mark down inventory but refused to do so because that would damage the Company's financial prospects. Further, in approving the inventory management practices of "Box and Hold," the defendants knowingly sanctioned procedures that violated the Company's own markdown policy, as stated in the Company's public filings. In doing so, they caused those filings to be materially misleading in that the disclosed policy no longer reflected actual practice. Lastly, despite knowledge of the true reasons for rising inventory levels, the defendants made repeated statements to the investment community either offering false 312*312 reassurances that inventory was under control or giving false explanations for its growth. In short, the Complaint alleges that the defendants engaged in conscious misstatements with the intent to deceive. There is no doubt that this pleading satisfies the standard for scienter under Hochfelder, and the requirement of the PSLRA that plaintiffs state facts with particularity that give rise to a strong inference of the required state of mind.

. . .

Accordingly, the judgment of the district court is vacated and the case remanded for further proceedings consistent with these rulings.

Table 1: *Circuit Court Rulings – Sample Selection*

Panel A: Selection of circuit court rulings		
		# Circuit Court Rulings
Circuit court rulings during Jan 1996– May 2018:		2,024
Less non-Rule 10b(5) securities fraud cases:	(975)	1,049
Less non-class action cases (e.g., SEC, DOJ, or individuals as plaintiffs):	(211)	838
Less missing rulings following district court dismissals:	(226)	612
Less duplicated rulings:	(133)	479
Less rulings with no citations:	(47)	432
Panel B: Circuit court rulings and GAAP violations		
		# Circuit Court Rulings
Rulings involving GAAP violations:	28%	119
Rulings not involving GAAP violations:	72%	313
Total rulings		432
Panel C: Type of alleged GAAP violations		
		# Circuit Court Rulings
Income statement allegations:		95
Revenue	64	
Other than revenue	31	
Non-income statement allegations:		24
Receivable, payable, or inventory	4	
Goodwill and or impairment	1	
Other balance sheet items	11	
Other allegations		8
Total GAAP rulings		119

Panel A reports the circuit court rulings data set that this paper uses. Panel B reports the number and the percentage of court rulings that involve GAAP violation allegations. Panel C provides an overview of the different types of GAAP violation allegations. A detailed description of the data collection process is in Appendix C.

Table 2: *Descriptive Statistics for Circuit Court Rulings*

Panel A: Circuit Court Rulings by Year

Year	All Rulings			GAAP Allegations				Other Allegations			
	Total	Dismissed		Total		Dismissed		Total		Dismissed	
	#	#	%	#	%	#	%	#	%	#	%
1997	15	10	66.7	2	13.3	1	50.0	13	86.7	9	69.2
1998	14	10	71.4	2	14.3	2	100.0	12	85.7	8	66.7
1999	17	11	64.7	4	23.5	2	50.0	13	76.5	9	69.2
2000	16	3	18.8	7	43.8	1	14.3	9	56.3	2	22.2
2001	17	11	64.7	3	17.6	1	33.3	14	82.4	10	71.4
2002	23	13	56.5	9	39.1	6	66.7	14	60.9	7	50.0
2003	16	11	68.8	8	50.0	4	50.0	8	50.0	7	87.5
2004	27	15	55.6	12	44.4	8	66.7	15	55.6	7	46.7
2005	22	15	68.2	9	40.9	5	55.6	13	59.1	10	76.9
2006	16	9	56.3	8	50.0	3	37.5	8	50.0	6	75.0
2007	21	12	57.1	6	28.6	4	66.7	15	71.4	8	53.3
2008	30	20	66.7	8	26.7	5	62.5	22	73.3	15	68.2
2009	30	19	63.3	12	40.0	8	66.7	18	60.0	11	61.1
2010	20	12	60.0	3	15.0	3	100.0	17	85.0	9	52.9
2011	27	16	59.3	4	14.8	1	25.0	23	85.2	15	65.2
2012	16	7	43.8	2	12.5	0	0.0	14	87.5	7	50.0
2013	22	13	59.1	3	13.6	2	66.7	19	86.4	11	57.9
2014	26	15	57.7	5	19.2	4	80.0	21	80.8	11	52.4
2015	17	11	64.7	6	35.3	5	83.3	11	64.7	6	54.5
2016	18	10	55.6	3	16.7	2	66.7	15	83.3	8	53.3
2017	16	11	68.8	2	12.5	1	50.0	14	87.5	10	71.4
2018 (till May)	6	4	66.7	1	16.7	1	100.0	5	83.3	3	60.0
Sample Period	432	258	59.7	119	27.5	69	58.0	313	72.5	189	60.4

This panel reports the distribution of circuit court rulings on securities litigation by year and by type of allegation involved in the court ruling. Col (2) reports the number of all circuit court rulings in each year; cols (3–4) report the circuit court rulings that dismiss the case (affirm the district court's dismissal decision); cols (5–8) present the circuit court rulings involving GAAP violation; cols (9–12) present the circuit court rulings that do not involve GAAP violation.

Table 2—*Continued*

Panel B: Circuit Court Rulings by Circuit

Circuit	All Rulings			GAAP Allegations				Other Allegations			
	Total	Dismissed		Total		Dismissed		Total		Dismissed	
	#	#	%	#	%	#	%	#	%	#	%
1st	32	24	75.0	8	25.0	3	37.5	24	75.0	21	87.5
2nd	84	43	51.2	17	20.2	7	41.2	67	79.8	36	53.7
3rd	43	25	58.1	7	16.3	4	57.1	36	83.7	21	58.3
4th	16	12	75.0	7	43.8	6	85.7	9	56.3	6	66.7
5th	28	17	60.7	8	28.6	5	62.5	20	71.4	12	60.0
6th	32	20	62.5	17	53.1	10	58.8	15	46.9	10	66.7
7th	25	16	64.0	3	12.0	1	33.3	22	88.0	15	68.2
8th	40	28	70.0	12	30.0	9	75.0	28	70.0	19	67.9
9th	82	39	47.6	23	28.0	10	43.5	59	72.0	29	49.2
10th	20	16	80.0	7	35.0	6	85.7	13	65.0	10	76.9
11th	27	18	66.7	8	29.6	8	100.0	19	70.4	10	52.6
DC	3	0	0.0	2	66.7	0	0.0	1	33.3	0	0.0
All Circuits	432	258	59.7	119	27.5	69	58.0	313	72.5	189	60.4

This panel reports the circuit court rulings on securities litigation after PSLRA during Jan 1996 and May 2018 by circuit. Col (2) reports the number of all circuit court rulings in each circuit; cols (3–4) report the circuit court rulings that dismiss the case (affirm the district court's dismissal decision); cols (5–8) present the circuit court rulings involving GAAP violation; cols (9–12) present the circuit court rulings that do not involve GAAP violation.

Table 3: *District Citations of Circuit Court Precedents*

Panel A: Home-Circuit and Cross-Circuit Citations by District Courts

		All Citations		Home-Circuit Citations		Cross-Circuit Citations	
Precedent Type	Precedents	Citations	Citations per Precedent	Citations	Citations per Precedent	Citations	Citations per Precedent
1st	32	1,713	53.5	1,071	33.5	642	20.1
2nd	84	9,453	112.5	7,939	94.5	1,514	18.0
3rd	43	3,706	86.2	2,459	57.2	1,247	29.0
4th	16	820	51.3	414	25.9	406	25.4
5th	28	1,223	43.7	625	22.3	598	21.4
6th	32	1,407	44.0	917	28.7	490	15.3
7th	25	1,143	45.7	719	28.8	424	17.0
8th	40	1,319	33.0	934	23.4	385	9.6
9th	82	5,641	68.8	4,564	55.7	1,077	13.1
10th	20	975	48.8	593	29.7	382	19.1
11th	27	1,383	51.2	748	27.7	635	23.5
DC	3	59	19.7	23	7.7	36	12.0
All Circuits	432	28,842	66.8	21,006	48.6	7,836	18.1
				Diff. Home - Cross-Circuit Citations			30.5
				t-stat			8.47^{***}

Panel B: GAAP and Non-GAAP Citations by Precedent Types

		All Cases		GAAP Cases		Non-GAAP Cases	
Precedent Type	Precedents	Citations	Citations per Precedent	Citations	Citations per Precedent	Citations	Citations per Precedent
GAAP	119	12,981	109.1	6,075	51.1	6,906	58.0
Non-GAAP	313	15,861	50.7	5,471	17.5	10,390	33.2
			58.4		33.6		24.8
		t-stat	4.81^{***}		6.25^{***}		3.54^{***}
				Diff. GAAP - Non-GAAP Cases			8.8
				χ^2			7.48^{***}

Table 3—*Continued*

Panel C: Home-Circuit and Cross-Circuit Citations by Precedent Age

		All Citations		Home-Circuit Citations		Cross-Circuit Citations	
Precedent Age	Precedents	Citations	Citations per Precedent	Citations	Citations per Precedent	Citations	Citations per Precedent
0	396	3,892	9.8	2,917	7.4	975	2.5
1	314	2,518	8.0	1,614	5.1	904	2.9
2	299	2,375	7.9	1,596	5.3	779	2.6
3	284	2,448	8.6	1,663	5.9	785	2.8
4	281	2,315	8.2	1,658	5.9	657	2.3
5	251	2,125	8.5	1,451	5.8	674	2.7
6	230	1,885	8.2	1,372	6.0	513	2.2
7	216	1,672	7.7	1,208	5.6	464	2.1
8	190	1,601	8.4	1,197	6.3	404	2.1
9	183	1,501	8.2	1,137	6.2	364	2.0
10	166	1,263	7.6	960	5.8	303	1.8
11	145	1,005	6.9	766	5.3	239	1.6
12	117	929	7.9	733	6.3	196	1.7
13	107	666	6.2	545	5.1	121	1.1
14	105	586	5.6	466	4.4	120	1.1
15	87	512	5.9	440	5.1	72	0.8
16	63	453	7.2	386	6.1	67	1.1
17	59	394	6.7	318	5.4	76	1.3
18	47	310	6.6	259	5.5	51	1.1
19	34	214	6.3	179	5.3	35	1.0
20	24	102	4.3	82	3.4	20	0.8
21	11	42	3.8	32	2.9	10	0.9
22	6	34	5.7	27	4.5	7	1.2

Table 3—*Continued*

Panel D: Citations by Precedent Year

		All Citations		Home-Circuit Citations		Cross-Circuit Citations	
Year Published	Precedents	Citations	Citations per Precedent	Citations	Citations per Precedent	Citations	Citations per Precedent
1997	15	1,254	83.6	787	52.5	467	31.1
1998	14	593	42.4	456	32.6	137	9.8
1999	17	2,769	162.9	1,686	99.2	1,083	63.7
2000	16	3,445	215.3	2,619	163.7	826	51.6
2001	17	2,867	168.6	2,073	121.9	794	46.7
2002	23	2,185	95.0	1,588	69.0	597	26.0
2003	16	863	53.9	603	37.7	260	16.3
2004	27	2,144	79.4	1,548	57.3	596	22.1
2005	22	1,386	63.0	979	44.5	407	18.5
2006	16	784	49.0	502	31.4	282	17.6
2007	21	1,914	91.1	1,496	71.2	418	19.9
2008	30	1,753	58.4	1,236	41.2	517	17.2
2009	30	2,360	78.7	1,852	61.7	508	16.9
2010	20	1,025	51.3	829	41.5	196	9.8
2011	27	855	31.7	634	23.5	221	8.2
2012	16	499	31.2	433	27.1	66	4.1
2013	22	386	17.5	276	12.5	110	5.0
2014	26	948	36.5	771	29.7	177	6.8
2015	17	415	24.4	323	19.0	92	5.4
2016	18	222	12.3	172	9.6	50	2.8
2017	16	153	9.6	123	7.7	30	1.9
2018 (till May)	6	22	3.7	20	3.3	2	0.3

This table reports the descriptives of the precedent citation. The sample consists of 432 precedents and 5,251 securities class action cases that cite these precedents.

Table 4: *Precedent Characteristics and Actual Citations*

	(1) Actual Citation	(2) Actual Citation	(3) Actual Citation
Home Circuit	0.104***	0.107***	0.107***
	(11.93)	(13.28)	(12.42)
GAAP Precedent × GAAP Case	0.022***	0.023***	0.023***
	(5.77)	(6.04)	(5.90)
GAAP Precedent	0.010***	0.011***	0.010***
	(3.73)	(4.09)	(3.73)
GAAP Case	0.006***	0.004***	0.004***
	(4.34)	(3.40)	(3.38)
Precedent Age	−0.001***	−0.001***	−0.000
	(−4.59)	(−9.67)	(−0.50)
Consistent Precedent	0.002*	0.002**	0.002**
	(1.91)	(2.11)	(1.98)
Liberal District Judge	0.003**	0.002	0.005***
	(2.51)	(1.29)	(6.40)
Intercept	0.002	0.023***	0.110***
	(1.40)	(3.79)	(3.68)
Precedent Year FE		Yes	
Precedent Circuit FE		Yes	
Case Year FE			Yes
Case Circuit FE			Yes
N	1,309,759	1,309,759	1,309,759
Adj. R^2	0.068	0.074	0.073

This table reports the result of precedent citation test. The sample consists of 1,309,759 possible precedent–citation pairs out of 432 precedents and the 5,251 securities class action cases citing these precedents, with the requirement that a citing case takes place after a precedent. Actual Citing is an indicator variable that takes value 1 if in a possible precedent–citation pair, the citing case actually cites the precedent, and zero otherwise. Home Cir. Precedent is an indicator variable that takes value 1 if the precedent and the case in a possible precedent–citation pair come from the same circuit, and zero otherwise. GAAP Precedent is an indicator variable that takes value 1 if a precedent involves GAAP violation allegations, and zero otherwise. GAAP Case is an indicator variable that takes value 1 if a citing case involves GAAP violation allegations, and zero otherwise. Precedent Age is the number of years between the precedent and the case in a possible precedent–citation pair. In Col (1), we use the following linear-probability model:

$$Prob(\text{Actual Citing}) = \beta_0 + \beta_1 \text{Home Cir. Precedent} + \beta_2 \text{GAAP Precedent} \times \text{GAAP Case} + \beta_3 \text{GAAP Precedent}$$

$$+\beta_4 \text{GAAP Case} + \beta_5 \text{Precedent Age} + \varepsilon.$$

In Col (2), we also include precedent year- and circuit- fixed effects; in Col (3), we replace them with case year- and circuit- fixed effects. t statistics in parentheses below coefficients are based on standard errors clustered by precedents. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table 5: *Circuit Court GAAP Precedents and District Court Rulings*

	(1) Dismissal	(2) Dismissal	(3) Dismissal
#Affirmed$_{\text{(filing, ruling)}}$	0.024***		
	(3.60)		
#Reversed$_{\text{(filing, ruling)}}$	−0.024**		
	(−2.61)		
#Affirmed$_{\text{(filing+3y, ruling+3y)}}$		0.004	
		(0.64)	
#Reversed$_{\text{(filing+3y, ruling+3y)}}$		0.002	
		(0.26)	
#AffirmedOtherCircuit$_{\text{(filing, ruling)}}$			0.002
			(0.95)
#ReversedOtherCircuit$_{\text{(filing, ruling)}}$			−0.002
			(−0.49)
Lenient GAAP Precedents	0.154	0.118	0.125
	(1.19)	(0.82)	(0.85)
Liberal Circuit	0.410	0.381	0.366
	(1.44)	(1.28)	(1.24)
Liberal District Judge	−0.021	−0.018	−0.018
	(−0.92)	(−0.83)	(−0.78)
CAR filing	0.182	0.148	0.143
	(1.74)	(1.51)	(1.53)
GAAP Case	−0.021	−0.021	−0.023
	(−0.86)	(−0.92)	(−0.98)
Intercept	−0.181*	−0.171*	−0.156
	(−2.06)	(−1.87)	(−1.73)
Year FE	Yes	Yes	Yes
Circuit FE	Yes	Yes	Yes
N	439	439	439
adj. R^2	0.065	0.048	0.049

This table tests the effect of new circuit court precedents on district courts' rulings using circuit court rulings that occur after filing a lawsuit at a district court but before the ruling of the district court in the following linear probability regression model:

$$Prob(\text{Dismissal}) = \beta_0 + \beta_1\ \#\text{Affirmed}_{\text{(filing, ruling)}} + \beta_2\ \#\text{Reversed}_{\text{(filing, ruling)}} + \boldsymbol{\beta} \cdot \boldsymbol{X} + \boldsymbol{\gamma} \cdot \boldsymbol{Y} + \varepsilon,$$

where $\boldsymbol{X}$ is a vector of circuit and district court level controls, and $\boldsymbol{Y}$ is a vector of case-level controls. The dependent variable Dismissal is an indicator variable taking the value one if the district court dismisses a lawsuit, and zero otherwise. Variable definitions are in Appendix A. t-statistics in parentheses are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table 6: *Summary Statistics*

Panel A: Univariate Descriptive Statistics						
	N	Mean	S.D.	p25	p50	p75
Lenient GAAP Precedents	65,154	0.400	0.339	0.000	0.400	0.600
Lenient non-GAAP Precedents	65,154	0.546	0.314	0.400	0.600	0.800
Sued	65,154	0.063	0.242	0.000	0.000	0.000
Misstatement	65,154	0.097	0.295	0.000	0.000	0.000
Fraud Misst.	65,154	0.013	0.112	0.000	0.000	0.000
Non-fraud Misst.	65,154	0.084	0.277	0.000	0.000	0.000
Overstatement	65,154	0.083	0.276	0.000	0.000	0.000
Understatement	65,154	0.014	0.116	0.000	0.000	0.000
Liberal Circuit	65,154	0.395	0.177	0.247	0.388	0.561
Big Auditors	65,154	0.788	0.409	1.000	1.000	1.000
Institutional Holdings	65,154	0.361	0.333	0.018	0.285	0.661
Financing	65,154	0.224	0.408	0.005	0.045	0.259
Log(#Analysts)	65,154	1.318	1.010	0.000	1.386	2.079
Book-to-market	65,154	0.531	1.009	0.228	0.436	0.761
Size	65,154	5.441	2.016	3.963	5.352	6.812
Sales Growth	65,154	0.277	1.052	-0.032	0.083	0.259
ΔReturn on Assets	65,154	-0.013	0.369	-0.046	0.006	0.045
Leverage	65,154	0.218	0.275	0.008	0.158	0.337
FPS	65,154	0.310	0.462	0.000	0.000	1.000
Buy-and-Hold Return	65,154	0.121	0.704	-0.305	0.011	0.354
Daily Return Volatility	65,154	0.041	0.024	0.024	0.035	0.052
Daily Return Skewness	65,154	0.541	1.405	-0.027	0.407	0.931
Share Turnover	65,154	188.0	189.9	61.9	127.9	244.4
State Unemployment	65,154	0.069	0.030	0.048	0.061	0.083
Blue State	65,154	0.682	0.466	0.000	1.000	1.000
State GDP	65,154	0.032	0.028	0.014	0.028	0.051
Strong-buy	65,154	0.112	0.315	0.000	0.000	0.000
PE Ratio	65,154	0.250	0.433	0.000	0.000	0.000
Long-Term Growth	65,154	0.188	0.391	0.000	0.000	0.000
Buy	65,154	0.157	0.364	0.000	0.000	0.000
Beat Consensus	65,154	0.685	0.218	0.583	0.714	0.833
Overconfidence	65,154	0.626	0.473	0.000	1.000	1.000
Sensitivity	65,154	0.219	0.156	0.130	0.186	0.266
Pay Slice	65,154	0.382	0.071	0.351	0.381	0.410
Independent Board	65,154	0.698	0.130	0.600	0.714	0.800
CEO Chair	65,154	0.768	0.416	1.000	1.000	1.000
F Score	65,154	1.051	0.250	0.925	1.091	1.228

Table 6—*Continued*

Panel B: Correlation Table

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)	(20)
(1) Lenient GAAP Precedents	1.00	0.18*	0.00	0.04*	0.00	0.05*	-0.07*	-0.10*	0.16*	0.01	0.15*	-0.10*	0.02*	-0.00	0.04*	-0.13*	-0.04*	0.01	-0.11*	-0.16*
(2) Lenient non-GAAP Precedents	0.22*	1.00	0.01	0.02*	0.00	0.02*	-0.19*	0.02*	0.05*	-0.00	0.06*	-0.02*	0.00	0.01*	0.02*	-0.01	-0.01*	0.02*	0.04*	0.02*
(3) Sued	0.00	0.01	1.00	0.14*	0.13*	0.10*	0.05*	0.04*	0.03*	-0.11*	0.08*	0.10*	-0.01	0.06*	0.04*	0.02*	0.05*	0.05*	0.02*	-0.02*
(4) Misstatement	0.04*	0.03*	0.14*	1.00	0.35*	0.92*	0.02*	0.03*	0.03*	0.01	0.08*	0.00	0.00	0.03*	0.02*	-0.02*	0.00	0.01	0.00	0.00
(5) Fraud Misst.	0.00	0.01	0.13*	0.35*	1.00	-0.03*	-0.00	0.01*	-0.00	-0.00	0.03*	0.01*	0.00	0.01*	0.01	0.01	0.01	0.02*	0.02*	0.02*
(6) Non-fraud Misst.	0.04*	0.03*	0.10*	0.92*	-0.03*	1.00	0.02*	0.02*	0.03*	0.01	0.08*	-0.00	0.00	0.03*	0.02*	-0.02*	0.00	0.00	-0.00	-0.01
(7) Liberal Circuit	-0.08*	-0.15*	0.05*	0.02*	-0.00	0.02*	1.00	-0.01	-0.02*	-0.05*	-0.08*	0.02*	-0.02*	0.12*	-0.05*	0.12*	-0.01*	0.05*	-0.01*	-0.06*
(8) Big Auditors	-0.10*	0.00	0.04*	0.03*	0.01*	0.02*	-0.01	1.00	0.20*	-0.07*	0.40*	0.05*	0.02*	0.04*	0.06*	-0.18*	0.03*	0.10*	0.04*	0.06*
(9) Institutional Holdings	0.15*	0.06*	0.04*	0.04*	0.00	0.04*	-0.02*	0.22*	1.00	-0.03*	0.49*	-0.01*	0.03*	0.01	0.11*	-0.40*	0.01	0.12*	-0.06*	-0.22*
(10) Book-to-market	-0.00	0.00	-0.04*	0.00	-0.00	0.01	-0.01	-0.05*	-0.03*	1.00	-0.03*	-0.21*	-0.10*	-0.14*	-0.29*	0.05*	-0.07*	-0.12*	-0.12*	0.05*
(11) Size	0.14*	0.07*	0.09*	0.07*	0.03*	0.07*	-0.07*	0.40*	0.52*	-0.04*	1.00	0.02*	0.03*	-0.11*	0.15*	-0.59*	-0.02*	0.12*	-0.08*	-0.16*
(12) Sales Growth	-0.06*	-0.02*	0.09*	-0.01*	0.00	-0.01*	0.04*	0.00	-0.09*	-0.04*	-0.07*	1.00	0.22*	0.03*	0.16*	-0.01	0.16*	0.13*	0.13*	0.05*
(13) ΔReturn on Assets	0.03*	0.01	-0.04*	0.01	-0.00	0.01	-0.03*	0.00	0.04*	0.01	0.03*	-0.16*	1.00	-0.00	0.31*	-0.07*	0.06*	0.13*	0.03*	0.01*
(14) FPS	-0.01	0.02*	0.06*	0.03*	0.01*	0.03*	0.12*	0.04*	-0.00	-0.05*	-0.11*	0.05*	-0.01*	1.00	-0.03*	0.15*	0.02*	0.09*	0.03*	-0.06*
(15) Buy-and-Hold Return	0.02*	0.03*	0.06*	0.02*	0.01*	0.02*	-0.02*	0.03*	0.02*	-0.11*	0.05*	0.04*	0.10*	0.01*	1.00	-0.28*	0.10*	0.12*	0.13*	-0.02*
(16) Daily Return Volatility	-0.10*	-0.01*	0.01	-0.02*	-0.00	-0.03*	0.11*	-0.18*	-0.40*	-0.01	-0.55*	0.11*	-0.07*	0.13*	-0.08*	1.00	0.00	-0.10*	-0.01	0.20*
(17) Strong-buy	-0.04*	-0.02*	0.05*	0.00	0.01	0.00	-0.01*	0.03*	0.00	-0.03*	-0.03*	0.08*	-0.00	0.02*	0.10*	-0.03*	1.00	0.01	0.04*	0.03*
(18) Beat Consensus	0.01	0.02*	0.04*	0.01	0.01*	0.00	0.04*	0.09*	0.13*	-0.03*	0.11*	-0.01	0.05*	0.08*	0.08*	-0.08*	-0.01*	1.00	0.11*	0.05*
(19) Overconfidence	-0.10*	0.03*	0.02*	0.00	0.02*	-0.01	-0.01*	0.04*	-0.07*	-0.04*	-0.07*	0.06*	-0.03*	0.03*	0.12*	0.01	0.04*	0.09*	1.00	0.16*
(20) CEO Chair	-0.15*	0.01	-0.02*	-0.00	0.02*	-0.01	-0.07*	0.06*	-0.24*	0.03*	-0.15*	0.05*	-0.01	-0.05*	0.02*	0.19*	0.03*	0.04*	0.16*	1.00

Panel B reports the Spearman (Pearson) correlation coefficients above (below) the diagonal, and p-value of significance below the coefficients. * $p < 0.01$

Table 7: *GAAP Precedents and Shareholder Litigation Against Misstating Firms*

	(1) Sued	(2) Sued	(3) Sued	(4) Sued
Lenient GAAP Precedents × Misstatement	−0.074***			
	(−4.11)			
Lenient GAAP Precedents × Fraud Misst.		−0.076		−0.078
		(−1.46)		(−1.50)
Lenient GAAP Precedents × Non-fraud Misst.			−0.061***	−0.063***
			(−3.67)	(−3.72)
Misstatement	0.138***			
	(13.84)			
Fraud Misst.		0.286***		0.296***
		(10.31)		(10.69)
Non-fraud Misst.			0.104***	0.109***
			(10.14)	(10.62)
Lenient GAAP Precedents	0.008**	0.002	0.006	0.007*
	(2.05)	(0.54)	(1.54)	(1.87)
Liberal Circuit	0.026***	0.025***	0.027***	0.024**
	(2.70)	(2.60)	(2.83)	(2.55)
Big Auditors	−0.012***	−0.012***	−0.013***	−0.012***
	(−4.84)	(−4.85)	(−5.07)	(−4.64)
Institutional Holdings	−0.024***	−0.023***	−0.024***	−0.023***
	(−5.66)	(−5.68)	(−5.80)	(−5.57)
Financing	0.031***	0.031***	0.031***	0.031***
	(5.36)	(5.34)	(5.33)	(5.37)
Log(#Analysts)	0.021***	0.020***	0.021***	0.021***
	(12.85)	(12.18)	(12.75)	(12.61)
Book-to-market	−0.005***	−0.005***	−0.005***	−0.005***
	(−5.40)	(−5.12)	(−5.30)	(−5.36)
Size	0.006***	0.006***	0.006***	0.005***
	(3.92)	(4.54)	(4.26)	(3.91)
Sales Growth	0.013***	0.013***	0.013***	0.013***
	(6.38)	(6.28)	(6.40)	(6.32)
ΔReturn on Assets	−0.013***	−0.012***	−0.013***	−0.012***
	(−3.50)	(−3.50)	(−3.49)	(−3.50)
Leverage	−0.017***	−0.016***	−0.017***	−0.017***
	(−2.74)	(−2.64)	(−2.66)	(−2.76)
FPS	0.013***	0.014***	0.014***	0.012***
	(5.22)	(5.66)	(5.49)	(5.21)
Buy-and-Hold Return	0.014***	0.014***	0.014***	0.014***
	(7.41)	(7.67)	(7.47)	(7.50)
Daily Return Volatility	0.228**	0.230**	0.224**	0.231**
	(2.45)	(2.47)	(2.41)	(2.49)
Daily Return Skewness	−0.004***	−0.005***	−0.005***	−0.004***
	(−4.68)	(−5.09)	(−4.84)	(−4.74)
Share Turnover	0.000***	0.000***	0.000***	0.000***
	(13.30)	(13.32)	(13.56)	(13.09)
State Unemployment	0.289***	0.246***	0.277***	0.281***
	(3.41)	(2.90)	(3.25)	(3.33)

Blue State	−0.005	−0.005	−0.005	−0.005
	(−1.24)	(−1.19)	(−1.27)	(−1.15)
State GDP	0.072	0.058	0.067	0.070
	(1.29)	(1.06)	(1.20)	(1.28)
Intercept	−0.101***	−0.097***	−0.100***	−0.099***
	(−6.83)	(−6.72)	(−6.70)	(−6.84)
Year FE	Yes	Yes	Yes	Yes
State FE	Yes	Yes	Yes	Yes
N	65,154	65,154	65,154	65,154
adj. R^2	0.070	0.067	0.061	0.076

This table reports the result of litigation occurrence tests for firms with misstatements with the following linear-probability model:

$$Prob(\text{Sued}) = \beta_0 + \beta_1 \text{ Lenient GAAP Precedents} + (\beta_2 + \beta_3 \text{ Lenient GAAP Precedents}) \cdot \text{Misstatement} + \boldsymbol{\beta} \cdot \boldsymbol{LitiCirl} + \varepsilon,$$

where ***LitiCirl*** is a vector of control variables that include FPS, Size, Sales Growth, Buy-and-Hold Return, Daily Return Volatility, Daily Return Skewness, Share Turnover, Leverage, Blue State, State GDP, State Unemployment, Liberal Circuit, Big Auditors, Institutional Holdings, ΔReturn on Assets, Financing, and year- and state-fixed effects. Variable definitions are in Appendix A. Column (1) tests with all misstatement, column (2) with only fraudulent misstatements, column (3) with only non-fraudulent misstatements, and column (4) with both fraudulent and non-fraudulent misstatement. t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table 8: *GAAP Precedents and Shareholder Litigation Against Misstating Firms – Partitioning Tests*

	Firm-Specific Lit. Risk		Op. Cash Flows		Inst. Holdings	
	Low	High	Low	High	Low	High
	(1)	(2)	(3)	(4)	(5)	(6)
	Sued	Sued	Sued	Sued	Sued	Sued
Lenient GAAP Precedents × Misstatement	−0.018	−0.105***	−0.118***	−0.025	−0.046**	−0.097***
	(−0.86)	(−4.34)	(−4.75)	(−1.19)	(−2.30)	(−3.97)
Lenient GAAP Precedents	−0.001	0.016***	0.006	0.011**	−0.005	0.020***
	(−0.22)	(2.74)	(0.99)	(2.14)	(−1.14)	(3.97)
Misstatement	0.076***	0.179***	0.157***	0.115***	0.111***	0.162***
	(6.50)	(14.19)	(11.05)	(10.45)	(9.77)	(12.10)
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
State FE	Yes	Yes	Yes	Yes	Yes	Yes
N	32,582	32,572	32,582	32,572	32,582	32,572
Adj. R^2	0.035	0.080	0.083	0.078	0.078	0.082
Test of Coefficient Equality for Misstatement × Lenient GAAP Precedents:						
F-stat	7.690***		9.611***		3.418*	
p-value	0.006		0.002		0.065	

This table reports the result of litigation occurrence tests for firms with misstatements under circuit Court of Appeals precedents of different GAAP precedent leniency in various subsamples. We estimate the following linear-probability model:

$$Prob(\text{Sued}) = \beta_0 + \beta_1 \text{ Lenient GAAP Precedents} + (\beta_2 + \beta_3 \text{ Lenient GAAP Precedents}_{j,t}) \cdot \text{Misstatement} + \boldsymbol{\beta} \cdot \boldsymbol{X} + \varepsilon,$$

where $\boldsymbol{X}$ is a vector of control variables including FPS, Size, Sales Growth, Buy-and-Hold Return, Daily Return Volatility, Daily Return Skewness, Share Turnover, Leverage, Blue State, State GDP, State Unemployment, Liberal Circuit, Big Auditors, Institutional Holdings, ΔReturn on Assets, Financing, and year-fixed and state-fixed effects. Variable definitions are in Appendix A. Columns 1, 3, and 5 (2, 4, and 6) use firm-years with below (above) annual median value of Firm-Specific Litigation Risk, Institutional Holdings, and Operating Cash Flows as a percentage of average assets, respectively. t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table 9: *GAAP-related Circuit Court Precedents and Auditor Litigation*

Sample:	Sued & Misstatement	Sued & Fraud Misst.	Sued & Non-fraud Misst.
	(1) Auditor Sued	(2) Auditor Sued	(3) Auditor Sued
Lenient GAAP Precedents	−0.136**	−0.247	−0.145***
	(−2.15)	(−1.44)	(−2.69)
Liberal Circuit	−0.035	−0.649	0.080
	(−0.18)	(−1.63)	(0.37)
Big Auditors	−0.033	−0.225*	0.076
	(−0.74)	(−1.70)	(1.50)
Institutional Holdings	−0.130	−0.153	−0.128
	(−1.51)	(−0.78)	(−1.60)
Financing	0.048	−0.055	0.031
	(1.00)	(−0.48)	(0.58)
Log(#Analysts)	0.046	0.078	0.024
	(0.79)	(0.53)	(0.44)
Book-to-market	−0.042	−0.169***	0.025
	(−1.42)	(−3.14)	(0.91)
Size	0.029	0.096**	−0.002
	(1.13)	(2.17)	(−0.09)
Sales Growth	0.008	−0.008	0.008
	(0.61)	(−0.16)	(0.59)
ΔReturn on Assets	0.034	0.043	0.024
	(1.59)	(0.77)	(0.85)
Leverage	−0.000	0.065	0.044
	(−0.00)	(0.27)	(0.52)
FPS	0.057	−0.032	0.046
	(0.71)	(−0.39)	(0.45)
Buy-and-Hold Return	0.022	0.038	0.016
	(0.46)	(0.56)	(0.33)
Daily Return Volatility	0.536	−1.163	1.430
	(0.41)	(−0.38)	(1.05)
Daily Return Skewness	−0.024	−0.027	−0.020
	(−0.92)	(−0.57)	(−0.76)
Share Turnover	0.000	0.000	0.000
	(1.58)	(1.11)	(1.24)
State Unemployment	1.967**	4.446	1.534*
	(2.09)	(1.15)	(1.67)
Blue State	−0.067	−0.112	−0.074
	(−1.16)	(−0.90)	(−1.24)
State GDP	0.931	−0.358	0.846
	(1.33)	(−0.19)	(1.14)
Inverse Mill's Ratio	0.691	1.219	0.495
	(1.23)	(1.24)	(0.81)
Intercept	−1.031	−3.030	−1.505
	(−0.60)	(−0.92)	(−0.76)
Year FE	Yes	Yes	Yes
State FE	Yes	Yes	Yes
N	1,040	278	762
Adj. R^2	0.108	0.249	0.090

This table reports the testing result of auditor litigation facing different GAAP precedents when firms with misstatements are facing shareholder litigation in the following linear-probability model:

$$Prob(\text{Auditor Sued}) = \beta_0 + \beta_1 \text{ Lenient GAAP Precedents} + \boldsymbol{\beta} \cdot \boldsymbol{X} + \beta_\lambda \lambda + \varepsilon,$$

where $\boldsymbol{X}$ is a vector of control variables that include FPS, Size, Sales Growth, Buy-and-Hold Return, Daily Return Volatility, Daily Return Skewness, Share Turnover, Leverage, Blue State, State GDP, State Unemployment, Liberal Circuit, Big Auditors, Institutional Holdings, ΔReturn on Assets, Financing, and year- and state-fixed effects. Variable definitions are in Appendix A. Column (1) tests using firms with litigation and all misstatement, column (2) using firms with litigation and only fraudulent misstatements, and column (3) using firms with litigation and only non-fraudulent misstatements. t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table 10: *GAAP-related Circuit Court Precedents and Firm Misstatement*

	(1) Misstatement	(2) Fraud Misst.	(3) Non-fraud Misst.
Lenient GAAP Precedents	0.009**	0.001	0.008**
	(2.22)	(0.64)	(2.18)
Strong-buy	0.011***	0.002	0.010**
	(2.71)	(0.99)	(2.56)
PE Ratio	0.010***	−0.001	0.011***
	(2.93)	(−0.84)	(3.46)
Long-Term Growth	0.008**	0.002	0.006**
	(2.48)	(1.63)	(1.97)
Buy	0.002	0.003**	−0.001
	(0.63)	(2.08)	(−0.24)
Beat Consensus	−0.023***	0.000	−0.023***
	(−4.00)	(0.13)	(−4.24)
Overconfidence	−0.000	0.001	−0.002
	(−0.11)	(1.29)	(−0.60)
Sensitivity	−0.024**	0.002	−0.025***
	(−2.47)	(0.44)	(−3.22)
Pay Slice	−0.009	0.002	−0.011
	(−0.52)	(0.25)	(−0.68)
Independent Board	−0.087***	−0.013**	−0.074***
	(−5.82)	(−2.34)	(−5.15)
CEO Chair	−0.004	−0.001	−0.003
	(−1.14)	(−1.09)	(−0.79)
Big Auditors	−0.007**	−0.004***	−0.003
	(−1.98)	(−3.09)	(−0.91)
Institutional Holdings	−0.006	−0.004*	−0.002
	(−1.22)	(−1.96)	(−0.45)
Financing	0.002	−0.000	0.002
	(0.56)	(−0.28)	(0.74)
Log(#Analysts)	−0.013***	−0.000	−0.013***
	(−6.06)	(−0.29)	(−6.47)
Book-to-market	0.003***	0.000	0.003***
	(2.80)	(0.88)	(2.68)
Size	0.015***	0.002***	0.012***
	(12.96)	(5.62)	(10.92)
Sales Growth	−0.001	−0.000	−0.001
	(−1.45)	(−0.75)	(−1.17)
ΔReturn on Assets	0.001	−0.001	0.002
	(0.48)	(−0.46)	(0.81)
Leverage	0.013***	0.003	0.011**
	(2.80)	(1.59)	(2.50)
FPS	0.023***	0.004***	0.020***
	(7.29)	(3.21)	(6.87)
Buy-and-Hold Return	0.005**	0.000	0.005**
	(2.46)	(0.37)	(2.56)
Daily Return Volatility	0.022	−0.015	0.037
	(0.29)	(−0.62)	(0.54)

Daily Return Skewness	-0.004^{***}	-0.000	-0.004^{***}
	(-4.55)	(-1.54)	(-4.19)
Share Turnover	0.000^{***}	0.000^{***}	0.000^{***}
	(6.04)	(5.08)	(5.28)
Liberal Circuit	0.032^{**}	0.011^{**}	0.022
	(2.25)	(2.09)	(1.59)
Blue State	-0.004	-0.003	-0.001
	(-0.67)	(-1.37)	(-0.23)
State GDP	-0.085	-0.012	-0.073
	(-1.01)	(-0.45)	(-1.00)
State Unemployment	-0.407^{***}	-0.013	-0.394^{***}
	(-3.60)	(-0.33)	(-3.87)
Intercept	0.094^{***}	-0.002	0.096^{***}
	(4.18)	(-0.26)	(4.10)
Year FE	Yes	Yes	Yes
State FE	Yes	Yes	Yes
N	65,154	65,154	65,154
adj. R^2	0.034	0.006	0.030

This table reports the testing result of financial misstatement for firms under circuit Court of Appeals precedents of different GAAP precedent leniency with the following linear-probability model:

$$Prob(\text{Misstatement}) = \beta_0 + \beta_1 \text{ Lenient GAAP Precedents} + \boldsymbol{\beta} \cdot \boldsymbol{MisreportCirl} + \varepsilon,$$

where $\boldsymbol{MisreportCirl}$ is a vector of control variables that include Long-Term Growth, Buy, Strong-buy, PE Ratio, Institutional Holdings, Beat Consensus, Overconfidence, Sensitivity, Pay Slice, Independent Board, CEO Chair, F Score, FPS, Size, Sales Growth, Buy-and-Hold Return, Daily Return Volatility, Daily Return Skewness, Share Turnover, Leverage, Blue State, State GDP, State Unemployment, Liberal Circuit, Big Auditors, Log(#Analysts), ΔReturn on Assets, Financing, and year- and state-fixed effects. Variable definitions are in Appendix A. Column (1) tests with all misstatement, column (2) with only fraudulent misstatements, and column (3) with only non-fraudulent misstatements. t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table 11: *Non-GAAP Precedents and Shareholder Litigation Against Misstating Firms*

	(1) Sued	(2) Sued	(3) Sued	(4) Sued
Lenient non-GAAP Precedents × Misstatement	−0.010			
	(−0.42)			
Lenient non-GAAP Precedents × Fraud Misst.		0.069		0.069
		(1.05)		(1.05)
Lenient non-GAAP Precedents × Non-fraud Misst.			−0.019	−0.018
			(−0.76)	(−0.72)
Misstatement	0.111***			
	(7.50)			
Fraud Misst.		0.217***		0.225***
		(5.56)		(5.77)
Non-fraud Misst.			0.087***	0.091***
			(5.37)	(5.66)
Lenient non-GAAP Precedents	−0.003	−0.005*	−0.003	−0.004
	(−0.96)	(−1.70)	(−0.82)	(−1.13)
Liberal Circuit	0.021**	0.021**	0.022**	0.020**
	(2.33)	(2.30)	(2.46)	(2.20)
Controls Litigation	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
State FE	Yes	Yes	Yes	Yes
N	65,154	65,154	65,154	65,154
adj. R^2	0.069	0.067	0.060	0.075

This table reports the robustness test result of the litigation occurrence tests for firms with misstatements under circuit Court of Appeals precedents of different non-GAAP precedent leniency with the following augmented linear-probability model:

$$\begin{aligned} Prob(\text{Sued}) \quad = \quad & \beta_0 + \beta_1 \text{ Lenient non-GAAP Precedents} + \\ & (\beta_2 + \beta_3 \text{ Lenient non-GAAP Precedents}) \cdot \text{Misstatement} + \boldsymbol{\beta} \cdot \boldsymbol{X} + \varepsilon, \end{aligned}$$

where $\boldsymbol{X}$ is a vector of control variables including FPS, Size, Sales Growth, Buy-and-Hold Return, Daily Return Volatility, Daily Return Skewness, Share Turnover, Leverage, Blue State, State GDP, State Unemployment, Liberal Circuit, Big Auditors, Institutional Holdings, ΔReturn on Assets, Financing, and year-, Fama-French-48-industry-, and state-fixed effects. Variable definitions are in Appendix A. Column (1) tests using all misstatement, column (2) using only fraudulent misstatements, column (3) using only non-fraudulent misstatements, and column (4) using both fraudulent and non-fraudulent misstatement. t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table 12: *Non-GAAP-related Circuit Court Precedents and Auditor Litigation*

Sample:	Sued & Misstatement	Sued & Fraud Misst.	Sued & Non-fraud Misst.
	(1) Auditor Sued	(2) Auditor Sued	(3) Auditor Sued
Lenient non-GAAP Precedents	−0.069	−0.145	−0.051
	(−1.12)	(−1.36)	(−0.85)
Controls Au. Litig.	Yes	Yes	Yes
Year FE	Yes	Yes	Yes
State FE	Yes	Yes	Yes
N	1,040	278	762
Adj. R^2	0.107	0.250	0.088

This table reports the testing result of auditor litigation facing different Non-GAAP precedents when firms with misstatements are facing shareholder litigation in the following linear-probability model:

$$Prob(\text{Auditor Sued}) = \beta_0 + \beta_1 \text{ Lenient non-GAAP Precedents} + \boldsymbol{\beta} \cdot \boldsymbol{X} + \beta_\lambda \lambda + \varepsilon,$$

where $\boldsymbol{X}$ is a vector of control variables that include FPS, Size, Sales Growth, Buy-and-Hold Return, Daily Return Volatility, Daily Return Skewness, Share Turnover, Leverage, Blue State, State GDP, State Unemployment, Liberal Circuit, Big Auditors, Institutional Holdings, ΔReturn on Assets, Financing, and year- and state-fixed effects. Variable definitions are in Appendix A. Column (1) tests using firms with litigation and all misstatement, column (2) using firms with litigation and only fraudulent misstatements, and column (3) using firms with litigation and only non-fraudulent misstatements. t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table 13: *Misstatement of Firms Facing Different Non-GAAP Circuit Court Precedents*

	(1) Misstatement	(2) Fraud Misst.	(3) Non-fraud Misst.
Lenient non-GAAP Precedents	−0.004	0.000	−0.004
	(−0.89)	(0.09)	(−1.02)
Controls Misreporting	Yes	Yes	Yes
Year FE	Yes	Yes	Yes
State FE	Yes	Yes	Yes
N	65,154	65,154	65,154
Adj. R^2	0.033	0.006	0.033

This table reports the testing result of financial misstatement for firms under circuit Court of Appeals precedents of different precedent leniency with the following linear-probability model:

$$Prob(\text{Misstatement}) = \beta_0 + \beta_1 \text{ Lenient non-GAAP Precedents} + \boldsymbol{\beta} \cdot \boldsymbol{Y} + \varepsilon,$$

where $\boldsymbol{Y}$ is a vector of control variables including Long-Term Growth, Buy, Strong-buy, PE Ratio, Institutional Holdings, Beat Consensus, Overconfidence, Sensitivity, Pay Slice, Independent Board, CEO Chair, F Score, FPS, Size, Sales Growth, Buy-and-Hold Return, Daily Return Volatility, Daily Return Skewness, Share Turnover, Leverage, Blue State, State GDP, State Unemployment, Liberal Circuit, Big Auditors, Log(#Analysts), ΔReturn on Assets, Financing, and year-, Fama-French-48-industry-, and state-fixed effects. Variable definitions are in Appendix A. Column (1) tests using all misstatement, column (2) with only fraudulent misstatements, column (3) with only non-fraudulent misstatements, column (4) with overstatements, and column (5) with understatements. t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Internet Appendix for "Judicial Precedents on GAAP Violations, Litigation Risk and Misreporting"

Table IA1: *GAAP Precedents and Shareholder Litigation Against Misstating Firms — Alternative Measure*

	(1) Sued	(2) Sued	(3) Sued	(4) Sued
Lenient GAAP Precedents, All × Misstatement	−0.076***			
	(−4.00)			
Lenient GAAP Precedents, All × Fraud Misst.		−0.076		−0.078
		(−1.44)		(−1.47)
Lenient GAAP Precedents, All × Non-fraud Misst.			−0.063***	−0.064***
			(−3.56)	(−3.61)
Misstatement	0.139***			
	(13.32)			
Fraud Misst.		0.287***		0.297***
		(10.07)		(10.42)
Non-fraud Misst.			0.105***	0.110***
			(9.82)	(10.29)
Lenient GAAP Precedents, All	0.009**	0.003	0.007	0.008*
	(2.13)	(0.67)	(1.65)	(1.92)
Liberal Circuit	0.027***	0.026***	0.028***	0.025**
	(2.74)	(2.63)	(2.87)	(2.58)
Big Auditors	−0.012***	−0.012***	−0.013***	−0.012***
	(−4.86)	(−4.85)	(−5.09)	(−4.66)
Institutional Holdings	−0.024***	−0.023***	−0.024***	−0.023***
	(−5.63)	(−5.68)	(−5.77)	(−5.54)
Financing	0.031***	0.031***	0.031***	0.031***
	(5.36)	(5.34)	(5.33)	(5.37)
Log(#Analysts)	0.021***	0.020***	0.021***	0.021***
	(12.84)	(12.17)	(12.75)	(12.60)
Book-to-market	−0.005***	−0.005***	−0.005***	−0.005***
	(−5.38)	(−5.12)	(−5.28)	(−5.34)
Size	0.006***	0.006***	0.006***	0.005***
	(3.91)	(4.54)	(4.25)	(3.90)
Sales Growth	0.013***	0.013***	0.013***	0.013***
	(6.38)	(6.28)	(6.40)	(6.32)
ΔReturn on Assets	−0.013***	−0.012***	−0.013***	−0.012***
	(−3.50)	(−3.50)	(−3.49)	(−3.50)
Leverage	−0.017***	−0.016***	−0.017***	−0.017***
	(−2.73)	(−2.64)	(−2.65)	(−2.75)
FPS	0.013***	0.014***	0.014***	0.012***
	(5.24)	(5.66)	(5.50)	(5.23)
Buy-and-Hold Return	0.014***	0.014***	0.014***	0.014***
	(7.42)	(7.67)	(7.48)	(7.51)
Daily Return Volatility	0.228**	0.230**	0.224**	0.231**
	(2.45)	(2.47)	(2.40)	(2.49)
Daily Return Skewness	−0.004***	−0.005***	−0.005***	−0.004***
	(−4.69)	(−5.09)	(−4.85)	(−4.75)
Share Turnover	0.000***	0.000***	0.000***	0.000***
	(13.29)	(13.31)	(13.57)	(13.08)
State Unemployment	0.287***	0.249***	0.275***	0.280***
	(3.40)	(2.96)	(3.24)	(3.34)
Blue State	−0.005	−0.005	−0.005	−0.005
	(−1.24)	(−1.20)	(−1.27)	(−1.16)
State GDP	0.072	0.058	0.068	0.071
	(1.30)	(1.07)	(1.22)	(1.29)
Intercept	−0.101***	−0.097***	−0.101***	−0.099***
	(−6.80)	(−6.70)	(−6.65)	(−6.80)

Year FE	Yes	Yes	Yes	Yes
State FE	Yes	Yes	Yes	Yes
N	65,154	65,154	65,154	65,154
adj. R^2	0.070	0.067	0.061	0.076

This table reports the result of litigation occurrence tests for firms with misstatements with the following linear probability regression model:

$$Prob(\text{Sued}) = \beta_0 + \beta_1 \text{ Lenient GAAP Precedents} + (\beta_2 + \beta_3 \text{ Lenient GAAP Precedents}) \cdot \text{Misstatement} + \boldsymbol{\beta} \cdot \boldsymbol{X} + \varepsilon,$$

where $\boldsymbol{X}$ is a vector of control variables that include FPS, Size, Sales Growth, Buy-and-Hold Return, Daily Return Volatility, Daily Return Skewness, Share Turnover, Leverage, Blue State, State GDP, State Unemployment, Liberal Circuit, Big Auditors, Institutional Holdings, ΔReturn on Assets, Financing, and year- and state-fixed effects. Variable definitions are in Appendix A of the paper and Table IA11 of this Internet Appendix. Column (1) tests with all misstatement, column (2) with only fraudulent misstatements, column (3) with only non-fraudulent misstatements, and column (4) with both fraudulent and non-fraudulent misstatement. t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table IA2: *GAAP-related Circuit Court Precedents and Auditor Litigation — Alternative Measure*

Sample:	Sued & Misstatement	Sued & Fraud Misst.	Sued & Non-fraud Misst.
	(1) Auditor Sued	(2) Auditor Sued	(3) Auditor Sued
Lenient GAAP Precedents, All	−0.153**	−0.302	−0.155***
	(−2.26)	(−1.29)	(−2.83)
Liberal Circuit	−0.085	−0.660	0.038
	(−0.43)	(−1.63)	(0.17)
Big Auditors	−0.040	−0.231*	0.074
	(−0.91)	(−1.77)	(1.62)
Institutional Holdings	−0.119	−0.170	−0.130*
	(−1.43)	(−0.68)	(−1.73)
Financing	0.044	−0.048	0.034
	(0.88)	(−0.37)	(0.70)
Log(#Analysts)	0.040	0.101	0.027
	(0.68)	(0.49)	(0.55)
Book-to-market	−0.042	−0.170***	0.024
	(−1.44)	(−3.13)	(0.88)
Size	0.027	0.099*	−0.001
	(1.07)	(1.92)	(−0.04)
Sales Growth	0.008	−0.005	0.008
	(0.57)	(−0.09)	(0.69)
ΔReturn on Assets	0.033	0.042	0.025
	(1.53)	(0.77)	(0.92)
Leverage	0.005	0.077	0.045
	(0.06)	(0.33)	(0.52)
FPS	0.048	−0.020	0.052
	(0.62)	(−0.19)	(0.60)
Buy-and-Hold Return	0.016	0.046	0.019
	(0.35)	(0.53)	(0.44)
Daily Return Volatility	0.429	−0.892	1.433
	(0.34)	(−0.25)	(1.08)
Daily Return Skewness	−0.021	−0.033	−0.022
	(−0.82)	(−0.54)	(−0.89)
Share Turnover	0.000	0.000	0.000
	(1.49)	(0.90)	(1.49)
State Unemployment	1.697*	4.069	1.204
	(1.75)	(0.92)	(1.31)
Blue State	−0.064	−0.131	−0.074
	(−1.07)	(−0.89)	(−1.28)
State GDP	0.961	−0.579	0.875
	(1.40)	(−0.27)	(1.19)
Inverse Mill's Ratio	0.627	1.357	0.538
	(1.13)	(0.98)	(1.01)
Intercept	−0.809	−3.452	−1.630
	(−0.48)	(−0.75)	(−0.95)
Year FE	Yes	Yes	Yes
State FE	Yes	Yes	Yes
N	1,040	278	762

adj. R^2	0.109	0.249	0.090

This table reports the testing result of auditor litigation facing different GAAP precedents when firms with misstatements are facing shareholder litigation in the following linear-probability model:

$$Prob(\text{Auditor Sued}) = \beta_0 + \beta_1 \text{ Lenient GAAP Precedents} + \boldsymbol{\beta} \cdot \boldsymbol{X} + \beta_\lambda \lambda + \varepsilon,$$

where $\boldsymbol{X}$ is a vector of control variables that include FPS, Size, Sales Growth, Buy-and-Hold Return, Daily Return Volatility, Daily Return Skewness, Share Turnover, Leverage, Blue State, State GDP, State Unemployment, Liberal Circuit, Big Auditors, Institutional Holdings, ΔReturn on Assets, Financing, and year- and state-fixed effects. Variable definitions are in Appendix A of the paper and Table IA11 of this Internet Appendix . Column (1) tests using firms with litigation and all misstatement, column (2) using firms with litigation and only fraudulent misstatements, and column (3) using firms with litigation and only non-fraudulent misstatements. t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table IA3: *GAAP Precedents and Firm Misstatement — Alternative Measure*

	(1) Misstatement	(2) Fraud Misst.	(3) Non-fraud Misst.
Lenient GAAP Precedents, All	0.010**	0.002	0.008*
	(2.26)	(1.28)	(1.93)
Strong-buy	0.011***	0.002	0.010**
	(2.72)	(0.99)	(2.57)
PE Ratio	0.010***	−0.001	0.011***
	(2.93)	(−0.84)	(3.46)
Long-Term Growth	0.009**	0.002	0.006**
	(2.48)	(1.64)	(1.97)
Buy	0.002	0.003**	−0.001
	(0.63)	(2.09)	(−0.24)
Beat Consensus	−0.023***	0.000	−0.023***
	(−4.00)	(0.12)	(−4.24)
Overconfidence	−0.000	0.001	−0.002
	(−0.10)	(1.29)	(−0.59)
Sensitivity	−0.024**	0.002	−0.025***
	(−2.47)	(0.44)	(−3.21)
Pay Slice	−0.009	0.002	−0.011
	(−0.52)	(0.25)	(−0.68)
Independent Board	−0.087***	−0.013**	−0.074***
	(−5.82)	(−2.35)	(−5.15)
CEO Chair	−0.004	−0.001	−0.003
	(−1.14)	(−1.08)	(−0.80)
Big Auditors	−0.007**	−0.004***	−0.003
	(−1.98)	(−3.08)	(−0.91)
Institutional Holdings	−0.006	−0.004*	−0.002
	(−1.22)	(−1.96)	(−0.45)
Financing	0.002	−0.000	0.002
	(0.55)	(−0.28)	(0.74)
Log(#Analysts)	−0.013***	−0.000	−0.013***
	(−6.06)	(−0.28)	(−6.48)
Book-to-market	0.003***	0.000	0.003***
	(2.80)	(0.88)	(2.68)
Size	0.015***	0.002***	0.012***
	(12.96)	(5.62)	(10.92)
Sales Growth	−0.001	−0.000	−0.001
	(−1.45)	(−0.75)	(−1.17)
ΔReturn on Assets	0.001	−0.001	0.002
	(0.48)	(−0.45)	(0.80)
Leverage	0.013***	0.003	0.011**
	(2.81)	(1.60)	(2.50)
FPS	0.023***	0.004***	0.020***
	(7.29)	(3.21)	(6.87)
Buy-and-Hold Return	0.005**	0.000	0.005**
	(2.46)	(0.36)	(2.57)
Daily Return Volatility	0.022	−0.016	0.037
	(0.29)	(−0.63)	(0.55)
Daily Return Skewness	−0.004***	−0.000	−0.004***
	(−4.55)	(−1.54)	(−4.19)
Share Turnover	0.000***	0.000***	0.000***
	(6.03)	(5.08)	(5.27)
Liberal Circuit	0.034**	0.012**	0.022
	(2.34)	(2.26)	(1.61)
Blue State	−0.004	−0.003	−0.001
	(−0.69)	(−1.40)	(−0.25)
State GDP	−0.082	−0.011	−0.070
	(−0.97)	(−0.44)	(−0.96)
State Unemployment	−0.391***	−0.010	−0.381***
	(−3.45)	(−0.27)	(−3.72)

Intercept	0.092^{***}	-0.003	0.095^{***}
	(4.11)	(-0.35)	(4.05)
Year FE	Yes	Yes	Yes
State FE	Yes	Yes	Yes
N	65,154	65,154	65,154
Adj. R^2	0.034	0.006	0.030

This table reports the testing result of financial misstatement for firms under circuit Court of Appeals precedents of different GAAP precedent leniency with the following logit regression model:

$$Prob(\text{Misstatement}) = \beta_0 + \beta_1 \text{ Lenient GAAP Precedents} + \boldsymbol{\beta} \cdot \boldsymbol{Y} + \varepsilon,$$

where $\boldsymbol{Y}$ is a vector of control variables that include Long-Term Growth, Buy, Strong-buy, PE Ratio, Institutional Holdings, Beat Consensus, Overconfidence, Sensitivity, Pay Slice, Independent Board, CEO Chair, F Score, FPS, Size, Sales Growth, Buy-and-Hold Return, Daily Return Volatility, Daily Return Skewness, Share Turnover, Leverage, Blue State, State GDP, State Unemployment, Liberal Circuit, Big Auditors, Log(#Analysts), ΔReturn on Assets, Financing, and year- and state-fixed effects. Variable definitions are in Appendix A of the paper and Table IA11 of this Internet Appendix . Column (1) tests with all misstatement, column (2) with only fraudulent misstatements, and column (3) with only non-fraudulent misstatements. t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table IA4: *Precedent Characteristics and Actual Citations – Logit Test*

	(1) Actual Citation	(2) Actual Citation	(3) Actual Citation
Home Circuit	3.034***	3.237***	3.327***
	(38.48)	(41.37)	(53.25)
GAAP Precedent × GAAP Case	0.561***	0.616***	0.598***
	(7.24)	(8.15)	(7.54)
GAAP Precedent	0.641***	0.637***	0.590***
	(4.08)	(3.98)	(3.72)
GAAP Case	0.376***	0.293***	0.285***
	(6.32)	(5.90)	(5.64)
Precedent Age	−0.038***	−0.074***	−0.010
	(−4.54)	(−12.30)	(−0.71)
Consistent Precedent	0.102	0.088	0.063
	(1.63)	(1.57)	(1.03)
Liberal District Judge	0.133***	0.103***	0.250***
	(2.76)	(3.74)	(11.19)
Intercept	−5.344***	−4.319***	−2.798***
	(−49.95)	(−12.24)	(−6.32)
Precedent Year FE		Yes	
Precedent Circuit FE		Yes	
Case Year FE			Yes
Case Circuit FE			Yes
N	1,309,759	1,309,759	1,309,040
Psu. R^2	0.222	0.250	0.246

This table reports the result of precedent citation test. The sample consists of 1,309,759 possible precedent–citation pairs out of 432 precedents and the 5,251 securities class action cases citing these precedents, with the requirement that a citing case takes place after a precedent. Actual Citing is an indicator variable that takes value 1 if in a possible precedent–citation pair, the citing case actually cites the precedent, and zero otherwise. Home Cir. Precedent is an indicator variable that takes value 1 if the precedent and the case in a possible precedent–citation pair come from the same circuit, and zero otherwise. GAAP Precedent is an indicator variable that takes value 1 if a precedent involves GAAP violation allegations, and zero otherwise. GAAP Case is an indicator variable that takes value 1 if a citing case involves GAAP violation allegations, and zero otherwise. Precedent Age is the number of years between the precedent and the case in a possible precedent–citation pair. In Col (1), we use the following logit model:

$$Prob(\text{Actual Citing}) = \beta_0 + \beta_1 \text{Home Cir. Precedent} + \beta_2 \text{GAAP Precedent} \times \text{GAAP Case} + \beta_3 \text{GAAP Precedent}$$

$$+\beta_4 \text{GAAP Case} + \beta_5 \text{Precedent Age} + \varepsilon.$$

In Col (2), we also include precedent year- and circuit- fixed effects; in Col (3), we replace them with case year- and circuit- fixed effects. t statistics in parentheses below coefficients are based on standard errors clustered by circuits. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table IA5: *District Court Rulings Sample*

Panel A: District Court Rulings Selection

		District Court Rulings
District rulings from Google Scholar Search:		5,244
Less non-Rule 10b(5) securities fraud or non-class-action cases:		1,831
Less rulings on other than motion-to-dismiss:		1,079
Matching with SCAC by company name:	(353)	726
Less: with incomplete control variables:	(287)	439

Panel B: District Court Rulings Description

	N	Obs.	Mean
Dismissal	439	356	0.811
Liberal District Judge	439	217	0.494
GAAP Case	439	178	0.405

Panel C: Descriptive Statistics

	N	Mean	S.D.	p25	p50	p75
#Days (filing, ruling)	439	735.7	440.3	453.0	590.0	890.0
$\#\text{Affirmed}_{(\text{filing, ruling})}$	439	1.426	2.537	0.000	0.000	2.000
$\#\text{Reversed}_{(\text{filing, ruling})}$	439	0.854	1.968	0.000	0.000	1.000
Existing GAAP Precedents	439	0.419	0.313	0.200	0.400	0.600
Liberal Circuit	439	0.343	0.176	0.214	0.296	0.466
CAR filing	439	−0.057	0.169	−0.074	−0.016	0.017

Panel A reports the district court rulings data set that this paper uses. Panel B reports the number and the percentage of district court rulings that are dismissed, ruled by a liberal judge, or involve GAAP violation allegations. Panel C reports summary statistics of variables used in the empirical test.

Table IA6: *Circuit Court GAAP Precedents and District Court Rulings — Logit Test*

	(1) Dismissal	(2) Dismissal	(3) Dismissal
#Affirmed$_{\text{(filing, ruling)}}$	0.236***		
	(4.67)		
#Reversed$_{\text{(filing, ruling)}}$	−0.186***		
	(−5.02)		
#Affirmed$_{\text{(filing+3y, ruling+3y)}}$		0.039	
		(0.90)	
#Reversed$_{\text{(filing+3y, ruling+3y)}}$		0.025	
		(0.36)	
#AffirmedOtherCircuit$_{\text{(filing, ruling)}}$			0.011
			(0.88)
#ReversedOtherCircuit$_{\text{(filing, ruling)}}$			−0.006
			(−0.28)
Lenient GAAP Precedents	1.548*	1.117	1.179
	(1.89)	(1.15)	(1.18)
Liberal Circuit	5.190**	4.782*	4.700*
	(2.36)	(1.87)	(1.76)
Liberal District Judge	−0.186	−0.121	−0.118
	(−1.05)	(−0.74)	(−0.68)
CAR filing	1.602**	1.184*	1.164**
	(2.25)	(1.93)	(2.06)
GAAP Case	−0.164	−0.167	−0.168
	(−0.86)	(−1.09)	(−1.02)
Intercept	−15.407***	−14.772***	−14.632***
	(−14.83)	(−14.56)	(−13.95)
Year FE	Yes	Yes	Yes
Circuit FE	Yes	Yes	Yes
N	403	403	403
pseudo R^2	0.119	0.095	0.096

This table tests the effect of new circuit court precedents on district courts' rulings using circuit court rulings that occur after filing a lawsuit at a district court but before the ruling of the district court in the following logit regression model:

$$Prob(\text{Dismissal}) = \beta_0 + \beta_1\ \#\text{Affirmed}_{\text{(filing, ruling)}} + \beta_2\ \#\text{Reversed}_{\text{(filing, ruling)}} + \boldsymbol{\beta}\cdot\boldsymbol{X} + \boldsymbol{\gamma}\cdot\boldsymbol{Y} + \varepsilon,$$

where $\boldsymbol{X}$ is a vector of circuit and district court level controls, and $\boldsymbol{Y}$ is a vector of case-level controls. The dependent variable Dismissal is an indicator variable taking the value one if the district court dismisses a lawsuit, and zero otherwise. Variable definitions are in Appendix A. t-statistics in parentheses are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table IA7: *GAAP Precedents and Shareholder Litigation Against Misstating Firms — Logit Test*

	(1) Sued	(2) Sued	(3) Sued	(4) Sued
Lenient GAAP Precedents × Misstatement	−0.612***			
	(−3.58)			
Lenient GAAP Precedents × Fraud Misst.		−0.330		−0.372
		(−1.10)		(−1.21)
Lenient GAAP Precedents × Non-fraud Misst.			−0.582***	−0.612***
			(−3.45)	(−3.50)
Misstatement	1.517***			
	(17.73)			
Fraud Misst.		2.124***		2.313***
		(13.93)		(15.19)
Non-fraud Misst.			1.217***	1.324***
			(13.07)	(13.92)
Lenient GAAP Precedents	0.111	0.001	0.077	0.096
	(1.53)	(0.01)	(1.08)	(1.34)
Liberal Circuit	0.487**	0.462**	0.494**	0.465**
	(2.39)	(2.26)	(2.45)	(2.26)
Big Auditors	−0.172***	−0.178***	−0.177***	−0.169***
	(−3.09)	(−3.26)	(−3.23)	(−3.04)
Institutional Holdings	−0.326***	−0.318***	−0.334***	−0.319***
	(−4.82)	(−4.85)	(−5.05)	(−4.69)
Financing	0.530***	0.522***	0.522***	0.532***
	(8.59)	(8.34)	(8.45)	(8.57)
Log(#Analysts)	0.453***	0.434***	0.447***	0.451***
	(14.19)	(13.36)	(14.18)	(13.88)
Book-to-market	−0.114***	−0.107***	−0.109***	−0.115***
	(−7.68)	(−7.13)	(−7.43)	(−7.64)
Size	0.080***	0.091***	0.086***	0.080***
	(3.60)	(4.19)	(3.91)	(3.60)
Sales Growth	0.141***	0.136***	0.137***	0.141***
	(10.03)	(9.70)	(10.04)	(9.96)
ΔReturn on Assets	−0.069**	−0.065**	−0.070**	−0.068**
	(−2.47)	(−2.42)	(−2.53)	(−2.45)
Leverage	−0.296**	−0.278**	−0.278**	−0.302**
	(−2.45)	(−2.35)	(−2.35)	(−2.48)
FPS	0.214***	0.234***	0.231***	0.209***
	(5.15)	(5.53)	(5.47)	(5.06)
Buy-and-Hold Return	0.184***	0.188***	0.185***	0.186***
	(6.58)	(6.94)	(6.94)	(6.54)
Daily Return Volatility	2.808*	2.689*	2.624*	2.885*
	(1.74)	(1.67)	(1.66)	(1.77)
Daily Return Skewness	−0.068***	−0.073***	−0.070***	−0.068***
	(−4.15)	(−4.61)	(−4.33)	(−4.20)
Share Turnover	0.001***	0.001***	0.001***	0.001***
	(13.21)	(13.72)	(13.99)	(12.85)
State Unemployment	5.235***	4.072***	4.918***	5.015***
	(3.80)	(2.92)	(3.55)	(3.63)
Blue State	−0.086	−0.084	−0.087	−0.080
	(−1.12)	(−1.10)	(−1.15)	(−1.05)
State GDP	0.520	0.209	0.400	0.497
	(0.51)	(0.21)	(0.40)	(0.48)
Intercept	−6.224***	−6.070***	−6.150***	−6.202***
	(−14.15)	(−14.02)	(−13.90)	(−14.26)
Year FE	Yes	Yes	Yes	Yes
State FE	Yes	Yes	Yes	Yes
N	65,154	65,154	65,154	65,154

Psu. R^2	0.130	0.119	0.117	0.134

This table reports the result of litigation occurrence tests for firms with misstatements with the following logit regression model:

$$Prob(\text{Sued}) = \beta_0 + \beta_1 \text{ Lenient GAAP Precedents} + (\beta_2 + \beta_3 \text{ Lenient GAAP Precedents}) \cdot \text{Misstatement} + \boldsymbol{\beta} \cdot \boldsymbol{X} + \varepsilon,$$

where $\boldsymbol{X}$ is a vector of control variables that include FPS, Size, Sales Growth, Buy-and-Hold Return, Daily Return Volatility, Daily Return Skewness, Share Turnover, Leverage, Blue State, State GDP, State Unemployment, Liberal Circuit, Big Auditors, Institutional Holdings, ΔReturn on Assets, Financing, and year- and state-fixed effects. Variable definitions are in Appendix A. Column (1) tests with all misstatement, column (2) with only fraudulent misstatements, column (3) with only non-fraudulent misstatements, and column (4) with both fraudulent and non-fraudulent misstatement. t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table IA8: *GAAP-related Circuit Court Precedents and Auditor Litigation – First Stage Probit Test*

	(1) Firm Sued & Misstatement	(2) Firm Sued & Fraud Misst.	(3) Firm Sued & Non-fraud Misst.
IV:			
ΔCash Sales	−0.002	−0.005***	−0.001
	(−1.12)	(−4.82)	(−0.81)
ΔEmployees	−0.000	−0.000	−0.000
	(−0.60)	(−0.79)	(−0.36)
Lenient non-GAAP Precedents	0.116*	0.125	0.101
	(1.76)	(1.35)	(1.43)
2nd Stage Vars:			
Lenient GAAP Precedents	−0.102	−0.163	−0.066
	(−1.29)	(−1.44)	(−0.90)
Liberal Circuit	0.197*	0.102	0.209
	(1.72)	(0.70)	(1.59)
Big Auditors	0.036	0.002	0.047
	(0.86)	(0.03)	(0.97)
Institutional Holdings	−0.144***	−0.178**	−0.112**
	(−3.42)	(−2.29)	(−2.26)
Financing	0.079**	0.058	0.079**
	(2.41)	(1.07)	(2.32)
Log(#Analysts)	0.112***	0.157***	0.084***
	(5.62)	(5.19)	(3.66)
Book-to-market	0.001	0.003	−0.001
	(0.06)	(0.22)	(−0.05)
Size	0.043***	0.036**	0.041***
	(3.84)	(2.14)	(3.46)
Sales Growth	0.021**	0.019*	0.020*
	(2.20)	(1.68)	(1.72)
ΔReturn on Assets	0.027	0.003	0.032
	(0.91)	(0.07)	(0.92)
Leverage	−0.068	−0.033	−0.074
	(−1.47)	(−0.40)	(−1.40)
FPS	0.157***	0.067	0.177***
	(5.34)	(1.54)	(5.50)
Buy-and-Hold Return	0.088***	0.062**	0.088***
	(4.37)	(2.18)	(4.54)
Daily Return Volatility	1.460*	1.913	1.141
	(1.72)	(1.56)	(1.20)
Daily Return Skewness	−0.049***	−0.047**	−0.045***
	(−4.46)	(−2.57)	(−3.80)
Share Turnover	0.001***	0.000***	0.001***
	(8.96)	(3.62)	(8.87)
State Unemployment	−0.002	−1.509	0.544
	(−0.00)	(−1.51)	(0.79)
Blue State	−0.097***	−0.092*	−0.087**
	(−2.77)	(−1.81)	(−2.41)
State GDP	−0.362	−1.223	0.027
	(−0.49)	(−1.41)	(0.04)
Intercept	−2.834***	−3.058***	−2.986***
	(−23.86)	(−18.11)	(−23.48)

Year FE	Yes	Yes	Yes
State FE	Yes	Yes	Yes
N	65,154	65,154	65,154
Psu. R^2	0.052	0.044	0.051

This table reports the testing result of auditor litigation facing different GAAP precedents when firms with misstatements are facing shareholder litigation in the following linear-probability model:

$$Prob(\text{Auditor Sued}) = \beta_0 + \beta_1 \text{ Lenient GAAP Precedents} + \boldsymbol{\beta} \cdot \boldsymbol{X} + \beta_\lambda \lambda + \varepsilon,$$

where $\boldsymbol{X}$ is a vector of control variables that include FPS, Size, Sales Growth, Buy-and-Hold Return, Daily Return Volatility, Daily Return Skewness, Share Turnover, Leverage, Blue State, State GDP, State Unemployment, Liberal Circuit, Big Auditors, Institutional Holdings, ΔReturn on Assets, Financing, and year- and state-fixed effects. Variable definitions are in Appendix A of the paper and Table IA11 of this Internet Appendix . Column (1) tests using firms with litigation and all misstatement, column (2) using firms with litigation and only fraudulent misstatements, and column (3) using firms with litigation and only non-fraudulent misstatements. t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table IA9: *GAAP-related Circuit Court Precedents and Auditor Litigation — Logit Test*

Sample:	Sued & Misstatement	Sued & Fraud Misst.	Sued & Non-fraud Misst.
	(1) Auditor Sued	(2) Auditor Sued	(3) Auditor Sued
Lenient GAAP Precedents	−0.903*	−1.672	−1.592***
	(−1.79)	(−0.82)	(−2.68)
Liberal Circuit	0.465	1.227	−0.132
	(0.28)	(0.26)	(−0.08)
Big Auditors	−0.419	−0.863	0.583
	(−1.04)	(−0.77)	(1.01)
Institutional Holdings	−0.752	−1.694	−1.252*
	(−1.08)	(−0.81)	(−1.65)
Financing	0.264	−0.198	0.177
	(0.67)	(−0.24)	(0.38)
Log(#Analysts)	0.276	−0.058	0.346
	(0.58)	(−0.03)	(0.72)
Book-to-market	−0.394	−1.273*	0.165
	(−1.52)	(−1.76)	(0.66)
Size	0.137	1.134**	−0.036
	(0.65)	(2.53)	(−0.15)
Sales Growth	−0.009	−0.469	0.055
	(−0.07)	(−0.96)	(0.44)
ΔReturn on Assets	0.270	0.638	0.269
	(1.36)	(0.87)	(1.08)
Leverage	0.205	−0.511	0.353
	(0.30)	(−0.21)	(0.41)
FPS	0.166	−0.569	0.413
	(0.24)	(−0.66)	(0.42)
Buy-and-Hold Return	0.021	0.267	0.166
	(0.05)	(0.38)	(0.34)
Daily Return Volatility	3.881	−14.220	15.659
	(0.39)	(−0.41)	(1.39)
Daily Return Skewness	−0.127	−0.273	−0.203
	(−0.58)	(−0.51)	(−0.74)
Share Turnover	0.003	0.005	0.004
	(1.12)	(1.25)	(1.25)
State Unemployment	26.311**	36.453	20.019
	(2.26)	(0.89)	(1.44)
Blue State	−0.831*	−1.067	−1.087
	(−1.66)	(−1.05)	(−1.53)
State GDP	11.595*	11.638	15.449**
	(1.79)	(0.56)	(2.11)
Inverse Mill's Ratio	3.968	10.803	5.029
	(0.85)	(0.88)	(0.86)
Intercept	1.452	−26.141	−17.854
	(0.10)	(−0.66)	(−0.95)
Year FE	Yes	Yes	Yes
State FE	Yes	Yes	Yes
N	867	203	633
Psu. R^2	0.152	0.354	0.183

This table reports the testing result of auditor litigation facing different GAAP precedents when firms with misstatements are facing shareholder litigation in the following logit regression model:

$$Prob(\text{Auditor Sued}) = \beta_0 + \beta_1 \text{ Lenient GAAP Precedents} + \boldsymbol{\beta} \cdot \boldsymbol{X} + \beta_\lambda \lambda + \varepsilon,$$

where $\boldsymbol{X}$ is a vector of control variables that include FPS, Size, Sales Growth, Buy-and-Hold Return, Daily Return Volatility, Daily Return Skewness, Share Turnover, Leverage, Blue State, State GDP, State Unemployment, Liberal Circuit, Big Auditors, Institutional Holdings, ΔReturn on Assets, Financing, and year- and state-fixed effects. Variable definitions are in Appendix A. Column (1) tests using firms with litigation and all misstatement, column (2) using firms with litigation and only fraudulent misstatements, and column (3) using firms with litigation and only non-fraudulent misstatements. t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table IA10: *GAAP-related Circuit Court Precedents and Firm Misstatement — Logit Test*

	(1) Misstatement	(2) Fraud Misst.	(3) Non-fraud Misst.
Lenient GAAP Precedents	0.094**	0.026	0.094*
	(1.98)	(0.23)	(1.84)
Strong-buy	0.160***	0.137	0.156***
	(3.10)	(1.11)	(2.93)
PE Ratio	0.115***	−0.071	0.141***
	(3.24)	(−0.82)	(3.74)
Long-Term Growth	0.107***	0.200**	0.087**
	(2.82)	(1.97)	(2.18)
Buy	0.005	0.223**	−0.030
	(0.12)	(2.00)	(−0.69)
Beat Consensus	−0.273***	0.016	−0.311***
	(−4.07)	(0.09)	(−4.27)
Overconfidence	−0.003	0.117	−0.021
	(−0.09)	(1.38)	(−0.56)
Sensitivity	−0.274***	0.023	−0.324***
	(−2.68)	(0.11)	(−3.32)
Pay Slice	−0.134	0.060	−0.166
	(−0.75)	(0.11)	(−0.84)
Independent Board	−0.939***	−0.819**	−0.917***
	(−6.63)	(−2.52)	(−5.95)
CEO Chair	−0.048	−0.107	−0.036
	(−1.19)	(−0.91)	(−0.88)
Big Auditors	−0.074*	−0.247**	−0.040
	(−1.76)	(−2.28)	(−0.86)
Institutional Holdings	−0.069	−0.209	−0.038
	(−1.31)	(−1.52)	(−0.63)
Financing	0.022	−0.021	0.029
	(0.56)	(−0.19)	(0.71)
Log(#Analysts)	−0.149***	−0.026	−0.165***
	(−5.97)	(−0.44)	(−6.42)
Book-to-market	0.036***	0.033	0.035***
	(2.76)	(0.97)	(2.63)
Size	0.167***	0.172***	0.160***
	(13.22)	(6.42)	(11.28)
Sales Growth	−0.017	−0.029	−0.016
	(−1.22)	(−0.80)	(−0.99)
ΔReturn on Assets	0.015	−0.035	0.025
	(0.45)	(−0.42)	(0.76)
Leverage	0.162***	0.230**	0.147***
	(3.21)	(2.30)	(2.80)
FPS	0.279***	0.291***	0.268***
	(8.43)	(3.66)	(7.69)
Buy-and-Hold Return	0.064***	0.028	0.067***
	(2.91)	(0.59)	(2.96)
Daily Return Volatility	−0.496	−1.700	−0.283
	(−0.51)	(−0.78)	(−0.28)
Daily Return Skewness	−0.045***	−0.037	−0.045***
	(−4.07)	(−1.28)	(−3.80)
Share Turnover	0.001***	0.001***	0.001***
	(7.40)	(6.86)	(6.32)
Liberal Circuit	0.412**	0.917*	0.242
	(1.96)	(1.75)	(1.06)
Blue State	−0.006	−0.228	0.015
	(−0.09)	(−1.32)	(0.21)
State GDP	−0.834	−0.369	−0.782
	(−0.82)	(−0.19)	(−0.78)
State Unemployment	−4.443***	−1.175	−4.746***
	(−3.51)	(−0.28)	(−3.74)

Intercept	-2.898^{***}	-5.828^{***}	-2.968^{***}
	(-13.27)	(-7.80)	(-12.60)
Year FE	Yes	Yes	Yes
State FE	Yes	Yes	Yes
N	65,154	65,154	65,154
Psu. R^2	0.055	0.053	0.055

This table reports the testing result of financial misstatement for firms under circuit Court of Appeals precedents of different GAAP precedent leniency with the following logit regression model:

$$Prob(\text{Misstatement}) = \beta_0 + \beta_1 \text{ Lenient GAAP Precedents} + \boldsymbol{\beta} \cdot \boldsymbol{Y} + \varepsilon,$$

where $\boldsymbol{Y}$ is a vector of control variables that include Long-Term Growth, Buy, Strong-buy, PE Ratio, Institutional Holdings, Beat Consensus, Overconfidence, Sensitivity, Pay Slice, Independent Board, CEO Chair, F Score, FPS, Size, Sales Growth, Buy-and-Hold Return, Daily Return Volatility, Daily Return Skewness, Share Turnover, Leverage, Blue State, State GDP, State Unemployment, Liberal Circuit, Big Auditors, Log(#Analysts), ΔReturn on Assets, Financing, and year- and state-fixed effects. Variable definitions are in Appendix A. Column (1) tests with all misstatement, column (2) with only fraudulent misstatements, and column (3) with only non-fraudulent misstatements. t statistics in parentheses below coefficients are based on standard errors clustered by circuit–year. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Table IA11: *Additional Definitions of variables used in this appendix*

Alternative Circuit Court Precedent Measures	
Lenient GAAP Precedents, All	The percentage of shareholder class action lawsuits that are dismissed by the circuit court in the nine most recent lawsuits with GAAP-violation allegations from after 1996 till each current year.*
Recent 3 Lenient GAAP Precedents	The percentage of shareholder class action lawsuits that are dismissed by the circuit court in the three most recent lawsuits with GAAP-violation allegations from after 1996 till each current year.*
Additional Auditor Litigation Variables	
Firm Sued & Misstatement	An indicator variable that equals 1 if the firm–year overlaps with the class period of a securities class action lawsuit, and at the same time the firm–year involves accounting misstatement as revealed in a later restatement , and 0 otherwise; securities class action lawsuits are obtained from the website of Securities Class Action Clearinghouse.
Firm Sued & Fraud Misst.	An indicator variable that equals 1 if the firm–year overlaps with the class period of a securities class action lawsuit, and at the same time the firm–year involves fraudulent accounting misstatement as revealed in a later restatement , and 0 otherwise; securities class action lawsuits are obtained from the website of Securities Class Action Clearinghouse.
Firm Sued & Non-fraud Misst.	An indicator variable that equals 1 if the firm–year overlaps with the class period of a securities class action lawsuit, and at the same time the firm–year involves non-fraudulent accounting misstatement as revealed in a later restatement , and 0 otherwise; securities class action lawsuits are obtained from the website of Securities Class Action Clearinghouse.
ΔEmployees	Changes in the number of employees.

* Circuit court rulings are from Google Scholar Case Law Search, district court ruling and citation from Google Scholar Case Law Search, and district court case filing date from Securities Class Action Clearinghouse (SCAC).