Chapter 16
Information Asymmetries in the Context of Restatement Announcements

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ABSTRACT

This chapter presents the results of an empirical investigation on stock trading activity in the context of restatement announcements. The aim is to explore whether sophisticated investors may anticipate accounting restatements, and which factors lead their trading strategies. The empirical analysis shows that sophisticated investors sell before and buy after the announcement. Moreover sophisticated investors trade more when information asymmetry and event-related risk are higher, and do not care about stock's recent performance. In contrast, unsophisticated investors do not follow a particular trading strategy before or after the announcement, stay away from trading when the information gap (risk) is too wide (high), but trade more on stock with positive past performance. Results suggest that sophisticated investors are able to anticipate restatements and exploit their information advantage to speculate.

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INTRODUCTION

The Financial Accounting Standards Board (FASB) defines a restatement as a revision of a previously issued financial statement to correct a material error. Restatements have gathered a considerable interest from researchers, regulators and investors due to the significant impact they have on issuers' value. A consistent portion of research investigates market reaction to accounting restatements. Several studies document large negative reaction with a loss in equity value of 10 percent, or even higher (Hribar & Jenkins, 2004; Palmrose, Richardson, & Scholz, 2004). Part of this reaction is due to revisions in firm's expected performance and part to a reduction in management capabilities and financial statements reliability (Badertscher, Hribar, & Jenkins, 2011). A recent strand of the literature focuses on the relation between information flow among investors and the market response to restatement announcements. Hribar et al. (2010) show that institutional investors tend to quit from restatement companies one quarter before the announcement. Badertscher et al. (2011) demonstrate that insider trading and company's share repurchase before a restatement announcements have a signaling effect for investors.

This chapter aims to extend this literature by investigating the difference between sophisticated and unsophisticated investors trading strategies in the context of restatement announcement. Previous studies adopt ownership data to discriminate investors. Differently, we adopt a microstructure approach and classify investors based on their trading behaviors. This allows us to document the trading strategies implemented by each investor's type on a daily basis.

This chapter explores four hypotheses about the difference between sophisticated and unsophisticated trading. The first hypothesis is that sophisticated investors are able to anticipate accounting restatement and sell before the event's disclosure. By comparing abnormal buy and sell trading volumes, it emerges that sophisticated investors tend to sell until the day before the announcement, whereas unsophisticated investors do not change their strategy in the same period. The second hypothesis is that, given that the information advantage rests on the side of sophisticated investors, they trade more when information asymmetry is higher. The results show a positive impact of information asymmetry on sophisticated investors trading volume. On the contrary, such an impact is negative for unsophisticated investors. The third hypothesis is that sophisticated investors trade more when the risk related to the impact of the announcement on the stock price is higher. Results are coherent with the expectations and show that an increase in uncertainty has a positive impact of sophisticated investors trading. Unsophisticated investors, instead, tend to stay away from too risky stocks. The fourth and last hypothesis is that sophisticated investors do not consider stock's recent performance in their decision process, while unsophis-

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