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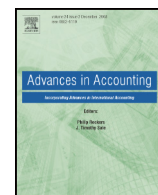

The market's response to earnings surprises after first-time going-concern modifications[☆,☆☆]

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ABSTRACT

This study investigates the market's response to earnings surprises after first-time going-concern modifications (GCMs). Using a sample of 581 firms and an events-study research design, we document a significant decrease in earnings response coefficients (ERCs) in the quarters following the GCM. However, this result appears to be driven by firms for which the GCM is unexpected. Specifically, we find that firms with high Z-scores prior to the GCM experience an immediate and prolonged decline in ERCs over the four quarters after the GCM, but find no change in ERCs for those firms with low Z-scores. These results are consistent with the GCM potentially resolving investors' fundamental uncertainty about future cash flows, and/or signaling that the earnings numbers generated by the firm are noisier or less persistent than was previously assumed. Further, we find no change in ERCs for a propensity-score matched control sample that did not receive GCMs, suggesting that the decline in earnings informativeness is not a response to general economic conditions. Finally, we document that institutional investors incorporate the information in the GCM. The study makes an important contribution to the going-concern literature by documenting that GCMs influence the pricing of earnings.

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1. Introduction

Under federal securities laws and auditing standards, auditors have a responsibility to evaluate the going-concern status of a client and to include an explanatory paragraph in the standard audit report when substantial doubt arises about an entity's ability to continue in existence.[1] The going-concern modification (hereafter, GCM) augments the auditors' professional opinion on the accuracy and completeness of a firm's reporting and disclosure with additional information about the auditors' assessment of the perceived risk regarding the continued viability of the client. Despite the fact that regulators and auditing standard setters have long mandated the disclosure, its usefulness to investors has been the subject of a long-standing debate.[2] Critics of the disclosure maintain that auditors have expertise in assurance audits and their ability to evaluate uncertainties is not necessarily superior to that of financial statement users (AICPA, 1978; Dopuch, Holthausen, Leftwich, Holthausen, & Leftwich, 1987; Menon & Williams, 2010; Mutchler, 1985).[3] On the other hand, advocates of the disclosure such as bankers and analysts, contend that auditors' knowledge would likely lead to better evaluations than those of financial statement users, since auditors have access to information that is not publicly available to investors

☆ Data availability: The data are publicly available from the sources identified in the paper.

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[1] See Section 10A (a) (3) of the Securities Exchange Act of 1934 ("Exchange Act"), which requires that each audit include "an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year," and paragraph .02 of AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (SAS No. 59 (AICPA, 1988).

[2] For example, the Statement of Auditing Standards (*SAS*) *No. 2* was issued by the American Institute of Certified Public Accountants (AICPA) in 1974. In 1982, the AICPA's proposal to eliminate the requirement was met with strong public opposition (Mann, 1982). In 1988, in response to increasing public pressure, the AICPA in 1988 issued *SAS No. 59*, which increased the auditor's responsibility to evaluate and disclose going concern problems, relative to its predecessor, *SAS No. 34*. Under *SAS No. 34* (AICPA, 1981, para. 3) an independent auditor was not required to search for evidential matter relating to continued existence. However, if during the course of the audit, information obtained raised uncertainty about the company's ability to continue, the auditor was required to evaluate the company's status and disclose any substantial doubts about continuity in the auditor's opinion (AICPA, para. 3). Under *SAS No. 59* (AICPA, 1988, para. 3), an independent auditor is required to proactively assess the going concern status of a client.

[3] Mutchler (1985) and Dopuch et al. (1987) posit that most GCMs are unlikely to convey new information to the market since they are simply confirmation of firms' financial deterioration and are predictable using publicly available information.

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and analysts (Bell & Wright, 1995; Mann, 1982).[4] Consistent with this perspective, regulators and standard setters such as the Public Company Accounting Oversight Board (PCAOB) and the Financial Accounting Standards Board (FASB) have been evaluating how to enhance the usefulness of the existing going-concern standard, particularly in the wake of the recent financial crisis (PCAOB, 2012a).[5] The continued importance of going-concern disclosures to investors, regulators, and standard setters, suggests a need for research on whether GCMs affect the usefulness of firms' earnings for market participants, which is the purpose of this study.

The extant research assessing the usefulness of GCMs have focused primarily on the immediate stock price response to GCMs, and find mixed evidence that GCMs provide new information to investors (Chow & Rice, 1982; Dodd, Dopuch, Holthausen, & Leftwich, 1984; Dopuch, Holthausen, & Leftwich, 1986; Elliott, 1982; Fleak & Wilson, 1994; Herbohn, Ragunathan, & Garsden, 2007; Jones, 1996; Kausar, Taffler, & Tan, 2009; Menon & Williams, 2010; Taffler, Lu, & Kausar, 2004).[6] Some recent studies have shifted away from the market reaction assessment of usefulness, to a focus on the asset valuation implication of GCMs. For example, Blay, Geiger, Geiger, and North (2011) find evidence that investors put more (less) weight on assets and liabilities directly related to abandonment (continuing) value, and Lennox (2013) finds evidence that auditors are more likely to issue GCMs when the book values of assets are high relative to their expected realizable values. In this study, we contend that since accounting recognition and measurement criteria under generally accepted accounting principles are premised on the going-concern assumption (where a return to profitability is the maintained hypothesis) (Joos & Plesko, 2005), evidence on whether GCMs alter the informativeness of earnings reports would be of interest to investors, regulators, and standard setters. Accordingly, we investigate the effect of first-time GCMs on the market's response to earnings surprises at subsequent earnings announcements.

Subramanyam and Wild (1996) document a negative relation between earnings informativeness and a *general* proxy for going-concern status, the Altman (Z-score). In this study we employ an events-study research design and focus on the relative informativeness of earnings before and after the receipt of a *specific* and unambiguous signal about firms' going-concern status—the auditors' GCM.[7] We measure the market's responsiveness to an earnings announcement by the slope coefficient in the regression of unexpected returns on unexpected earnings—called an earnings response coefficient (Cho & Jung, 1991; Collins & DeAngelo, 1990; Elliott & Hanna, 1996; Hackenbrack & Hogan, 2002; Holthausen & Verrecchia, 1988; Lang, 1991; Subramanyam & Wild, 1996; Wilson, 2008). The earnings response coefficient (ERC) has been shown to be negatively related to the market's expectation about the amount of variability, or noise, in the firm's present and future earnings numbers (Cho & Jung, 1991; Collins & DeAngelo, 1990; Holthausen & Verrecchia, 1988; Lang, 1991; Wilson, 2008), negatively related to the precision of the pre-disclosure (non-earnings) information, and positively related to the fundamental uncertainty in investors' prior beliefs about firm value (Holthausen & Verrecchia, 1988) and the length of the earnings revision horizon (Subramanyam & Wild, 1996).

Using the predictions from the Holthausen and Verrecchia (1988) model and the results from extant research, we posit that the receipt of a GCM could lead to a decrease in ERCs for a number of reasons. First, we suggest that a GCM reduces investors' fundamental uncertainty about future cash flows, since it is a credible signal that auditors have substantial doubts about the viability of the firm.[8] Second, by providing information about the likelihood of realizing future cash flows, the GCM effectively preempts some of the information in subsequent earnings announcements, thus reducing the informational relevance of earnings. Third, Elliott and Hanna (1996) find that the stock price response to earnings news is dampened in the presence of large write-offs because of the high level of noise in the accounting earnings numbers relative to the actual economic earnings. Similarly, Wilson (2008) documents a decline in ERCs after restatements due to the increased noise in post-restatement earnings. GCM firms are likely to have more transitory components in earnings due to the increased likelihood of write-offs, discontinued operations and/or restructuring charges, as management attempts to reduce costs and increase cash flows—implying that earnings are noisier (less informative) about the future cash flows of the firm. Finally, a GCM could also signal that the length of the future period for which earnings revisions are expected to persist is much shorter than was previously assumed.[9] In summary, the GCM results in a smaller price response to unexpected earnings at subsequent earnings announcements.

Using quarterly data, we document a shift in the relative informativeness of earnings after firms receive first-time GCMs. Specifically we report a decrease in ERCs for the sample of 581 first-time GCMs. However the decrease is not observed until the second quarter after the GCM, consistent with Taffler et al.'s (2004) conclusion that the stock market appears to underreact to the bad news signal in GCMs. Further, we show that ERCs subsequently rebound to pre-GCM levels, suggesting that the decrease in earnings informativeness appears to be transitory.

However, prior studies such as Loudder et al. (1992); Fleak and Wilson (1994); Jones (1996) and Blay and Geiger (2001) suggest the need to partition the sample of GCM firms based on whether the GCM is expected, since they show that only firms with unexpected GCMs experience negative stock price reaction to the disclosure. We use Z-scores to proxy for investors' prediction of firms' going-concern status (Subramanyam & Wild, 1996), and partition the sample into expected and unexpected sub-samples based on the Z-score (Altman, 1968) measured at the beginning of the fiscal year of the GCM. We posit that for firms with low (high) Z-scores the GCM is expected (unexpected) and therefore less (more) likely to provide new information to investors about future earnings/cash flows.[10] We find results consistent with our conjecture. In particular, we document a decrease in ERCs for the high Z-score (unexpected GCM) firms and no significant long-term change in ERCs for the low Z-score (expected GCM) firms. The decrease in ERCs is immediate and persists over the four quarters subsequent to

[4] As recently as 2012, the Certified Financial Analysts (CFA) Institute and the Public Company Accounting Oversight Board (PCAOB) Investor Advisory Group (IAG) surveyed financial analysts and investors, respectively, on the importance of the going concern disclosure. The survey responses confirm that analysts and investors still consider (1) the going concern disclosure relevant in their analysis of firms' future cash flows, and (2) the auditor (as well as management) should be responsible for the disclosure (CFA, 2012; PCAOB, 2012b).

[5] The Financial Accounting Standards Board (FASB) in 2008 issued the proposed statement *Going Concern*, which for the first time would have resulted in guidance on going-concern being included in the accounting literature. The proposed statement would have required management of an entity to assess whether that entity would be able to continue as a going-concern on a look-forward basis. As of January 11, 2012, the FASB has decided against issuing this statement (FASB, 2012). This decision has essentially maintained the status quo where only auditors are required to opine on the going-concern status of client companies. As recently as May of 2012, the Standing Advisory Group of the PCAOB met to discuss possible changes to the *Going Concern* standard.

[6] See Carson et al. (2012) for a comprehensive discussion of the going-concern literature.

[7] We use the terms "usefulness," "informativeness," "quality" and "information content" interchangeably in this paper.

[8] For example, Chen and Church (1996) and Holder-Webb and Wilkins (2000) find that GCMs reduce the surprise associated with bankruptcy announcements, suggesting that investors incorporate the information in a GCM in assessing the likelihood of bankruptcy. Second, the receipt of a GCM may cause stock exchanges to question whether the firm should continue to be listed. The New York Stock Exchange listing rules indicate that receiving a GCM may provide cause for a company to be delisted (Menon and Williams (2010).

[9] Subramanyam and Wild (1996) document that the ERC is positively related to the length of the future period for which earnings revisions are expected to persist.

[10] Firms are classified as low Z-score (high Z-score) if their Z-score is below (above) the industry median (based on 2 digit SIC code) at the beginning of the fiscal year of the GCM.

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