Available online at www.sciencedirect.com
SCIENCE DIRECT®

Journal of Accounting and Economics 38 (2004) 263–296

JOURNAL OF Accounting & Economics

www.elsevier.com/locate/econbase

In denial? Stock market underreaction to going-concern audit report disclosures☆

Richard J. Taffler*, Jeffrey Lu, Asad Kausar

Cranfield School of Management, Cranfield University, Cranfield, Bedford MK43 0AL, UK

Received 26 February 2003; received in revised form 22 September 2004; accepted 30 September 2004
Available online 25 December 2004

Abstract

We investigate the stock price reaction to UK going-concern audit report disclosures in the calendar year subsequent to publication. Over this period our firm population underperforms by between 24% and 31% depending on the benchmark adopted. This market underreaction to such an unambiguous bad news release is not a post-earnings announcement drift phenomenon; it is also robust to other potentially confounding explanations. However, whatever the reasons for such stock mispricing, we find costly arbitrage prevents rational investors forcing prices back into line with fundamental value. Our results have implications for the market's ability to impound bad news appropriately and the incompleteness of arbitrage in such small "loser" firm situations.

JEL classification: G14; M40; M41

Keywords: Market anomalies; Investor biases; Behavioral finance; Limits to arbitrage

☆This paper has considerably benefited from the helpful comments of Vineet Agarwal, Ray Ball, Sudipta Basu (the discussant), Philip Brown, Ilia Dichev (the referee), Wayne Guay, S.P. Kothari, Peter Pope, Jinn-Yang Uang, Shaojun Zhang and Jerry Zimmerman (the editor), as well as from participants at the July 2002 Financial Reporting and Business Communication Conference, Cardiff Business School, the American Accounting Association Meeting, Honolulu, August 2003, the 2003 Journal of Accounting and Economics Conference, Kellogg School of Management, October 2003 and in seminars held at the Cranfield School of Management, University of Lancaster, Queens University, Belfast and Glasgow Caledonian University. The secretarial assistance of Lisa Brooks is also gratefully acknowledged.
*Corresponding author. Tel.: +44 1234 754543; fax: +44 1234 752554.
E-mail address: r.j.taffler@cranfield.ac.uk (R.J. Taffler).

0165-4101/$ - see front matter © 2004 Published by Elsevier B.V.
doi:10.1016/j.jacceco.2004.09.004

1. Introduction

An increasing body of research suggests that the stock market takes time to assimilate bad news, in contrast to a more timely incorporation of good (positive) news. For example, Womack (1996) shows that analysts' new buy recommendations provide only small and short-lived price increases whereas new sell recommendations appear to take up to 6 months for their implications to be fully incorporated in market prices, with average 6-month abnormal returns of −9.1%. Dichev and Piotroski (2001) demonstrate that markets respond in similar ways to Moody's bond rating changes, finding no significant abnormal returns following upgrades but negative abnormal returns of between −10% and −14% in the first year following downgrades with a further −3% to −7% in each of the second and third years following the original announcement. Likewise, Dichev (1998) shows that stocks in the highest decile of bankruptcy risk underperform those with low bankruptcy risk (lowest 70% probability of bankruptcy) by around 14% in the year following portfolio formation, and that this pattern continues on a rather more attenuated basis for a further 3 years.

Other areas with apparent incomplete stock price reaction to new information events include the post-earnings announcement drift anomaly (e.g. Ball and Brown, 1968; Bernard and Thomas, 1989, 1990), dividend cuts and omissions versus increases (Michaely et al., 1995), IPOs/SEOs (e.g. Ritter, 1991; Loughran and Ritter, 1995, 1997; Spiess and Affleck-Graves, 1995) and stock splits (e.g. Ikenberry and Ramnath, 2002). Both potential measurement problem issues and behavioral explanations for these apparent empirical irregularities are discussed in the literature.

This paper contributes to the "underreaction" literature by providing a sharply defined setting for testing the speed of market reaction to a very serious and unambiguous bad news event, the receipt of a first time going-concern modified (GCM) audit report by a firm. In addition, since most of the market anomalies research has been conducted in US capital markets, our UK context allows us to extend this literature by exploring related issues in an alternative trading environment. Two related studies are those of Willenborg and McKeown (2001) and Weber and Willenborg (2003) who explore the case of going-concern audit opinions in micro-cap IPOs. In particular, Willenborg and McKeown (2001) find IPOs with a GCM audit report on the private-company financial statements contained in their prospectus significantly underperform those with non-going-concern audit reports by around 25% in the first year post-IPO and by three times that on a 3-year horizon. The authors attribute their results to the private information conveyed by the going-concern opinion helping uninformed investors better estimate IPO value in the secondary market. In a companion paper, Weber and Willenborg (2003) break down this analysis by type of audit firm and find that 1-year aftermarket performance is more negative for firms receiving going-concern opinions than those with clean opinions for Big 6 and national firms but not for local firms.

We explore the medium-term price reaction to going-concern audit report disclosures by London Stock Exchange (LSE) firms over the one calendar year