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Does the stock market underreact to going concern opinions? Evidence from the U.S. and Australia ☆

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Abstract

We examine 12-month returns following disclosure of first-time going concern (GC) opinions in the U.S. and Australia. We find no evidence of significant negative abnormal returns associated with GC opinions in Australia. In the U.S., negative abnormal returns subsequent to GC opinions are sensitive to choice of expected returns—notably, there are no significant negative abnormal returns when using factor models or after controlling for momentum. Overall, contrary to Taffler, Lu, Kausar's [2004. In denial? Stock market underreaction to going-concern audit report disclosures. Journal of Accounting and Economics 38, 263–285.] U.K. results, we are unable to document a market anomaly in the U.S. or Australia associated with GC opinions.
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1. Introduction

Taffler et al. (2004) document that U.K. firms receiving first-time going concern audit opinions (henceforth GC opinions) on average underperform various return benchmarks by 28–35% during the 12 months following the opinion announcement. The Taffler, Lu and Kausar (henceforth TLK) study is a part of a burgeoning literature that documents anomalous market behavior in general and underreaction to bad news events in particular.[1] Much of this literature concludes that the documented returns' patterns are unlikely explained by risk or other rational considerations but represent anomalous market behavior arising from human information processing biases (Kahneman et al., 1982). In a similar vein, TLK conclude that their evidence suggests anomalous market underreaction to the GC opinions that is inconsistent with conventional notions of market efficiency. Specifically, TLK observe that they "cannot reject an irrational investor explanation for [their] results with investors apparently underreacting to or, in effect, denying the bad news conveyed by a going concern audit opinion".[2]

Ceteris paribus, if the principal source of the GC opinion anomaly is human information processing bias, one would expect to observe similar inefficiency in other markets (countries). On the other hand, if the TLK's evidence is limited to the U.K. stock market, then country-specific institutional features or other market peculiarities are a more likely explanation for their findings. Accordingly, in this paper we investigate whether the GC opinion anomaly identified by TLK in the U.K. is present in other markets such as those of the U.S. and Australia.

Our sample comprises 1159 GC opinions in the U.S. over the 1993–2004 period and 91 GC opinions in Australia over the 2000–2004 period. As in TLK, we examine returns' patterns over the 12 months succeeding the GC opinion. To verify the robustness of our results, we examine several alternative measures of risk-adjusted returns, including those using benchmarks (reference portfolios and control firms) matched on risk characteristics, as well as abnormal returns using conventional factor models. Overall, we are unable to find evidence that stock markets in the U.S. and Australia underreact to GC opinions. For the Australian sample, we are unable to find significant negative returns under any of our returns' definitions.[3] We do find that our U.S. sample firms underperform benchmarks based on certain risk characteristics (i.e., book-to-market and size). However, we find no evidence of negative abnormal returns using well-accepted factor models. The inability of

[1]Studies documenting anomalous market reaction to information events in general are too numerous to cite. Studies documenting market underreaction to various types of bad news events include the following: financial analysts' sell recommendations (Womack, 1996); bond rating downgrades (Dichev and Piotroski, 2001); accounting restatements (Hirschey et al., 2003); class-action lawsuits (Griffin et al., 2004).

[2]While TLK acknowledge that high transactions costs could inhibit the arbitrage process in their sample, they interpret the results as the anomalous delayed reaction by the stock market to the GC opinion news that is distinct and different from other documented forms of market underreaction, such as those related to momentum (Jegadeesh and Titman, 1993), post earnings announcement drift (Bernard and Thomas, 1989) and bankruptcy risk (Dichev, 1998).

[3]One could argue that our insignificant Australian results may simply arise from lack of power given the small sample size. There are two reasons why low power is unlikely to explain our results. First, our sample (91 firm-years) is comparable in size to TLK's (104 firm-years); therefore, our differential results can not be attributed to differences in statistical power. Second, returns under certain definitions (e.g., momentum control firm matched return and one-factor abnormal returns) are *positive* while they are of economically insignificant magnitudes for other definitions.

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