Do Investors Respond to Explanatory Language Included in Unqualified Audit Reports?

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Abstract: This paper investigates whether investors respond to explanatory language added to standard (unqualified) audit reports. While prior research finds that explanatory language added to unqualified audit reports is associated with restatements and discretionary accruals, surveys suggest that many investors limit their attention to the unqualified nature of the opinion. We use three-day abnormal returns and abnormal trading volume to measure investor responses to unqualified audit reports issued from 2000 – 2009. While we do not find a price reaction to non-going concern explanatory language, we find significantly *higher* abnormal trading volume when audit reports with explanatory language that discuss prior restatements,other consistency matters,"emphasis of a matter" are issued. Further, we find that audit reports with explanatory language that reference changes in accounting principle and audit-related disclosures (division of responsibility and scope limitations) are associated with significantly *lower* abnormal trading volume than audit reports without explanatory language. Overall, our results imply that (1) investors respond to explanatory language under current U.S auditing standards and (2) certain types of explanatory language result in greater investor disagreement and belief revision.

Keywords: explanatory language, audit reports, investor reaction, financial reporting quality

JEL: M40, M41, M42, M48

1. Introduction

Auditors often add explanatory language to unqualified (i.e., standard) audit reports of public companies to emphasize certain "matters" the auditor believes warrant the attention of financial statement users, such as the adoption of a new accounting standard or change in accounting methods, doubt about going concern status, and reliance on other auditors during the engagement. Prior research finds that several types of explanatory language are informative of financial reporting quality (Czerney, Schmidt, and Thompson. 2014; Butler, Leone, and Willenborg 2004). However, investors claim that present-day auditors' reports are boilerplate (Rapoport 2013) and have asked standard setters (including the PCAOB, IAASB, and European Commission) to undertake projects to enhance the information content of audit reports (FRC 2013; IAASB 2013; PCAOB 2013).

In this study, we investigate the investor-perceived information content of auditor explanatory language under current auditing standards. Survey research indicates that investors may not perceive explanatory language to be informative. Investors state they are primarily interested in the nature of the audit opinion (i.e., unqualified or not) and the identity of the signing auditor (Gray, Turner, Coram, and Mock 2011), suggesting that investors may not attend to explanatory language. Further, current auditing standards (i.e., AU 508, AU 543) state that explanatory language should not be construed as a qualification of the audit report but rather should be viewed as equivalent to a standard audit report *without* explanatory language. Thus, investors who are aware of the auditing standards may not attend to explanatory language knowing that the language is not intended to signal risk.

However, there are two reasons why investors may respond to explanatory language. First, several types of explanatory language under current standards were considered to be opinion *qualifications* prior to 1989 when auditing standards allowed "except-for" qualifications highlighting the inconsistency of the financial statements with prior periods and "subject-to"

qualifications for material uncertainties. Because prior research provides some evidence that pre-SAS No. 58 opinion qualifications were informative to investors (e.g. Choi and Jeter 1992; Fields and Wilkins 1991), it is possible that the related types of explanatory language under current standards are informative because the underlying substance of the opinion modifications are the same. Second, some types of explanatory language are associated with subsequent restatements and discretionary accruals (Czerney et al. 2014; Butler et al. 2004), suggesting that explanatory language highlights low financial reporting quality in some circumstances. Thus, perceptive investors might attend to the detailed language embedded in the audit report.

We collect all unqualified audit reports issued to SEC registrants from 2000 through 2009 and utilize text-parsing software to identify and categorize explanatory language following auditing standard AU Section 508 – *Reports on Audited Financial Statements*. Our categories of explanatory language are (1) *Inconsistency* with previously issued financial statements (adoption of new accounting principles, changes in accounting methods, and references to previous restatements), (2) "*Emphasis of matters"* in financial reports (e.g., significant transactions, estimates, or litigation), (3) *Audit-related* information (division of auditor responsibility, scope limitations, and other audit-related disclosures), and (4) *Other* language that references supplemental information, going concern, and/or financial distress.

We then investigate whether investors respond to explanatory language by examining short-window (-1, 1) absolute value cumulative abnormal returns and abnormal trading volume during the three-day window surrounding the issuance of unqualified audit reports with and without explanatory language. These two measures of investor reactions provide different insights into whether investors view explanatory language as informative. While stock price reactions reflect the average change in investors' beliefs due to the new information, trading volume reactions reflect the extent of individual belief revision among market participants (Beaver 1968; Kim and Verrecchia 1991). Trading volume reactions can provide more sensitive tests than price

reactions because an information release may not affect the overall expectation of the market, but can significantly influence the expectations of individual investors (Bamber, Barron, and Stevens 2011; Cready and Hurtt 2002; Beaver 1968).[1] For this reason, using both measures together allows for greater insight into whether investors respond to the information conveyed in explanatory language.

While we find no evidence that non-going concern explanatory language is associated with absolute abnormal returns, several types of explanatory language are associated with abnormal trading volume. Specifically, most types of explanatory language that were considered opinion *qualifications* prior to SAS No. 58 (i.e., explanatory language that discusses previous restatements, other consistency matters, and "emphasis of a matter" paragraphs) are associated with significantly *higher* abnormal trading volume than audit reports without explanatory language.[2] This abnormally high trading volume implies investor disagreement and belief revision concerning auditors' disclosures. In addition, we find that audit reports with explanatory language that discuss the adoption of new accounting standards, division of auditor responsibility, scope limitations, and absence of review procedures are associated with significantly lower abnormal trading volume. These results imply that certain types of accounting or audit-related explanatory language are associated with greater consensus among investors regarding the implications of this information. Overall, the results indicate that although explanatory language is not associated with a change in the overall market valuation of a firm, investors respond to explanatory language included in unqualified audit reports under current U.S. standards.

[1] Prior research documents significant trading volume reactions to information releases that are not accompanied by significant stock price reactions (see Bamber et al. 2011 for a review). Because prior literature is mixed as to whether opinion qualifications and going concern opinions result in significant stock *price* reactions, we view trading volume tests as the primary test of our research question.

[2] The one exception to this statement is explanatory language regarding the adoption of new accounting standards which were treated as an "except-for" qualification prior to SAS No. 58. This particular type of explanatory language is associated with significantly *lower* trading volume.

Our findings are relevant to standard-setters currently considering changes to the audit report. First, contrary to focus group and survey-based evidence suggesting that many investors do not attend to audit reports, our findings indicate that investors do respond to financial statements accompanied by audit reports containing explanatory language. Second, our study suggests that auditor explanatory language can either exacerbate or ameliorate information asymmetry depending on the type of explanatory language. Because the consistency with which investors interpret the content of audit reports is likely a primary concern of standard setters developing new audit reporting standards, our results suggest that providing guidance to financial statement users about how to interpret the proposed auditor disclosures may help to enhance investor consensus regarding the implications of new auditor disclosures.

Finally, our study contributes to the literature on the perceived information content of audit reports. Prior research provides mixed evidence as to whether going concern explanatory language and pre-SAS No. 58 opinion qualifications are informative to investors (e.g. Menon and Williams 2010; Choi and Jeter 1992). Our study adds to this literature by documenting that, when measured by trading volume, investors respond to non-going concern explanatory language added to unqualified audit reports and that investor belief revision is found primarily among explanatory language matters that were considered to be opinion *qualifications* prior to SAS No. 58. Because nearly all prior studies examine only stock price reactions to audit reports, our findings examining trading volume provide a more powerful test of investor response and contribute a new dimension to this literature by suggesting that many audit reports are informative to investors even in absence of a stock price reaction.

The remainder of the study is organized as follows. Section 2 develops the hypotheses and discusses prior research. Section 3 describes the research design and sample selection process. Section 4 presents the results, while Section 5 concludes and discusses limitations and avenues for future research.

2. Background and Hypothesis Development

Background Information

Effective for reports issued on or after January 1, 1989, AU Section 508 provides auditors with (1) guidance on seven circumstances that may warrant explanatory language (EL) and (2) discretion to add an explanatory paragraph with EL to emphasize any financial statement matter the auditor wishes to emphasize. First, if the audit report is based, in part, on the work of another auditor, the primary auditor can disclose such division of responsibility. Second, auditors can highlight unusual client circumstances that justify a departure from generally accepted accounting principles in the client's financial statements. Third, auditors should add EL if substantial doubt exists as to the client's ability to continue as a going concern unless the auditor's substantial doubt is mitigated by management's plans to address the going concern matter. Fourth, an auditor can emphasize a change in accounting principles or the client's application of accounting principles. Fifth, an auditor can note other circumstances that affect the comparability of the financial statements across time periods such as the existence of a restatement or change in audit opinion from one period to the next. Sixth, auditors should provide EL if the client has omitted information required under Regulation S-K or if such information has not been reviewed. Seventh, auditors may notify investors that other standard setters have required the inclusion of additional unaudited information with the basic financial statements or that unaudited information is inconsistent with the financial statements (AU Section 550). Lastly, auditors also have discretion to add an "emphasize of a matter" paragraph to draw users' attention to matters disclosed in the financial statements that the auditor deems warrants investors' attention.

Although auditors commonly add EL to unqualified audit reports in accordance with AU 508 (Czerney et al. 2014; Butler et al. 2004), standard-setters question whether the present-day audit report provides investors with value-relevant information. For example, the PCAOB notes that while auditors may use emphasis of a matter paragraphs under the current reporting model,

this language "is not effective in providing transparency into the financial reporting process," (PCAOB 2011-003, p. 9). As a result, standard-setters are considering expanding the audit reporting model by mandating the inclusion of language that discusses "key" or "critical" audit matters (Cohn 2013; Tysiac 2013). The additional required language is intended to make the audit report more relevant to investors by providing investors with deeper insights into the company's financial statements (Tysiac 2013).

Hypothesis Development

Audits are intended to reduce agency costs and enhance the credibility of financial statements (Watts and Zimmerman 1986; Jensen and Meckling 1976). Although recent studies find that independent audits are valuable to firms (e.g. Minnis 2011; Kim et al. 2011; Haw et al. 2008), prior research provides mixed evidence as to whether audit reports communicate information to financial statement users. For example, some studies indicate that audit reports with going-concern explanatory language are associated with lower company valuation and higher cost of capital (e.g. Brazel et al. 2011; Menon and Williams 2010). However, the significant market reaction to going concern explanatory language is not documented by all studies (Ogneva and Subramanyam 2007) and some studies document an inefficient reaction to a going concern announcement (Kauser, Taffler, and Tan 2009). Similarly, studies examining the information content of "subject-to" and "except-for" audit opinion qualifications in the pre-SAS No. 58 period also report mixed evidence (Firth 1978; Choi and Jeter 1992; Fields and Wilkins 1991; Elliott 1982; Dopuch, Holthausen, and Leftwich 1986; Keller and Davidson 1983). However, prior research has not examined the perceived information content of non-going-concern EL embedded in unqualified audit reports.

Professional standards and prior survey research suggests that investors may not perceive EL to be informative. For example, AU Section 508 states that EL should not (1) change the overall conclusion that the financial statements are fairly stated and (2) provide information

beyond what is available in the financial statements. Thus, investors who are knowledgeable of auditing standards are unlikely to attend to EL. In addition, some prior survey research indicates that investors limit their attention to the nature of the audit opinion (i.e., unqualified or not) and the identity of the signing auditor (Gray et al. 2011). For example, interviews of bankers, analysts, and non-professional investors indicate that "users consider the auditor's report to be 'boilerplate' and typically do not read the auditor's report..." (Gray et al., 2011, p. 669).[3] Similarly, the PCAOB's Investor Advisory Group survey reports that only 7% of respondents read the full audit report, while 73% "skim [the] report quickly" and 18% believe the report "is of no use to them" (Carcello, Harrison, Sauter, and Yeager 2011).

However, some investors may perceive EL to be informative. First, certain prior studies indicate that "subject-to" and "except-for" opinion qualifications in the pre-SAS No. 58 period were informative to investors (Choi and Jeter 1992; Fields and Wilkins 1991). Specifically, "subject-to" qualifications for material uncertainties now arise primarily as "emphasis of a matter" paragraphs in unqualified audit reports (Davis 2004). "Except-for" qualifications that previously highlighted the inconsistency of financial statements with prior periods now appear as EL discussing the adoption of new accounting principles, changes in the application of accounting methods, emphasis of prior period restatements, and other consistency-related modifications. Because these former opinion *qualifications* are now characterized as EL in *unqualified* reports under current standards, investors may be attentive to these types of EL.

Second, some surveys provide evidence that perceptive investors may attend to EL. For example, one respondent to the CFA Institute's 2011 Independent Auditor's Report Survey commented that "The [audit] report is useful if one can read between the lines. Most of the auditor's reports appear to have fairly standardized wording. However, sometimes there are

[3] Asare and Wright (2012) note that the "primary advantage" of the standard auditor's report is that investors do not need to read it to understand its meaning.

nuances, which let the careful reader note that the state of affairs is not as it should be." (CFA 2011, p. 9). Likewise, a respondent to the CFA Institute's 2010 survey stated "As it stands right now, only those who understand the codes of the profession can grasp the meaning of the report. It ought to be easier for any educated user to get the right understanding of it" (CFA 2010, p.11). The perception by these respondents that the audit report contains subtle risk-related information is supported by prior studies documenting that some types of EL are associated with discretionary accruals (Butler et al. 2004) and higher likelihood of subsequent restatement (Czerney et al. 2014).

In summary, investor complaints about the information content of the present-day audit report suggests that, in general, investors either are (1) fully aware of all information in the present-day auditor's report and wish for more or (2) fixate on the opinion provided by the report and fail to attend to the additional explanatory language. Although some anecdotal evidence suggests that certain investors may attend to the additional auditor-provided explanatory language, it is unclear ex-ante whether investors, on average, respond to explanatory language added to an unqualified audit reports. Finally, because prior research documents mixed evidence regarding the information content of going concern EL and audit opinion qualifications measured using stock price reactions, we state Hypothesis 1 in the null form:

> **H1:** Investor reaction to financial statements accompanied by audit reports including explanatory language is not significantly different from zero.

3. Research Design

Categorizing Explanatory Language

We use text-parsing software to identify whether the unqualified audit reports in our sample contain EL and categorize the EL, based on the guidance provided in AU Section 508.11, "Explanatory Language Added to the Auditor's Standard Report." We validate the accuracy of the coding using manual validation tests. A detailed discussion of our EL categorization and validation procedures can be found in Appendix A.

We set an indicator variable equal to one if the audit report contains any explanatory language, and zero otherwise (*ANY_EL*). We also categorize EL following the guidance in AU 508.[4] *ACCTGPRIN* is an indicator variable equal to one if the audit report contains explanatory language that identifies adoption of a new accounting standard or a change in accounting methods, and zero otherwise. *EMPHASIZE_RESTATE* is an indicator variable equal to one if the audit report includes explanatory language stating that current or comparative period financial statement information has been restated, amended, revised, or corrected, and zero otherwise. *OTHER_CONSISTENCY* is an indicator variable equal to one if the audit report contains explanatory language that mentions the comparability or consistency of financial statement data or a basis of presentation other than accounting principles generally accepted in the United States, and zero otherwise. *EMPHASIS_OF_MATTER* is an indicator variable equal to one if the audit report contains explanatory language that discusses a merger or acquisition, impending or ongoing litigation, significant transactions with affiliated parties, management's use of estimates in preparation of the financial statements, the translation of financial statement amounts from a foreign currency to U.S. dollars, or other various matters that the auditors chose to highlight to

[4] Some categories of EL under AU 508, such as the omission of required information under Reg S-K, arise infrequently and are excluded from the sample due to Compustat, CRSP, and IBES data requirements.

financial statement users, and zero otherwise. *DIVISION* is an indicator variable equal to one if the auditor divided responsibility for the current year audit report and equals zero otherwise. *SCOPE_REVIEW* is an indicator variable equal to one if the audit report contains explanatory language that (1) limits the scope of the auditor's work or (2) discusses the performance or absence of review procedures in prior quarterly periods, and zero otherwise. *SUPPINFO* is an indicator variable equal to 1 if the audit report contains explanatory language referencing additional schedules to be read in conjunction with, or included in, the financial statements, and 0 otherwise. Last, *FINDISTRESS* is an indicator variable equal to one if the audit report contains explanatory language that (1) expresses substantial doubt about the company's ability to continue as a going concern, (2) comments on material uncertainty concerning the company's future prospects, or (3) mentions bankruptcy or reorganization, and 0 otherwise.

Multivariate Model

We investigate whether investors attend to EL by examining absolute value cumulative abnormal returns and abnormal trading volume surrounding the issuance of unqualified audit reports with EL. As stated previously, we measure the information content of EL using both returns and trading volume because neither a price reaction nor a volume reaction alone provides a complete characterization of information content (Dontoh and Ronen 1993). We begin by examining returns because it is the most commonly used measure of information content in the prior literature. We then examine trading volume because it is often a more powerful indicator of information content (Chen and Sami 2008) as the high variance in daily returns makes it difficult to detect investor responses to information events that have potentially only modest valuation effects (Cready and Hurtt 2002). In addition, trading volume reactions to information capture changes in the expectations of individuals investors, while price reactions reflect changes in the expectations of the market as a whole (Beaver 1968). Lastly, trading volume can provide evidence regarding information asymmetry and investor disagreement as to how to interpret new

information. Because our research seeks to inform regulators about the information content in current EL, the consistency with which investors interpret the information in EL is likely to interest regulators. In sum, we estimate the following multivariate regression model to measure the information content of auditor explanatory language:

$$|ABRET| \text{ or } ABVOL = \alpha + EXPLANATORY\ LANGUAGE + CONTROLS + \varepsilon$$

We calculate three-day (-1, 1) absolute abnormal returns (|*ABRET*|) as the absolute value of three-day cumulative abnormal returns over the period (-1, 1) surrounding the filing date of the annual financial statements less the same day return for the CRSP value weighted portfolio. We calculate three-day (-1, 1) abnormal volume (*ABVOL*) as the sum of the ratios of the number of shares traded to the total shares outstanding for each of the three trading days in the event window, less the sum of the ratios of the total number of shares traded on the New York and American Stock Exchanges to the total shares outstanding on the New York and American Stock Exchanges for each of the three trading days in the event window.[5, 6] Since the independent auditor's report is included in the annual SEC filing, the annual report filing date represents the first date on which the content of the report is publicly available to financial statement users. Although information other than the audit report is released concurrently in the annual report, our approach is consistent with prior research examining the information content of audit reports and specific disclosures in Form 10-K filings using short window returns (e.g., Griffin 2003; Menon and William 2010;

[5]We examine trading volume rather than the number of transactions due to the high cost of using transaction based data. Cready and Ramanan (1995) conclude that using transaction data is preferable to volume for very small sample sizes, when trading volume does not yield statistically significant reactions, when the reaction is expected to be small or concentrated among small investors, and when the research question focuses on individual investors' decision to trade. Because our study does not meet any of these four guidelines, we focus on trading volume.

[6] We restrict the calculation of market volume to the New York and American Stock Exchanges following Burks (2011). We calculate abnormal volume using a market-based measure of volume, rather than firm-specific volume, so that the average trading volume during a non-announcement period of interest reflects both trading in response to the constant flow of information and non-informational trading (Bamber et al. 2011). The manner in which we calculate *ABVOL* is analogous to *ABRET*.

Hammersley, Myers, and Shakespeare 2008; Omer, Shelley, and Thompson 2012; Qi, Wu, and Haw 2000; Boone and Raman 2004).[7] The variables for *EXPLANATORY LANGUAGE* are previously defined.

We control for other factors that may be associated with investors' reactions to annual report filings. We use the natural logarithm of market value of equity (*SIZE*) as of each company's fiscal year-end to proxy for company size. *LEVERAGE* is the ratio of a company's long-term debt to total assets. *ROA* is the return on assets, where net income is the numerator and total assets is the denominator in the calculation. *LOSS* is an indicator variable equal to one if the company reports a net loss for the fiscal year, and zero otherwise.

We also control for factors associated with the timing of the annual report filing. Prior research finds a positive association between audit report modifications and the time it takes to issue the audit report (e.g., Ashton, Willingham, and Elliott 1987; Bamber, Bamber, and Schoderbek 1993). *REPORTLAG* is the natural logarithm of the number of days between the report filing date and fiscal year end. *EARNANNOUNCE* is an indicator variable equal to one if the company announces earnings during the three-day annual report filing date window, and equal to zero otherwise. In our *ABVOL* regressions, we control for the unsigned return using *Abs(ABRET)*.

Next, we control for investors' expectations and other news that may concurrently or previously affect returns as of the report filing date. *BETA* is the slope coefficient from the regression of the company's stock return on the daily return on the value-weighted portfolio over the period (-250, -21) relative to the annual reporting filing date.[8] *MEANFE* is the fourth quarter

[7] See the untabulated sensitivity analyses section below for additional analysis controlling for the magnitude and existence of information disclosed in the audit report.

[8] We begin our window at t = -250 trading days because there are approximately 250 trading days in an average year, providing a measure of Beta based on the year leading up to the annual report filing date. We cap our window for calculating Beta at t = -21 to reduce the influence of returns that are anticipating the information in the annual report.

earnings surprise, calculated as the difference between reported fourth quarter earnings per share (as reported in IBES) less the mean earnings forecast among analysts providing estimates within 180 days prior to the earnings announcement date, scaled by the absolute value of the mean analyst forecast. We control for pre-disclosure information asymmetry using the difference between the highest and lowest analyst earnings forecasts, scaled by the absolute value of the mean forecast (*FORECASTSPREAD*), following Atiase and Bamber (1994).[9]

Sophisticated financial statement users may perceive the information content of EL differently than non-professional investors (Gray et al. 2011; CFA 2011; CFA 2010). In addition, firms with higher analyst following and institutional ownership may have different information environments which could affect the perceived information content of the audit report language. For example, Cready and Mynatt (1991) conclude that large investors rely on earnings announcements, rather than the release of corporate annual reports and Menon and Williams (2010) find that institutional owners divest shares in firms receiving audit reports that contain going concern EL. In addition, Roulstone (2003) documents greater liquidity among firms with higher analyst following and Franco, Kothari, and Verdi (2011) document that financial statement comparability is associated with analyst following as well as analyst forecast accuracy and dispersion. Accordingly, we control for analyst following and institutional ownership. We measure analyst following as the natural logarithm of the number of analysts who provided an earnings forecast within 180 days prior to the earnings announcement date (*FOLLOWING*). We measure institutional ownership as the natural logarithm of the proportion of shares held by institutional investors relative to the total shares outstanding as of fiscal year end (*INSTOWN*).

Finally, we control for characteristics of the auditor, auditor-company relationship, and audit report. We control for auditor tenure using the natural logarithm of the number of years the

[9] Also consistent with Atiase and Bamber (1994), we perform a sensitivity test where we exclude observations with reported earnings per share that range between -$0.20 and $0.20. Our results are unaffected.

current auditor has been the primary auditor for the company (*TENURE*). We also control for auditor size because Gray et al. (2009) report that financial statement users look for a Big N signature on the audit report and Teoh and Wong (1993) find Big N audit clients have higher earnings response coefficients. These studies suggest that investors view financial reports audited by a Big N firm as more credible. In addition, Big N auditors are more likely to issue a modified opinion when accruals are high, suggesting greater reporting conservatism for Big N auditors versus other auditors (Francis and Krishnan 1999). *BIGN* is an indicator variable that equals one if the auditor is Arthur Andersen, Deloitte and Touche, Ernst & Young, KPMG, or PricewaterhouseCoopers, and zero otherwise. We control for whether the auditor identifies a material weakness in internal control over financial reporting using *ICMW*, which equals one if the audit report identifies one or more material weaknesses in internal control over financial reporting, and zero otherwise. *CONTROL_OPINION* is an indicator variable that equals one if the auditor opines on the effectiveness of internal control over financial reporting, and zero otherwise. Finally, *REFPRED* is an indicator variable that equals one if the audit report contains EL that references the work of a predecessor auditor, and zero otherwise.[10]

We include indicator variables to control for year and industry and winsorize all continuous variables at 1% and 99%. We adjust the standard errors using the White (1980) correction to control for heteroskedasticity and cluster the standard errors by company and report filing date to control for the dependence of returns and volume among financial statements filed on the same day. Appendix B provides detailed definitions of our model variables.

[10] Reference to the work of predecessor auditors is made in the introductory paragraph of the audit report and is not a type of EL prescribed by AU Section 508.

4. Empirical Results

Sample Selection

To construct our sample, we begin with 37,163 observations for the period 2000 - 2009 with data available in Audit Analytics. We eliminate 878 observations that do not have necessary data in Compustat or CRSP for our empirical models. We then eliminate 15,800 observations without information in IBES. The resulting sample size for our returns regressions is 20,405. The sample for our abnormal volume regressions contains 32 fewer observations due to missing market volume data, resulting in a final sample size of 20,373. Table 1 summarizes this sample selection procedure.

[Insert Table 1 Here]

Descriptive Statistics

Table 2 presents the frequency and percentage of audit reports with EL, as well as the average number of AU 508 EL categories per audit report. Panel A presents such statistics by fiscal year. Overall, we observe an upward trend in the prevalence of EL over the sample period. Notably, the proportion of audit reports with EL nearly doubles from 44% in 2000 to 85% in 2007. The average number of EL categories per audit report is elevated after the passage of the Sarbanes-Oxley Act in 2002. Table 2, Panel B presents explanatory language by industry. On average, the number of language additions per firm is similar across industries, ranging from 1.384 additions per audit report in the Energy sector to 1.589 additions per audit report in the Utilities sector.

[Insert Table 2 Here]

Univariate Statistics

Table 3, Panel A presents univariate statistics for |*ABRET*| and *ABVOL* comparing observations with EL to observations without EL. The mean |*ABRET*| for observations with EL equals 0.0399 and mean |*ABRET*| observations without EL equals 0.0409. The mean returns for

both groups are statistically different from zero ($p<0.01$). The difference in returns between reports with and without EL is not statistically significant. The mean *ABVOL* for observations with EL equals 0.0057 whereas mean *ABVOL* for observations without EL equals 0.0028. This difference in *ABVOL* of 0.0029 is statistically significant ($p<0.01$), indicating that, on average, financial statements filed with audit reports that contain EL are associated with higher abnormal trading volume than financial statements filed with audit reports that do not contain EL. Table 3, Panel B presents univariate statistics for absolute abnormal returns and abnormal volume for each category of explanatory language.

[Insert Table 3 Here]

Table 4, Panel A provides descriptive and univariate statistics for each of the control variables we include in our model. Panel B shows the mean and median for each control variable, with company-year observations separated by the inclusion or absence of explanatory language. We find that companies whose audit reports contain explanatory language, are, on average, larger, more highly levered, have higher ROA, and have shorter audit report lags. Additionally, companies that receive an unqualified audit report with explanatory language are more likely to announce earnings that coincide with the filing of their financial statements, have significantly higher pre-announcement period betas, beat the mean analyst consensus forecast by a wider margin, have a larger analyst following, and have a higher proportion of institutional ownership than companies with audit reports without explanatory language. In addition, mean auditor tenure, Big N auditor, material weaknesses, and references to predecessor auditors are higher among firms with audit reports that contain EL versus firms with audit reports that do not include EL.

[Insert Table 4 Here]

Correlation Table

Table 5 presents pairwise correlation coefficients for all independent variables included in our multivariate analysis. The pairwise correlations among most of the independent variables

are less than 0.40. Multicollineairty diagnostics confirm the stability of the coefficient estimates, indicating that the larger correlations are not problematic in our regression models. .

[Insert Table 5 Here]

Multivariate Analysis

Table 6 presents coefficient estimates for our multivariate models which examine absolute value cumulative abnormal returns and abnormal volume surrounding audit report filings. Column (1) presents the results of our regression of |*ABRET*| on *ANY_EL* and control variables. The coefficient for *ANY_EL* is positive and statistically significant ($p<0.05$), indicating that, on average, EL is associated with a larger absolute change in stock price. Column (2) presents the results of our regression of |*ABRET*| on each EL type categorized according to AU 508 and control variables. The results in this column indicate that the significant coefficient for *ANY_EL* can be attributed to *FINDISTRESS,* consistent with Menon and Williams (2010) who document a significant price reaction to going concern explanatory language. The coefficients for all other AU 508 EL variables are not statistically significant.

Column (3) presents the results of our regression of *ABVOL* on *ANY_EL* and control variables. The coefficient for *ANY_EL* is not statistically significant, indicating that, on average, EL is not associated with significantly different abnormal trading volume than reports without EL. However, Column (4) presents the results of our regression of *ABVOL* on each EL type categorized according to AU 508 and control variables. The coefficients for all AU 508 EL variables of interest are statistically significant, suggesting that the insignificant coefficient in Column (3) reflects the aggregation of EL types with both significantly higher and lower trading volume. The coefficient for *ACCTGPRIN* is negative and statistically significant ($p<0.05$), suggesting that EL that discusses changes in accounting standards or methods is associated with lower trading volume around the annual report filing date. The coefficients for *EMPHASIZE_RESTATE* and *OTHER_CONSISTENCY* are positive and statistically significant

($p<0.05$), indicating that auditor EL that discusses comparability of the current financial statements with comparative periods is associated with higher trading volume around the annual report filing date. The coefficient for *EMPHASIS_OF_MATTER* is positive and significant ($p<0.01$), suggesting that investors attend to auditor "emphasis of a matter" EL.

The coefficients for the two types of EL that pertain directly to the auditing function and extent of assurance, *DIVISION* and *SCOPE_REVIEW*, are negative and statistically significant ($p<0.05$ and $p<0.01$, respectively). Finally, the coefficients for *SUPPINFO* and *FINDISTRESS* are positive and statistically significant ($p<0.10$ and $p<0.01$, respectively). The positive and significant ($p<0.01$) coefficient for *FINDISTRESS* indicates that going concern opinions are associated with higher abnormal trading volume around the annual report filing date.

When placed in the context of prior literature examining EL and pre-SAS No. 58 audit report qualifications, these results indicate that investor disagreement is significantly higher for most types of EL that were considered to be opinion qualifications in the pre-SAS No. 58 period. Specifically, *EMPHASIZE_RESTATE* and *OTHER_CONSISTENCY* were considered to be "except-for" opinion qualifications and *EMPHASIS_OF_MATTER* and *GOING_CONCERN* were generally considered to be "subject-to" qualifications. Although prior research finds mixed evidence when examining the price reaction to these types of opinion qualifications, our findings add a new dimension to this literature and provide one explanation for the mixed results in the literature.

In addition, our results indicate greater investor disagreement for some types of EL that are associated with lower financial reporting quality. Butler et al. (2004) find that material uncertainties and going concern opinions are associated with significantly negative discretionary accruals and Czerney et al. (2014) report that emphasis of previous restatements and "emphasis of a matter" paragraphs are associated with higher likelihood that the financial statements will be restated. Czerney et al. (2014) also document higher likelihood of a subsequent restatement when

audit reports contain EL discussing changes in accounting principles and division of responsibility. However, these types of EL are associated with significantly lower abnormal trading volume, which suggests that investors recognize some, but not all, types of EL that are associated with lower financial reporting quality.

Overall, the results of our volume-based analysis in Table 5 provide evidence that investors generally do view EL added to unqualified audit reports as informative, even though our returns-based analysis does not reveal a significant association with any type of EL other than *FINDISTRESS*. The differences in results between our return and volume analyses are consistent with prior research documenting significant trading volume reactions to information releases that do not produce significant stock price reactions (e.g., Cready and Hurtt 2002; Bailey, Li, Mao, and Zhong 2003).

[Insert Table 6 Here]

Untabulated Sensitivity Analyses

Our main analysis presumes that EL is equally informative to investors in the cross-section of audit reports filed during the year. However, factors such as the timing of the audit report and the composition of a firm's investor base may affect investors' perceptions of auditor explanatory language. To investigate these possibilities, we perform supplemental analysis on sample companies partitioned on additional related variables of interest.

First, we test whether the composition of the client's investor base affects investors' response to the audit report by partitioning the sample into quartiles of institutional investor ownership. Our results appear to be driven by firms in the highest quartile of institutional ownership although *EMPHASIS_OF_MATTER* is statistically significant across three of the four quartiles. Second, we consider the role of pre-disclosure information asymmetry by partitioning the sample into quartiles based on analyst forecast spread. Again, our results are found primarily in the highest quartile of information asymmetry which is consistent with Bamber and Cheon

(1995) who conclude that statistically significant differences in trading volume but not prices are more likely when pre-disclosure information asymmetry is higher.

Third, the passage of the Sarbanes-Oxley Act significantly changed the legal and regulatory audit environment. We examine audit reports issued in the pre-Sarbanes-Oxley Act era (2000 and 2001) separately from audit reports issued in the post-Sarbanes-Oxley Act era (2002-2009). Among audit reports filed before the passage of the Sarbanes-Oxley Act (17 percent of sample audit reports), the results are consistent for returns, but only the result for *EMPHASIS_OF_MATTER* remains consistent for volume. Among audit reports filed after the passage of the Sarbanes-Oxley Act, the results are consistent with Table 5. Overall, our results appear to be primarily driven by audit reports issued in the post-Sarbanes-Oxley period.

Fourth, we assess the sensitivity of our results to other measures of returns and volume. The results examining absolute abnormal returns are consistent when calculating firm-specific returns using CRSP size or using portfolios following Daniel, Grinblatt, Titman, and Wermers (1997). We also consider the alternative event windows of (-1, 5) and (-1, 10) surrounding the filing of the annual financial statements and obtain consistent results. With respect to the sensitivity of the volume results, Bamber et al. (2011) suggest examining both adjusted and unadjusted trading volume because an adjusted measure may exclude part of the information effect of interest whereas an unadjusted measure may yield more measurement error and correlated omitted variables. We re-perform the volume-based regression analyses using unadjusted volume calculated as the natural logarithm of the sum of the ratios of the number of shares traded to the total shares outstanding for each of the three trading days in the event window. The results examining unadjusted trading volume are consistent with those shown in Table 5.

Fifth, investors may not be reacting to the EL itself, but rather to management's corresponding discussion of like matters elsewhere in the financial statements. To confirm that investors react to the EL in the audit report rather than the corresponding management disclosures,

we perform two additional analyses. One, we re-estimate Column 4 in Table 6 after including controls for the materiality of the underlying matters discussed in EL following Czerney et al. (2014). The coefficients for all EL variables are statistically significant and have the same sign as in the original estimation, except for *ACCTGPRIN*, which is not statistically significant. We then re-estimate Column 4 in Table 6 separately for each type of EL using a sample of observations most likely to receive each type of EL. We impose sample restrictions and control for the materiality of the underlying EL items, where possible, following Czerney et al. (2014). Our results for *EMPHASIS_OF_MATTER*, *DIVISION*, and *SCOPE_REVIEW* are consistent with those in Table 6, Column 4. In addition, the coefficients for several types of *ACCTGPRIN* are consistent with the results reported in Table 6 when we include the first mention of each type of EL during the sample period.[11]

Finally, although we winsorize all continuous variables at the one percent level, we assess the sensitivity of our results to influential observations using both robust regression and median fit (quantile) regression. Our results are consistent with those shown in Table 5 for trading volume in both specifications. However, the coefficients for *FINDISTRESS* in the returns regressions are not statistically significant under either estimation procedure. Overall, these tests indicate that our inferences for trading volume are not sensitive to influential observations.

5. Conclusion

This paper investigates whether investors respond to explanatory language included in unqualified audit reports that have been found to be associated with lower financial reporting quality. Using three-day absolute value abnormal returns and abnormal trading volume to measure investor reactions to explanatory language in unqualified audit reports issued from 2000 – 2009, we provide evidence that investors find explanatory language informative. While we find no price

[11] Investor reaction to *ACCTGPRIN* EL referencing adoption of SFAS No. 133, SFAS Nos. 142 or 144, SFAS No. 158, and FIN 48 is statistically significant.

reaction to non-going concern explanatory language, we find significantly *higher* abnormal trading volume in the three day period surrounding the issuance of audit reports with explanatory language that discusses prior restatements and other consistency matters and those that include "emphasis of a matter" paragraphs. Further, we find that audit reports with explanatory language that references changes in accounting principle and audit-related disclosures (i.e., division of responsibility, scope limitations, and review procedures) are associated with significantly *lower* abnormal trading volume than audit reports without explanatory language. Overall, our findings suggest that investors attend to the information included in explanatory language but may disagree as to the implications of this information.

Our findings are important to standard-setters currently considering changes to the audit report. Our research suggests that certain types of some present-day explanatory language are informative to investors although survey evidence indicates that many investors may not attend to EL or fully recognize which language is indicative of risk. Thus, standard-setters should be aware that investors may need some guidance on how to interpret the proposed "critical audit matters" or "key audit matters" if such auditor disclosures are ultimately mandated. Finally, our study contributes to the literature on the perceived information content of audit reports. While prior research documents that going concern explanatory language and pre-SAS No. 58 opinion qualifications are informative to investors (e.g. Menon and Williams 2010; Choi and Jeter 1992), our study documents that non-going concern explanatory language added to unqualified audit reports is also informative to market participants. Further, because nearly all prior studies examine only stock price reactions to audit reports, our findings examining trading volume contribute a new dimension to this literature and suggest that many audit reports are informative to investors even in absence of a stock price reaction.

Appendix A

Explanatory Language Categorization Procedure and Validation

Audit Report Categorization Procedure

We use text-parsing procedures to categorize the explanatory language, if any, included in public company unqualified audit reports filed in EDGAR between 2000 and 2009. After manually reviewing a sample of audit reports to identify key words indicative of explanatory language, we categorize audit reports into 25 types of explanatory language following the guidance in AU 508.11.

For example, *ACCTGPRIN* reflects the maximum value of eight coding categories in which we identify company-year audit reports mentioning a change in accounting methods or adoption of a new accounting standard. Explanatory language pertaining to the adoption of SFAS 123, SFAS 142 or 144, FIN 48, SFAS 158, SFAS 133, SFAS 143, and SFAS 157 or 159 are the most prevalent, but we also allow for mention of other accounting method or standard changes. To identify audit reports that discuss adoption of SFAS 143 and FIN 47, which address accounting for asset retirement obligations, we search audit reports for language containing variations on the phrases "Standard No. 143," "Interpretation No. 47," or "asset retirement obligation" as a 1, and zero otherwise. An analogous mapping is completed for the remainder of our categories to generate the summary, AU 508 section categories (*ACCTGPRIN*, *EMPHASIZE_RESTATE*, *OTHER_CONSISTENCY*, *DIVISION*, *EMPHASIS_OF_MATTER*, *SUPPINFO*, *SCOPE_REVIEW*, and *FINDISTRESS*). Audit reports containing no explanatory language are categorized as including no explanatory language.

Validation Procedures

We tested the accuracy of our coding on a random sample of 825 audit reports initially categorized as including explanatory language and 500 audit reports initially categorized as not including EL. Our tests on this random sample of reports provides agreement exceeding 95% for all categories of explanatory language except supplemental information. After revising our text parsing routines for supplemental information, we randomly selected an additional 335 audit reports and determined that our revised text procedures correctly classified references to supplemental information for 96% of audit reports tested.

Additional consideration of integrated reports in the post-SOX period

The discussion of material weaknesses in integrated reports introduces an opportunity to misclassify the existence of explanatory language in an unqualified audit report. We reviewed our key phrases and determined that, due to open-ended nature of "emphasis of a matter" language, this type of EL could be subject to misclassification due to integrated reports. Accordingly, we manually revised all "emphasis of a matter" EL appearing in the same year as an adverse internal control opinion to confirm correct classification of EL in integrated reports.

Appendix B
Variable Definitions

Dependent Variables	
|ABRET|	The absolute value of the three-day cumulative abnormal return over the period (-1, 1) surrounding the filing date of the annual financial statements
ABVOL	The sum of the three-day trading volume scaled by common shares outstanding relative to the three-day trading volume scaled by common shares outstanding among all NYSE and AMEX listed companies for the period (-1, 1) surrounding the filing date of the annual financial statements
Explanatory Language Variables	
ACCTGPRIN	Equals one if the explanatory language references adoption of a new accounting standard or a change in accounting methods, and zero otherwise
EMPHASIZE_RESTATE	Equals one if the audit report states that prior (comparative) period financial statement balances have been restated or otherwise amended, revised, or corrected, and zero otherwise
OTHER_CONSISTENCY	Equals one if the audit report mentions fresh start accounting, references a basis of presentation other than accounting principles generally accepted in the United States, or discusses reclassifications or adjustments to financial statements amounts or disclosures (without restatement), and zero otherwise
EMPHASIS_OF_MATTER	Equals one if the audit report discusses a merger or acquisition, impending or ongoing litigation or lawsuit, significant transactions with affiliated parties, management's use of estimates, the translation of financial statement amounts from a foreign currency to U.S. dollars, or other matter the auditor deemed worthy of highlight, and zero otherwise
DIVISION	Equals one if the audit report indicates division of responsibility for the current year and equals zero otherwise
SCOPE_REVIEW	Equals one if the audit report mentions a scope limitation, the performance of review procedures, or absence of a review in prior quarterly periods, and zero otherwise

(continued on next page)

Appendix B (continued)

SUPPINFO	Equals one if the audit report mentions supplemental information included in, or to be read in conjunction with, the financial statements, and zero otherwise
FINDISTRESS	Equals one if the audit report expresses substantial doubt about the auditee's ability to continue as a going concern, if there is uncertainty about the auditee's future prospects (without explicitly mentioning going concern), or the paragraph discusses reorganization or bankruptcy, and zero otherwise
Control Variables	
SIZE	The natural logarithm of the market value of equity as of the end of the current fiscal year
LEVERAGE	Long-term debt scaled by total assets as of the current fiscal year end
ROA	Net income for the current fiscal year scaled by total assets as of the current fiscal year end
LOSS	An indicator variable equal to 1 if the company reports a net loss for the current fiscal year, and 0 otherwise
REPORTLAG	The natural logarithm of the number of days between the filing date of the annual financial statements and the fiscal year end date
EARNANNOUNCE	An indicator variable that equals 1 if the company announces its fourth quarter earnings during the three-day filing date event window, and 0 otherwise
BETA	The slope coefficient from the model $R_i = \alpha + \beta R_{mkt}$, where R_i is the daily return on the company's stock and R_{mkt} is the daily return on the value-weighted portfolio, over the 220 day period (-250, -21) relative to the filing date of the current year financial statements
MEANFE	The difference between the fourth quarter actual earnings and the average analyst forecast using the most recent analyst forecast of reporting analysts within 180 days prior to the earnings announcement date, scaled by the absolute value of the mean analyst forecast

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Appendix B (continued)

FORECASTSPREAD	The difference between the highest analyst earnings forecast and lowest analyst earnings forecast for the fourth quarter of the current fiscal year, scaled by the absolute value of the mean analyst forecast
FOLLOWING	The natural logarithm of the number of analysts issuing forecasts for fourth quarter earnings within 180 days prior to the earnings announcement date
INSTOWN	The natural logarithm of the number of the company's shares held by institutional investors relative to the total number of shares outstanding as of the current fiscal year end
TENURE	The natural logarithm of the number of years the current auditor has been engaged by the company as its primary external auditor
BIGN	An indicator variable that equals 1 if the company's external auditor is Arthur Andersen, Deloitte, Ernst & Young, KPMG, or PriceWaterhouseCoopers, and 0 otherwise
ICMW	An indicator variable that equals 1 if the company's audit report includes a material weakness on internal controls over financial reporting, and 0 otherwise
CONTROL_OPINION	An indicator variable that equals 1 if the company's audit report includes an opinion on internal controls over financial reporting, and 0 otherwise
REFPRED	An indicator variable that equals 1 if the company's audit report includes explanatory language that references a predecessor auditor, and 0 otherwise
ΔINSTOWN	The difference between the proportion of shares held by institutional investors relative to total shares outstanding as of the last reporting date prior to the 10-K filing date and the proportion of shares held by institutional investors relative to total shares outstanding as of the first reporting date after to the 10-K filing date

Appendix C
Examples of Explanatory Language

Refer to Appendix B for variable definitions.

ACCTGPRIN
SFAS_123 and *SFAS_158*
"As discussed in Note 1 to the financial statements, in 2006 the company changed its method of accounting for stock-based compensation and pension and other post-retirement benefits…"
~ A.O. Smith Corporation

FIN_48 and *SFAS_157/159*
"As discussed in Note 3 to the consolidated financial statements, on January 1, 2008, the Corporation adopted the provisions of Statement of Financial Accounting Standards No. 157, Fair Value Measurements, for its financial assets and liabilities. Also, as discussed in Note 16 to the consolidated financial statements, on January 1, 2007, the Corporation adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109." ~ Kimberly-Clark Corporation

EMPHASIZE_RESTATE
"As discussed in Note 2, the Company has restated its financial statements for the years ended January 31, 1999 and 1998." ~ Computer Learning Centers, Inc.

OTHER_CONSISTENCY
FRESH_START
"As a result, the consolidated balance sheet as of December 31, 2000, and the related statements of consolidated operations and cash flows for the period December 19 to December 31, 2000, are presented on a different basis than that for the periods before fresh start, and therefore, are not comparable." ~ Dynacore Holdings Corporation

DIFF_GAAP
"Accounting principles generally accepted in The Netherlands vary in certain respects from those, generally accepted in the United States. Application of accounting principles generally accepted in the United States would have required the adjustments described under Note 28 to the consolidated financial statements of KLM Royal Dutch Airlines and in our opinion are fairly reflected in all material respects." ~ KLM Royal Dutch Airlines

REVISION
"As described in Note 2, these consolidated financial statements have been revised to reflect the Company's change in reporting of sales and marketing rebates. We audited the adjustments described in Note 2 that were applied to revise the fiscal 2001 consolidated financials statements. In our opinion, such adjustments are appropriate and have been properly applied." ~ Radnor Holdings Corporation

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Appendix C (continued)

EMPHASIS_OF_MATTER
MERGER
"Con-way acquired CFI on August 23, 2007, Cougar Logistics on September 5, 2007 and Chic Logistics on October 18, 2007 (the Acquisitions) and management excluded the Acquisitions from its assessment of the effectiveness of Con-way's internal control over financial reporting as of December 31, 2007. The Acquisitions represent 34.7% of Con-way's total assets and 4.3% of Con-way's revenues as reported in the consolidated financial statements for the year ended December 31, 2007." ~ Con-way Inc.

LAWSUIT
"As more fully discussed in Notes 10 and 14 to the consolidated financial statements, the Company is involved in substantial litigation as both plaintiff and defendant." ~ Internet Law Library, Inc.

REL_PARTY
"As discussed in Note 7, the Company has engaged in significant Related Party transactions." ~ Global ePoint, Inc.

ESTIMATES
"As discussed in Note 2, the consolidated financial statements include investments valued at $1,788,001,000 as of December 31, 2000 and $1,228,497,000 as of December 31, 1999 (96 percent and 95 percent, respectively, of total assets) whose values have been estimated by the board of directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the board of directors in arriving at its estimate of value of such investments and have inspected the underlying documentation, and in the circumstances we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, the board of directors' estimate of values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material." ~ Allied Capital Corporation

TRANSLATE
"Our audits also comprehended the translation of Hong Kong dollar amounts into U.S. dollar amounts and, in our opinion, such translation has been made in conformity with the basis stated in note 2. Such U.S. dollar amounts are presented solely for the convenience of readers in the United States of America." ~ New China Homes, Ltd.

OTHER_EOM
"As discussed in Note 1, the Company is an operating subsidiary of Tyco International Ltd. Certain costs and expenses presented in the financial statements represent allocations and management's estimates of the costs of services provided to the Company by Tyco International Ltd. As a result, the financial statements presented may not be indicative of the financial position or results of operations that would have been achieved had the Company operated as a nonaffiliated entity." ~ Tycom Ltd

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Appendix C (continued)

AUDITRELATED
DIVISION
"We did not audit the financial statements of certain subsidiaries, including those consolidated by the proportionate consolidation method, whose assets constitute 49% and 18% of the total consolidated assets as at December 31, 2000 and 1999 respectively, and whose revenues constitute 56%, 16% and 31% of the total consolidated revenues for the years ended December 31, 2000, 1999, and 1998 respectively. The financial statements of those subsidiaries were audited by other auditors whose reports thereon were furnished to us. Our opinion, insofar as it relates to amounts emanating from the financial statements of such subsidiaries, is based solely on the said reports of the other auditors." ~ Koor Industries Ltd.

SCOPE_LIMIT
"We were not engaged to examine management's assessment of the effectiveness of Emtec, Inc. and subsidiaries' internal control over financial reporting as of August 31, 2008, included in the accompanying "Management's Report on Internal Control Over Financial Reporting" and, accordingly, we do not express an opinion thereon." ~ Emtec, Inc.

REVIEW
"We did not have an adequate basis to complete reviews of quarterly information in accordance with standards established by the American Institute of Certified Public Accountants…" ~ Xerox Corporation

SUPPINFO
"In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements." ~ Atlantic City Electric Company

FINDISTRESS
DISTRESS
"The Company incurred substantial losses during 2009 and 2008 due to impairments in the carrying value of loans and certain investment securities. These asset impairments have reduced the Company's, and its subsidiary bank's, equity, earnings capacity and regulatory capital ratios, and resulted in a charge off of the Company's goodwill and a full valuation allowance against deferred tax assets. Management has described its plan to improve the Company's and its subsidiary bank's equity, earnings capacity and regulatory capital ratios in Note 2 to the financial statements." ~ Integra Bank Corporation

GC
"The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note B to the financial statements.... These matters raise substantial doubt about the Company's ability to continue as a going concern. Management's plan in regards to these matters is described in Note B. The financial statements do not include any adjustments that might result from the outcome of this uncertainty." ~ Badger Paper Mills, Inc.

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Appendix C (continued)

FINDISTRESS (continued)
REORG
"As discussed in Note 1 to the consolidated financial statements, effective December 29, 2003, Magellan received final clearance of significant contingencies related to the implementation of its plan of reorganization, which had been confirmed on October 8, 2003 by the United States Bankruptcy Court for the Southern District of New York. Magellan officially emerged from bankruptcy as of January 5, 2004." ~ Magellan Health Services

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TABLE 1
Sample selection

Company-year observations with requisite data in Audit Analytics for 2000 – 2009	37,163
Less observations missing CRSP or Compustat data	-878
Less observations missing IBES data	-15,880
Sample size used for returns regressions	20,405
Less observations for which market volume is missing	-32
Sample size used for abnormal volume regressions	20,373

TABLE 2
Descriptive statistics for explanatory language variables

Panel A: Explanatory language categories by fiscal year

Fiscal Year	N	ANY_EL	%	Avg. EL Items
2000	1,838	813	44.20%	1.165
2001	1,618	870	53.80%	1.215
2002	1,758	1,331	75.70%	1.562
2003	2,080	1,552	74.60%	1.54
2004	2,238	1,414	63.20%	1.418
2005	2,316	1,348	58.20%	1.333
2006	2,266	1,935	85.40%	1.589
2007	2,149	1,819	84.60%	1.575
2008	2,047	1,553	75.90%	1.511
2009	2,095	1,465	69.90%	1.451
Total	20,405	14,100	69.10%	1.467

Panel B: Explanatory language by industry

Industry	N	ANY_EL	%	Avg. EL Items
Energy	1,292	925	71.60%	1.384
Materials	944	707	74.90%	1.491
Industrials	2,664	1,974	74.00%	1.551
Consumer Disc.	2,526	1,870	74.00%	1.516
Consumer Staples	479	325	67.80%	1.425
Health Care	3,302	2,282	69.10%	1.45
Financials	3,591	1,839	51.20%	1.313
Information Tech.	4,502	3,258	72.40%	1.476
Telecomm	350	273	78.00%	1.582
Utilities	755	647	85.70%	1.589
Total	20,405	14,100	69.10%	1.467

Notes:
Table 2 presents descriptive statistics for our explanatory language variables. Avg. EL Items show the average number of AU 508 EL categories discussed within the audit report, among reports that contain EL.

TABLE 3
Univariate statistics for absolute cumulative abnormal returns and abnormal volume

Panel A: Univariate test of returns and volume for explanatory language and unmodified reports

	N	Mean |*ABRET*|	Test |*ABRET*| = 0
ANY_EL = 0	6,305	0.0409	63.659***
ANY_EL = 1	14,100	0.0399	91.669***
Total	20,405	0.0402	111.572***
Test ANY_EL – Non-ANY_EL = 0		-0.0010	-1.270

	N	Mean *ABVOL*	Test *ABVOL* = 0
ANY_EL = 0	6,296	0.0028	6.939***
ANY_EL = 1	14,077	0.0057	20.566***
Total	20,373	0.0048	21.044***
Test (ANY_EL=1) – (ANY_EL=0) = 0		0.0029	5.989***

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TABLE 3 (continued)

Panel B: Univariate test of returns for categories of explanatory language

		|ABRET|		*ABVOL*	
Variables	Obs = 1	Mean	Diff Mean	Mean	Diff Mean
ACCTGPRIN					
SAB_101	112	0.0510***	0.0109##	0.0194***	0.0147###
SFAS_142/144	2,385	0.0297***	-0.0119###	0.0072***	0.0027###
SFAS_143	597	0.0229***	-0.0178###	0.0067***	0.0020
SFAS_158	1,474	0.0320***	-0.0088###	0.0020**	0.0030###
SFAS_123	3,216	0.0358***	-0.0053###	0.0059***	0.0013##
SFAS_133	576	0.0304***	-0.0101###	0.0049***	-0.0001
FIN_48	1,794	0.0511***	0.0119###	0.0002	-0.0050###
SFAS_157/159	439	0.0544***	0.0145###	0.0022	-0.0026#
OTHER_STD	1,173	0.0374***	-0.0030#	0.0068***	0.0022##
Total	9,003	0.0366***	-0.0065###	0.0053***	0.0009##
EMPH. RESTATE	455	0.0374***	-0.0028	0.0101***	0.0055###
OTH. CONSIST.					
FRESH_START	43	0.0463***	0.0061	0.0175***	0.0127##
DIFF_GAAP	33	0.0368***	-0.0034	0.0068	0.0020
REVISION	94	0.0462***	0.0060	0.0182***	0.0135###
Total	169	0.0445***	0.0044	0.0153***	0.0106###
E. OF MATTER					
MERGER	528	0.0354***	-0.0049##	0.0109***	0.0062###
LAWSUIT	14	0.0468***	0.0066	0.0167*	0.0120
REL_PARTY	9	0.0730***	0.0328#	0.0169	0.0121
ESTIMATES	5	0.1080	0.0678###	0.0266	0.0219
TRANSLATE	9	0.0613**	0.0211	0.0160*	0.0112
OTHER_EOM	23	0.0418***	0.0016	0.012	0.0072
Total	581	0.0373***	-0.003	0.0114***	0.0068###
SCOPE REVIEW					
SCOPE_LIMIT	1,438	0.0451***	0.0053###	-0.0016*	-0.0069###
REVIEW	5	0.0514*	0.0112	0.0321	0.0273#
Total	1,439	0.0451***	0.0053###	-0.0015*	-0.0068###
SUPPINFO	8,488	0.0388***	-0.0023###	0.0068***	0.0034###
FINDISTRESS	385	0.1077***	0.0688###	0.0121***	0.0074###

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TABLE 3 (continued)

Notes:

*** p<0.01, ** p<0.05, * p<0.10 indicate that mean Abs(ABRET) and mean ABVOL are significantly different from zero based on two tailed tests. ### p<0.01, ## p<0.05, # <0.10 indicate that the difference in mean Abs(ABRET) or ABVOL for observations with explanatory language is significantly different from mean Abs(*ABRET*) or *ABVOL* for observations without explanatory language.

TABLE 4
Descriptive and univariate statistics

Panel A: Descriptive Statistics

Variables	Mean	Std. Dev.	5%	25%	Median	75%	95%
SIZE#	3,142	7,600	46	205	639	2,124	16,263
LEVERAGE	0.177	0.198	0.000	0.003	0.111	0.288	0.574
ROA	-0.031	0.243	-0.459	-0.019	0.025	0.068	0.153
LOSS	0.298	0.457	0.000	0.000	0.000	1.000	1.000
REPORTLAG#	72.517	14.423	52.000	60.000	73.000	82.000	91.000
EARNANNOUNCE	0.120	0.325	0.000	0.000	0.000	0.000	1.000
Abs(ABRET)	0.040	0.051	0.002	0.010	0.023	0.049	0.140
BETA	1.106	0.655	0.134	0.655	1.043	1.488	2.340
MEANFE	0.758	2.201	0.004	0.049	0.149	0.455	3.245
FORECASTSPREAD	0.565	1.459	0.000	0.027	0.135	0.413	2.429
FOLLOWING#	5.841	5.086	1.000	2.000	4.000	8.000	17.000
INSTOWN#	0.506	0.328	0.000	0.224	0.548	0.780	0.983
TENURE#	8.660	7.482	1.000	3.000	6.000	12.000	27.000
BIGN	0.863	0.343	0.000	1.000	1.000	1.000	1.000
ICMW	0.039	0.195	0.000	0.000	0.000	0.000	0.000
CONTROL_OPINION	0.568	0.495	0.000	0.000	1.000	1.000	1.000
REFPRED	0.035	0.183	0.000	0.000	0.000	0.000	0.000

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TABLE 4 (continued)

Panel B: Univariate statistics

	ANY_EL = 1		*ANY_EL* = 0			
	Mean	Median	Mean	Median	Diff Mean	Test Statistic
SIZE#	3,417	744	2,527	452	891	7.746***
LEVERAGE	0.189	0.132	0.150	0.077	0.039	13.835***
ROA	-0.028	0.029	-0.038	0.014	0.010	2.719***
LOSS	0.300	0.000	0.293	0.000	0.007	1.033
REPORTLAG#	71.598	72.000	74.573	75.000	-2.975	-13.678***
EARNANNOUNCE	0.134	0.000	0.089	0.000	0.046	86.772***
Abs(ABRET)	0.040	0.023	0.041	0.024	-0.001	-1.27
BETA	1.117	1.050	1.081	1.022	0.035	3.549***
MEANFE	0.793	0.152	0.678	0.133	0.114	3.428***
FORECASTSPREAD	0.590	0.152	0.509	0.100	0.081	3.670***
FOLLOWING#	6.110	5.000	5.240	4.000	0.870	12.869***
INSTOWN#	0.540	0.605	0.430	0.427	0.110	21.049***
TENURE#	9.242	7.000	7.357	5.000	1.885	20.752***
BIGN	0.888	1.000	0.809	1.000	0.079	233.986***
ICMW	0.045	0.000	0.026	0.000	0.019	42.210***
CONTROL_OPINION	0.592	1.000	0.512	1.000	0.080	113.506***
REFPRED	0.038	0.000	0.029	0.000	0.009	10.754***

Notes:

#SIZE, *REPORTLAG*, *INSTOWN*, *FOLLOWING*, and *TENURE* have not been logarithm-transformed in this table. Test statistics for these variables are based on the logarithmic transformed variable. The test statistic for continuous variables is a T statistic. The test statistic for binary variables is a chi square statistic. The number of observations equals 20,405.

TABLE 5
Correlation table

Variables	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
1	1.00																
2	**0.10**	1.00															
3	**0.09**	**0.13**	1.00														
4	**0.02**	**0.35**	0.01	1.00													
5	0.01	**-0.37**	**0.02**	**-0.60**	1.00												
6	**-0.11**	**-0.43**	**-0.06**	**-0.19**	**0.21**	1.00											
7	**0.07**	**-0.13**	**0.05**	**-0.13**	**0.12**	**-0.05**	1.00										
8	-0.01	**-0.25**	0.01	**-0.24**	**0.27**	**0.13**	**0.20**	1.00									
9	**0.02**	**0.14**	**-0.03**	**-0.06**	**0.14**	**-0.08**	**-0.02**	**0.10**	1.00								
10	**0.02**	**-0.17**	**0.04**	**-0.08**	**0.23**	**0.07**	**0.09**	**0.13**	**0.02**	1.00							
11	**0.03**	0.00	**0.07**	**-0.02**	**0.18**	**-0.05**	**0.02**	**0.07**	**0.11**	**0.53**	1.00						
12	**0.09**	**0.66**	**0.06**	**0.15**	**-0.13**	**-0.36**	**-0.12**	**-0.09**	**0.22**	**-0.08**	**0.18**	1.00					
13	**0.15**	**0.35**	**0.09**	**0.22**	**-0.18**	**-0.28**	**-0.05**	**-0.11**	**0.12**	**-0.05**	**0.05**	**0.34**	1.00				
14	**0.14**	**0.25**	**0.08**	**0.10**	**-0.07**	**-0.20**	**0.00**	**-0.06**	**0.03**	**-0.04**	**0.02**	**0.17**	**0.13**	1.00			
15	**0.11**	**0.34**	**0.10**	**0.02**	**-0.02**	**-0.11**	**-0.13**	**-0.05**	**0.12**	**-0.08**	**0.01**	**0.26**	**0.17**	**0.30**	1.00		
16	**0.05**	**-0.03**	0.00	0.00	**0.04**	**0.14**	**0.09**	0.01	**0.05**	**0.07**	**0.06**	**-0.02**	**0.02**	**-0.03**	**-0.05**	1.00	
17	**0.07**	**0.20**	**0.03**	**0.12**	**-0.13**	**-0.48**	**0.12**	**-0.07**	**0.15**	**0.03**	**0.08**	**0.22**	**0.27**	**0.11**	**-0.08**	**0.18**	1.00
18	**0.02**	0.00	0.00	-0.01	0.01	**0.07**	**-0.02**	**-0.02**	**-0.02**	**-0.02**	**-0.02**	-0.01	-0.01	**-0.22**	**0.02**	**-0.02**	**-0.14**

Notes:

This table presents pairwise correlation coefficients based on 20,405 observations. Bold indicates that the pairwise correlation is statistically significant at $p<0.05$. 1=ANY_EL, 2=SIZE, 3=LEVERAGE, 4=ROA, 5=LOSS, 6=REPORTLAG, 7=EARNANNOUNCE, 8=|ABRET|, 9=BETA, 10=MEANFE, 11=FORECASTSPREAD, 12=FOLLOWING, 13=INSTOWN, 14=TENURE, 15=BIGN, 16=ICMW, 17=CONTROL_OPINION, and 18=REF_PRED.

TABLE 6
Multivariate analyses

	(1)		(2)		(3)		(4)	
	|*ABRET*|	|*ABRET*|	*ABVOL*		*ABVOL*	
Variables	Estimate	t-stat	Estimate	t-stat	Estimate	t-stat	Estimate	t-stat
ANY_EL	0.0017**	2.085			0.0003	0.552		
ACCTGPRIN			-0.0013	-1.591			-0.0011**	-2.029
EMPHASIZE_RESTATE			-0.002	-0.964			0.0029**	2.011
OTHER_CONSISTENCY			0.0007	0.194			0.0066**	2.208
EMPHASIS_OF_MATTER			-0.0015	-0.713			0.0056***	3.200
DIVISION			-0.0005	-0.142			-0.0051**	-2.159
SCOPE_REVIEW			0.002	1.208			-0.0039***	-3.611
SUPPINFO			0.0001	0.146			0.0010*	1.698
FINDISTRESS			0.0323***	6.596			0.0087***	3.500
SIZE	-0.0050***	-11.536	-0.0048***	-10.979	0.0011***	3.551	0.0012***	3.635
LEVERAGE	0.0062**	2.446	0.0063**	2.481	0.0065***	3.629	0.0065***	3.609
ROA	-0.0164***	-6.328	-0.0106***	-4.014	0.0056***	3.125	0.0070***	4.272
LOSS	0.0080***	6.461	0.0084***	6.849	-0.0024***	-3.298	-0.0022***	-3.100
REPORTLAG	0.0083***	2.722	0.0067**	2.183	-0.0088***	-3.407	-0.0096***	-3.684
EARNANNOUNCE	0.0244***	13.996	0.0234***	13.492	0.0112***	11.082	0.0109***	10.767
Abs(ABRET)					0.2085***	16.055	0.2064***	15.989
BETA	0.0098***	7.679	0.0100***	7.790	0.0011***	3.551	0.0012***	3.635
MEANFE	0.0012***	4.059	0.0011***	3.823	0.0065***	3.629	0.0065***	3.609
FORECASTSPREAD	-0.0007**	-2.015	-0.0006*	-1.735	0.0056***	3.125	0.0070***	4.272
FOLLOWING	0.0046***	5.619	0.0044***	5.401	-0.0024***	-3.298	-0.0022***	-3.100
INSTOWN	-0.0062***	-3.370	-0.0052***	-2.875	-0.0088***	-3.407	-0.0096***	-3.684
TENURE	-0.0019***	-4.111	-0.0018***	-3.968	0.0112***	11.082	0.0109***	10.767
BIGN	0.0015	1.177	0.0018	1.395	0.0015	1.550	0.0014	1.423
ICMW	-0.0015	-0.748	-0.0012	-0.559	0.0021	1.639	0.0015	1.171
CONTROL_OPINION	-0.002	-1.098	-0.0012	-0.642	-0.0043***	-3.245	-0.0061***	-4.557
REF_PRED	-0.0029**	-2.023	-0.0037**	-2.455	0.0004	0.349	0.0008	0.792

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TABLE 6 (continued)

	(1)		(2)		(3)		(4)	
	|ABRET|		*|ABRET|*		*ABVOL*		*ABVOL*	
Variables	Estimate	t-stat	Estimate	t-stat	Estimate	t-stat	Estimate	t-stat
Industry Indicators	Included		Included		Included		Included	
Year Indicators	Included		Included		Included		Included	
Constant	0.0400***	2.854	0.0451***	3.182	-0.0017	-0.146	0.0021	0.176
Observations	20,405		20,405		20,373		20,373	
R-squared	0.226		0.232		0.311		0.314	

Notes:

*** p<0.01, ** p<0.05, * p<0.10 based on two tailed tests. T statistics are presented in parentheses. Indicator variables for year and industry are included in all models but omitted for brevity.