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RESEARCH NOTES

The Information Content of Withdrawn Audit Qualifications: New Evidence on the Value of “Subject-To” Opinions

L. Paige Fields and Michael S. Wilkins

SUMMARY

Statement on Auditing Standards No. 58 (AICPA 1988) effectively eliminated the “subject-to” audit opinion which auditors used to highlight financial statement uncertainties. Elimination of the “subject-to” report implied the Auditing Standards Board’s belief that the opinion conveyed no material information to users. Several market-based studies of the value of “subject-to” opinions have yielded mixed results. A major limitation in most of these studies was a lack of precision in identifying the exact date upon which information, if any, was revealed to the market.

This study extends the previous work by examining the common share price reactions to public announcements of withdrawn “subject-to” opinions. The sample consists of 52 withdrawn opinions announced between 1978 and 1987. Each announcement had to be free of potentially contaminating information that might have affected common stock prices. Also, adequate common stock price data had to be readily available for all firms. To measure the impact of the announcement, a method was employed by which expected returns (calculated for a period prior to the time closely surrounding the announcement) were compared to the returns during the announcement period. Results indicate an increase in returns attributable to the announcement.

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Additional analyses using only those announcements for which there was no preliminary public information concerning the withdrawals increased the strength of the finding. Further analysis also revealed that the strongest unexpected increase in returns accompanied those withdrawals originally related to asset realization and going concern matters.

Overall the results indicate that "subject-to" opinions do provide information to investors and that their elimination may have been premature.

INTRODUCTION

THE Auditing Standards Board recently issued Statement on Auditing Standards No. 58 which, among other things, eliminates "subject-to" (hereafter ST) qualifications (AICPA, 1988). SAS No. 58 dictates that financial statement qualifications now be based on matters which are more substantive than those which previously required qualification. That is, uncertainties alone regarding financial statements are insufficient to justify a qualified opinion.¹ This ruling implies that the information previously conveyed by ST qualifications has insignificant economic value.

Conservatism dictates that the least restrictive, yet effective guidelines be used to determine when an opinion is qualified. If past ST qualifications were viewed as important by users of accounting information, then the uncertainties underlying these opinions should also comprise the basis for future qualifications. The primary question involves whether ST opinions have information content.

Previous empirical evidence regarding the value of ST qualifications is mixed. During the 1980s several studies attempted to document the effects of qualified audit opinions

on firms' common stock prices.² The main difficulty encountered in most of these prior studies was the lack of precision in identifying the date upon which information, if any, was revealed to the market (*i.e.* the event date). Studies which examined disclosures other than press releases (*e.g.*, annual reports or 10-K releases) found no significant share-price reaction to ST opinions, and thus concluded that these qualifications do not have significant information content. However, Dopuch *et al.* (1986) found that public announcements of ST qualifications are associated with negative share-price responses, and concluded that these announcements of qualifications have information value.³

Although the overall empirical findings are inconclusive, the adoption of SAS No. 58 implies that the weight of the evidence supports the idea that ST qualifications are not valuable to users of accounting information. The purpose of this study is to examine share-price reactions to public announcements of withdrawn qualifications in order to provide new evidence regarding the value of ST opinions.⁴ Cross-sectional

²As examples, see Dopuch *et al.* (1986); Dodd *et al.* (1984); Davis (1982); Chow and Rice (1982); Elliott (1982); Ball *et al.* (1979); and Firth (1978). See Keller (1983) for the effect of qualified opinions on trading volume.

³Elliott (1982) also utilizes a small subsample ($n = 16$) of publicly-announced qualified audit opinions and finds that these opinions may convey negative information.

⁴A ST opinion signals potential adverse effects due to uncertainties. Conversely, withdrawn qualifications provide unambiguous signals that the potential effects of such uncertainties have ended. Therefore, the magnitude (not just the sign) of the share-price impact of qualification issuances may differ from that of qualification withdrawals.

¹Prior to adoption of SAS No. 58, "subject-to" opinions were issued when a material uncertainty existed which might have affected the future financial condition of the firm. Current and future qualifications are to be issued only when scope limitations exist or when the financial statements do not conform to generally accepted accounting principles.

regression analysis was used to investigate the relation between anticipation of the withdrawal announcement and the share-price reaction to the withdrawal announcement. The evidence suggests that the Auditing Standards Board may have acted prematurely in eliminating ST opinions.

The remainder of the paper is organized as follows: the next section describes the sample selection procedure and methodology; next, the results and implications are presented; and then a summary and conclusions section is presented.

SAMPLE SELECTION AND METHODOLOGY

Sample Selection

Firms included in the final sample met the following criteria:

1. The qualification withdrawal was publicly announced either in *The Wall Street Journal*, in the *UMI Newspaper Abstracts*, or over the *Dow Jones News Service* wire between 1970 and 1989.⁵
2. Complete common stock returns data were available for each announcing firm on the Center for Research in Security Prices (CRSP) NYSE/AMEX or NASDAQ Daily Returns Files.
3. The announcing firm made no other firm-specific material announcement within two trading days of the announcement of the qualification removal.⁶

Application of these criteria resulted in a sample of 52 withdrawn qualifications publicly announced between 1978 and 1987.

⁵The UMI Newspaper Abstracts contain information from *The Wall Street Journal*, *The New York Times*, *The Washington Post*, *The Boston Globe*, *The Chicago Tribune*, and *The Atlanta Constitution*.

⁶Firm-specific material events are those shown in the finance and accounting literature to have statistically or marginally statistically significant impacts on common stock prices, such as earnings and dividend announcements.

Methodology

Average daily abnormal returns to common stock were measured around the announcement dates of the withdrawn qualifications. Abnormal returns (AR_{jt}) were calculated for the period beginning 21 days before to 20 days after the announcement date, using the market model:

$$AR_{jt} = R_{jt} - (\hat{\alpha}_j + \hat{\beta}_j R_{mt}), \quad (1)$$

where R_{jt} is the return of security j for period t , and R_{mt} is the return on the center for Research in Security Prices NYSE/AMEX or NASDAQ market index for period t . The estimated coefficients $\hat{\alpha}_j$ and $\hat{\beta}_j$ were calculated using the 200 trading days that end 22 days prior to the announcement date.⁷

Tests of statistical significance were based on standardized abnormal returns where the standard deviation of the sum of the AR_{jt} series over the time period from $t = T_1$ to $t = T_2$ is given by equation (2).⁸

$$S_{JT} = \left\{ \hat{\sigma}_j^2 \left[T + \frac{T^2}{N} + \frac{T^2 (\bar{R}_{mT} - \bar{R}_m)^2}{\sum_{t=1}^T (R_{mt} - \bar{R}_m)^2} \right] \right\}^{1/2} \quad (2)$$

The value $\hat{\sigma}_j^2$ is the mean square error of the market model regression for firm j , \bar{R}_m is the mean market index return over the estimation period, N is the number of returns in the estimation period, and \bar{R}_{mT} is the mean market index return during period T . The number of sample observations in the period from $t = T_1$ to $t = T_2$ is defined as T , where T is $T_2 - T_1 + 1$.

⁷The parameters are estimated using the method of Scholes and Williams (1977) and ordinary least squares, without significant differences in results.

⁸See Mikkelsen and Partch (1988).

Assuming that the abnormal returns are multivariate normal and cross-sectionally independent, the null hypothesis that the mean abnormal return is zero was tested with the following statistic (Z):

$$Z = \frac{1}{\sqrt{n}} \sum_{j=1}^n \sum_{t=T_1}^{T_2} \frac{AR_{jt}}{S_{jT}}. \quad (3)$$

The statistic in equation (3) has an asymptotically unit normal distribution and n denotes the sample size.

RESULTS AND IMPLICATIONS

Panel A of table 1 presents average daily and average announcement period abnormal

TABLE 1
Percentage Daily Average and Announcement Period Average Abnormal Returns, Z-values, and Percentage Cumulative Average Abnormal Returns (PANEL A) and Summary Statistics Regarding Announcement Period Abnormal Returns (PANEL B) for the Sample of 52 Withdrawn Qualifications

PANEL A			
Event Day	Average Abnormal Return	Z-value ^a	Cumulative Average Abnormal Return ^b
-10	0.193%	1.136	0.193%
-9	-0.201	-1.077	-0.008
-8	-0.178	-0.389	-0.186
-7	0.564	0.516	0.378
-6	0.351	0.667	0.729
-5	0.125	0.759	0.854
-4	0.044	-0.436	0.898
-3	-0.033	0.458	0.865
-2	0.052	-0.396	0.917
(-1,0)	2.298	4.047**	3.215
1	-0.109	-0.103	3.106
2	-0.295	-1.326	2.811
3	0.177	0.804	2.988
4	-0.210	-0.159	2.778
5	0.094	0.236	2.872
6	0.100	1.194	2.972
7	-0.248	-0.350	2.724
8	-0.794	-1.634	1.930
9	-0.503	-1.398	1.427
10	0.028	0.210	1.455

PANEL B					
Mean	Median	Standard Deviation	Minimum	Maximum	Percent Positive
2.298%	0.959%	5.975%	-6.593%	29.499%	61.54%

^aThe null hypothesis is that the average standardized abnormal return is equal to zero.
^bAbnormal returns are calculated for the period beginning 21 days before to 20 days after the announcement date.
 **significant at the .001 level.

returns for the full sample of 52 withdrawn qualified audit opinions. The average announcement period abnormal return is 2.298 percent, significant at the .001 level ($Z = 4.047$).⁹ The median announcement period abnormal return is 0.959 percent. The individual firms' announcement period returns (hereafter ARs) range from -6.593 percent to 29.499 percent (see panel B), with 61.54 percent of the sample firms experiencing positive share-price performance during the announcement period. These results complement the negative announcement period share-price performance associated with first-time qualifications documented by Dopuch *et al.* (1986) and Elliott (1982).¹⁰

In table 2 the frequencies of ARs across various ranges are reported for the sample of 52 firms. The majority of negative ARs (17 of 20) lie between -2.99 percent and 0.00 percent. Half of the positive ARs (16 of 32) lie between 0.01 percent and 2.99 percent, and three exceed 10.00 percent. Omitting the three large positive ARs does not alter the findings. That is, the average announcement period abnormal return for the 49 remaining observations is 1.223 percent ($Z = 2.783$), significant at the .01 level.

The types of original ST qualifications and the distribution of the withdrawal announcements over the sample period are presented in table 3. Over half (28) of the 52 original qualifications were due to uncertainties regarding pending litigation. The type of original qualification occurring least frequently involved rate refunds associated with electric utility firms. The withdrawal announcements are spread relatively evenly

TABLE 2
Frequencies of Individual Firms'
Announcement Period Abnormal
Returns for the Sample of 52
Withdrawn Qualifications

Range	Frequency
Less than -5.00%	3
-4.99% to -4.00%	0
-3.99% to -3.00%	0
-2.99% to -2.00%	7
-1.99% to -1.00%	6
-0.99% to 0.00%	4
0.01% to 0.99%	7
1.00% to 1.99%	5
2.00% to 2.99%	4
3.00% to 3.99%	2
4.00% to 4.99%	2
5.00% to 5.99%	2
6.00% to 6.99%	1
7.00% to 7.99%	1
8.00% to 8.99%	3
9.00% to 9.99%	2
Greater than 10.00%	3

over the sample period, with the greatest number of announcements (10) occurring in 1982. Positive share-price performance is consistently observed across years (7 of 10 years) and types of qualifications (4 of 5 types).

Although Dopuch *et al.* (1986) examined the share-price reactions to public announcements of qualifications, they did not isolate the responses to qualifications publicly announced prior to other disclosures such as annual report or 10-K releases.¹¹ To assess the "pure" information content of the withdrawn qualification this study measures the share-price response to 28 withdrawn qualifications which have public announcements prior to other forms of disclosure. The results are reported in panel A of table 4.

⁹The results are not sensitive to the use of the equally-weighted or value-weighted index or to a change in the parameter estimation period.

¹⁰Dopuch *et al.* (1986) document a 4.7 percent negative average announcement period abnormal return for 114 publicly-announced qualified opinions, and Elliott (1982) finds a 4.8 percent negative average announcement period abnormal return for 16 publicly-announced qualifications.

¹¹Dopuch *et al.* (1986) reveal that 18 of their 70 sample qualifications which have identifiable financial report release dates were publicly announced prior to other forms of disclosure.

TABLE 3
Distribution of Withdrawn Qualifications and Mean Abnormal Returns (AR) By Type and By Year

Year	Pending Litigation	Asset Realization	Future Financing	Rate Refunds	Going Concern	Total	Mean AR
1978	2	1	0	0	0	3	1.89%
1979	3	3	0	1	0	7	1.55%
1980	7	0	0	0	0	7	-0.36%
1981	0	0	1	0	0	1	-0.02%
1982	6	1	0	0	3	10	1.96%
1983	3	1	1	1	1	7	1.26%
1984	2	0	0	0	3	5	6.07%
1985	3	0	1	0	1	5	7.07%
1986	1	1	0	0	2	4	-0.03%
1987	1	0	2	0	0	3	3.73%
Total	28	7	5	2	10	52	—
Mean AR	1.28%	3.08%	1.16%	-0.85%	5.79%	—	2.30%

These 28 firms have a positive average announcement period abnormal return of 3.876 percent which is significant at the .001 level ($Z = 4.424$).¹² The median announcement period abnormal return is 1.592 percent (see panel B). Moreover, approximately 71 percent of the firms experience positive announcement period share-price performance.

In table 5 the frequencies of ARs across various ranges are reported for the subsample of 28 firms. The positive ARs are relatively evenly distributed throughout the range of positive values, with the largest number of firms having ARs between 2.00 percent and 2.99 percent.

The impact upon share price appears to have been stronger when the public announcement preceded any other form of disclosure. This may be due to the fact that these withdrawals were less anticipated,

thereby causing greater impact at announcement. This possibility was investigated by estimating the following ordinary least squares regression model for the full sample (t-values in parentheses):

$$\begin{aligned}
 AR_{jt} = & 0.00891 \\
 & (0.8270) \\
 & + 0.04762 \text{ PROXIMITY}_j \\
 & (3.050) \\
 & - 0.00001 \text{ FIRMSIZE}_j \quad (4) \\
 & (-1.520)
 \end{aligned}$$

PROXIMITY is a dummy variable representing the proximity of the withdrawal to the original qualification. This variable is equal to 1 when the public announcement of the withdrawn qualification occurs within one fiscal year of the qualification's original issuance, and 0 for all other announcements. Withdrawals which are announced shortly after the original qualification may be less anticipated. FIRMSIZE is the pre-withdrawal number of shares outstanding multiplied by the common share price on the Friday prior to the withdrawal. Because small firms may receive less attention from analysts and the media, the chance of in-

¹²The subsample of 28 firms with withdrawals announced publicly prior to other forms of disclosure contains the three largest positive announcement period abnormal returns. With these observations omitted, the two-day average abnormal return is 1.978 percent ($Z = 2.815$), significant at the .01 level.

TABLE 4

Percentage Daily Average and Announcement Period Average Abnormal Returns, Z-values, and Percentage Cumulative Average Abnormal Returns (PANEL A) and Summary Statistics Regarding Announcement Period Abnormal Returns (PANEL B) for the Sample of 28 Withdrawn Qualifications Publicly Announced Prior to Other Forms of Disclosure

PANEL A					
Event Day	Average Abnormal Return	Z-value ^a	Cumulative Average Abnormal Return ^b		
-10	-0.235%	0.025	-0.235%		
-9	-0.102	-0.652	-0.337		
-8	0.093	0.408	-0.244		
-7	0.982	1.122	0.738		
-6	0.412	1.019	1.150		
-5	-0.147	0.198	1.003		
-4	0.059	-0.245	1.062		
-3	-0.062	0.870	1.000		
-2	0.009	-0.133	1.009		
(-1,0)	3.876	4.424**	4.885		
1	-0.381	-1.062	4.504		
2	-0.743	-1.692	3.761		
3	0.018	0.271	3.779		
4	-0.398	0.146	3.381		
5	0.578	1.274	3.959		
6	0.324	1.008	4.283		
7	-0.325	-0.645	3.958		
8	-1.022	-0.798	2.936		
9	-0.989	-1.934	1.947		
10	-0.326	-0.463	1.621		

PANEL B					
Mean	Median	Standard Deviation	Minimum	Maximum	Percent Positive
3.876%	1.592%	7.040%	-6.593%	29.499%	71.43%

^aThe null hypothesis is that the average standardized abnormal return is equal to zero.

^bAbnormal returns are calculated for the period beginning 21 days before to 20 days after the announcement date.

**significant at the .001 level.

formation "leakage" prior to announcement is less likely for these firms. In essence, more of the total effect of the withdrawn qualification may be detected at announcement.

The overall model (equation 4) is statis-

tically significant at the .006 level ($F = 5.576$), and has relatively high explanatory power (adjusted $R^2 = 0.152$). The significant coefficient estimate for PROXIMITY and the marginally significant coefficient

TABLE 5
Frequencies of Individual Firms'
Announcement Period Abnormal
Returns for the Sample of 28
Withdrawn Qualifications Publicly
Announced Prior to Other Forms of
Disclosure

Range	Frequency
Less than -5.00%	1
-4.99% to -4.00%	0
-3.99% to -3.00%	0
-2.99% to -2.00%	3
-1.99% to -1.00%	2
-0.99% to 0.00%	2
0.01% to 0.99%	2
1.00% to 1.99%	5
2.00% to 2.99%	2
3.00% to 3.99%	2
4.00% to 4.99%	0
5.00% to 5.99%	1
6.00% to 6.99%	0
7.00% to 7.99%	1
8.00% to 8.99%	3
9.00% to 9.99%	1
Greater than 10.00%	3

estimate for FIRMSIZE suggest that share-price responses to withdrawn qualifications are stronger when the withdrawals are less anticipated.

SUMMARY AND CONCLUSIONS

This study of public announcements of 52 withdrawn "subject-to" qualified audit opinions documents a statistically significant positive average announcement period abnormal return. Further, withdrawals which are relatively less anticipated result in stronger positive abnormal performance upon announcement. The results suggest that withdrawn "subject-to" opinions are valuable to investors because they convey information which affects shareholder wealth. Statement on Auditing Standards No. 58 dictates that financial statement qualifications now be based on more substantive matters. The results of this study suggest that this new standard underestimates the value of "subject-to" qualifications.

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