

## AFAANZ 2019-2020 Grant Outcomes Report

### (1) Name, Position, Contact Details for each applicant

Principal applicant:

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### (2) Project Title

Arbitrage and Going Concern Audit Opinions: Corporate Insiders in Australia

### (3) Updated Project Summary (500 words) including any variations between the project undertaken and the original application

We examine if Australian going concern audit opinions (GCOs) are overly conservative inducing higher post-announcement negative returns, or if the market has incorporated ex-ante information with no price impact. We further investigate if corporate insiders obtain abnormal returns ex-ante trading on GCOs which contain type I error, as evidenced by GCOs withdrawn in subsequent audit year (GCOWs). We extend prior studies on insider trading volumes from pre-GCOs to abnormal returns post-GCOs, by investigating if GCOWs is associated with differential abnormal returns.

Data on auditor identities, audit opinions and the bases of opinions are hand-collected from the annual financial reports of Australian listed companies for the period 2011-2018. We identify firms with first-time GCOs issued during 2011-2017, and trace their audit opinions in the next reporting period to segregate them into continued GCOs (GCOCs) or GCOs withdrawn (GCOWs) firms. We obtain matched annual accounting variables and market prices from the Worldscope database, and insider trading data from the Thomson Reuter database for all insider purchases and sales which occurred around the GCOs. All insider trades are then aggregated at the firm-quarter level to obtain a net insider purchase value (Ke et al., 2003).

While prior studies such as Dhaliwal et al. (2016) and Chen et al. (2013) use predicted insider trades to infer insider trading behaviour, we improve on their methodologies by measuring insider trading behaviour using actual real time insider trades to calculate abnormal returns. To avoid the impact of seasonal trend in insider trading, we proxy insider trading behaviour around the GCO using the change of net purchase value ( $\Delta NPVQ$ ). To test whether insiders in GCOW firms are net purchasers with higher  $\Delta NPVQ$  than those in CGCO firms, we run multivariate regressions with controls from the insider trading and auditing literature, which include firm size, contrarian trading tendencies, firm opacity, firm age, profitability, bankruptcy risk, recent new funds raising, auditor quality, industry and year fixed effects.

We find the pooled market adjusted buy-and-hold abnormal returns for all GCO announcements are consistently negative for most of the post announcement year, but after the subsequent year audit report they become insignificant. We argue that a GCO contains incremental negative information for the market, but only in the short term with price mean reversion over the longer term. However, we observe very different price evolutions between the two sub-samples of GCOWs and GCOCs. After GCO announcement, there are slightly negative returns for GCOWs at the start, followed by a slow positive increase, and then a positive acceleration from 20 trading days after the subsequent year audit report announcement. For GCOC firms there is a continuing negative return decline.

To explore factors contributing to the differential market price reactions on GCO announcements, we examine the trading behaviour of corporate insiders and the subsequent returns from their trading. We find increased net insider purchases in the quarter immediately following the GCO, which results in significant long-term returns. This result is consistent in the period of accelerated price increases for GCOW firms. Hence, insider purchases provide both a predictive and a confirmatory signal of a subsequent GCOW.

## References

Chen, C., Martin, X., and Wang, X. (2013). Insider trading, litigation concerns, and auditor going-concern opinions. *The Accounting Review*, 88 (2), 365–393.

Dhaliwal, D., Hallman, K. K., and Pereira, R. (2016). Insider trading and going concern opinions: A re-examination. *Working Paper*, University of Texas at Austin and University of Missouri-Columbia.

Ke, B., Huddart, S., and Petroni, K. (2003). What insiders know about future earnings and how they use it: Evidence from insider trades. *Journal of Accounting and Economics*, 35(3), 315-346.

(4) Funds Granted: \$5,000

(5) Detailed Report on Expenditure of Funds against Budget Items, with variations explained

### Expenditure of Funds

Budget Items	Budgeted Amount \$	Actual Expenditure \$	Variance* \$
Part time Research Assistant (RA)	7,500	2,588	-4,912
Travel costs to meet with RA and co-researcher for collaboration	2,500	2,412	-88
Total	10,000	5,000	-5,000
Grant fund allocated		5,000	

\* Explanation for Variance:

The variance is due to the allocated grant fund (\$5,000) being only half of the amount (\$10,000) applied and budgeted for.

(6) Outcomes, for example, working papers, presentations and publications (give full details, including abstracts)

A preliminary draft of a working paper has been prepared based on our research and data analyses, an abstract of the working paper is provided below.

Abstract:

This study documents that corporate insiders can benefit from going concern audit opinions (GCOs) that contain type I errors, with auditors issuing a going concern opinion withdrawal (GCOW) in the subsequent year. We hypothesize and confirm that the anticipatory corporate insiders trading during the quarter immediately after the GCO announcement forms a strong signal for a GCOW for their firms in the subsequent year. We find that these anticipatory trades are associated with firms that do not have severe financial problems associated with the GCO issuance. Finally, arbitrage hedge portfolios are constructed to provide evidence that corporate insiders do benefit from abnormal profits.

(7) Future Intentions for this Project (give full details)

a. Conference submissions

We will submit the revised manuscript to conferences such as AFAANZ 2021, American Accounting Association Annual Meeting, European Accounting Association Annual Congress and other reputable international annual meetings to solicit comments from reviewers and conference participants to improve the research.

b. Journal submissions

We target the submission to top-tier international auditing and accounting journals such as *Auditing: A Journal of Practice & Theory*, *Journal of International Accounting Research*, *Contemporary Accounting Research*, and *Accounting and Finance*.

c. Grant applications

We will consider extending our project to study other related aspects of audit opinions, and apply for new grant funding to support databases acquisition, manual data collection and research assistant costs.

d. Projects

We will consider extending our study to related projects such as the investigations of auditor appointments and switches, analyst revisions, etc.

## (8) Summary of Outcomes and Benefits

We augment US studies by examining if Australian going concern audit opinions (GCOs) are overly conservative inducing higher post-announcement negative returns, or if the market has incorporated ex-ante information with no price impact. We further investigate if corporate insiders obtain abnormal returns ex-ante trading on GCOs. We extend prior studies on insider trading volumes from pre-GCOs to abnormal returns post-GCOs, by investigating if GCOs withdrawn in subsequent period is associated with differential abnormal returns.

Analysing subgroups of continuing going concern opinion (GCOC) and going concern opinion withdrawal (GCOW) firms yields results with significant negative returns after GCO announcement for GCOC firms, and positive returns for GCOWs. We hypothesize and confirm that the anticipatory trading of corporate insiders, with asymmetric private information, drives the positive GCOW returns. Finally, arbitrage hedge portfolios are constructed to confirm that corporate insiders do benefit from abnormal profits.

Our findings provide insights to auditors, investors and regulators on the economic consequences of overly conservative GCOs, and offer an explanation as to why prior studies, that do not separate GCOWs from GCOCs, provide conflicting post GCO abnormal returns.