

Informed Trade and the Market (Non-)Reaction to SOX 404 Material Weakness Disclosures

Cory Cassell

Walton College of Business
University of Arkansas

Tyler Kleppe

Gatton College of Business & Economics
University of Kentucky

Andrew Pierce*

andrew.t.pierce@manchester.ac.uk

Alliance Manchester Business School
University of Manchester

October 2022

Abstract: Motivated by survey evidence that buy-side analysts consider material weakness in internal controls over financial reporting (ICFR) to be a prominent red flag of intentional managerial manipulation of the firm's financial statements, we re-examine the market response to auditor Section 404(b) attestations that indicate the existence of a material weakness in internal controls (ICMW). Our analyses reveal that Section 404(b) auditor report dates are preempted by significant informed trade. Transient institutional shareholders reduce their long equity positions in firms with forthcoming ICMW news, and this selling is associated with significant negative pre-announcement abnormal returns. For ICMW report dates preceded by low informed trading, we observe a -27 to -29 basis point significant difference in one-day abnormal returns relative to ICMW report dates preceded by high informed trade. Our findings suggest that investors highly value external auditor attestation regarding ICFR, and that an event date negative market reaction for ICMW disclosures is not observable, on average, because informed trading increases the informativeness of stock prices in advance of the disclosure.

*Corresponding author. We appreciate helpful comments and suggestions from Dane Christensen, Nick Guest, Jed Nielsen, Hojun Seo (FARS discussant), and participants at the 2017 Arkansas Accounting Research Conference, the 2018 BYU Accounting Research Symposium, and the 2019 American Accounting Association FARS Midyear Meeting. We thank our respective institutions for gracious financial support. We are also greatly indebted to Margaret Warren for her able assistance and comments related to a previous version of this study, which circulated under the title—*Does Corporate Access Facilitate Informed Trading? Evidence from Trading in Advance of Internal Control Disclosures*.