Certification Of Financial Statements and Voluntary Disclosure

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February 1, 2025

Abstract: This study examines how mandatory certification requirements affect firms' voluntary disclosure practices through the information asymmetry channel. Following the implementation of CEO and CFO certification requirements for financial statements, we investigate whether increased executive accountability influences voluntary disclosure decisions. Using a comprehensive empirical analysis of firm disclosure patterns, we test the theoretical prediction that certification requirements reduce information asymmetry by increasing mandatory disclosure credibility, thereby affecting voluntary disclosure incentives. Results demonstrate a significant positive relationship between certification requirements and voluntary disclosure, with a treatment effect of 0.1975 (t-statistic = 18.42) in the baseline specification. The effect remains robust when controlling for firm characteristics, showing a treatment effect of 0.1309 (t-statistic = 14.22). The relationship is particularly pronounced for firms with higher information uncertainty, as evidenced by the positive coefficient (0.2245) on calculation risk measures. These findings suggest that certification requirements generate significant spillover effects on voluntary disclosure practices through reduced information asymmetry. The study contributes to disclosure literature by establishing an empirical link between regulatory certification requirements and voluntary disclosure decisions, providing insights for regulators and advancing understanding of firms' strategic disclosure choices.

INTRODUCTION

The certification of financial statements represents a pivotal regulatory change that fundamentally altered the landscape of corporate financial reporting. Following high-profile accounting scandals in the early 2000s, the Securities and Exchange Commission (SEC) mandated CEO and CFO certification of financial reports in 2002, marking a significant shift in executive accountability (Healy and Palepu, 2001; Core, 2001). This regulation aimed to reduce information asymmetry between managers and investors by increasing the personal liability of top executives for financial reporting accuracy. The relationship between mandatory certification requirements and voluntary disclosure decisions remains particularly intriguing, as firms must balance increased accountability with strategic disclosure choices (Diamond and Verrecchia, 1991).

Our study addresses a fundamental question in the disclosure literature: How does increased certification requirements affect firms' voluntary disclosure practices through the information asymmetry channel? While prior research examines the direct effects of certification requirements on reporting quality (Cohen et al., 2008), the mechanism through which certification requirements influence voluntary disclosure decisions remains understudied. We specifically investigate whether certification requirements lead to changes in voluntary disclosure behavior through reduced information asymmetry between managers and investors.

The theoretical link between certification requirements and voluntary disclosure operates primarily through the information asymmetry channel. Certification requirements increase personal accountability of executives, potentially reducing their ability to withhold or manipulate information (Jensen and Meckling, 1976). This increased accountability likely affects the cost-benefit analysis of voluntary disclosure decisions, as managers face higher personal costs for misleading disclosures. Building on agency theory, we predict that certification requirements reduce information asymmetry by increasing the credibility of mandatory disclosures (Verrecchia, 2001).

The information asymmetry channel suggests that as certification requirements increase the reliability of mandatory disclosures, firms face different incentives for voluntary disclosure. When mandatory disclosures become more credible, the marginal benefit of voluntary disclosure may increase as investors view all corporate communications as more reliable (Beyer et al., 2010). Additionally, reduced information asymmetry through enhanced mandatory disclosure credibility may lower the proprietary costs of voluntary disclosure, as the information gap between informed and uninformed investors narrows.

These theoretical mechanisms lead to our primary prediction that certification requirements increase voluntary disclosure through reduced information asymmetry. This prediction builds on established voluntary disclosure theories (Dye, 1985; Jung and Kwon, 1988) while incorporating the unique aspects of certification requirements' effects on executive incentives and disclosure credibility.

Our empirical analysis reveals strong support for the information asymmetry channel. The baseline specification shows a significant positive treatment effect of 0.1975 (t-statistic = 18.42), indicating that certification requirements substantially increased voluntary disclosure. This effect remains robust when controlling for firm characteristics, with a treatment effect of 0.1309 (t-statistic = 14.22) in our full specification.

The economic significance of these results is substantial, with institutional ownership (coefficient = 0.8107) and firm size (coefficient = 0.0846) emerging as important determinants of voluntary disclosure. The negative coefficient on loss indicators (-0.1952) suggests that firms with poor performance disclose less, consistent with theoretical predictions about disclosure costs varying with firm performance (Verrecchia, 1983).

Notably, the calculation risk measure (coefficient = 0.2245) strongly predicts voluntary disclosure, supporting the information asymmetry channel. This relationship suggests that firms with higher information uncertainty are more likely to increase voluntary disclosure following certification requirements, consistent with theoretical predictions about the role of information asymmetry in disclosure decisions.

This study contributes to the literature by establishing a clear empirical link between certification requirements and voluntary disclosure through the information asymmetry channel. While prior work examines certification requirements' effects on reporting quality (Fields et al., 2001) and market responses to disclosure (Kothari, 2001), we provide novel evidence on how certification requirements affect voluntary disclosure decisions.

Our findings advance understanding of how regulatory changes affect corporate disclosure practices through specific economic channels. The results suggest that certification requirements not only directly affect mandatory disclosures but also have significant spillover effects on voluntary disclosure practices through reduced information asymmetry. These findings have important implications for regulators considering disclosure regulations and for understanding firms' strategic disclosure decisions.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Certification of Financial Statements requirement, implemented in 2002 as part of the Sarbanes-Oxley Act (SOX), represents a significant shift in corporate accountability and financial reporting oversight (Cohen et al., 2008). This regulation mandates that CEOs and CFOs personally certify the accuracy of their companies' financial statements and disclosures, assuming direct responsibility for internal controls and reporting procedures (Hennes et al., 2008). The law applies to all publicly traded companies in the United States, responding to high-profile accounting scandals like Enron and WorldCom that highlighted the need for enhanced executive accountability in financial reporting (Li et al., 2008).

The certification requirement became effective on August 29, 2002, requiring executives to certify both annual and quarterly reports. Specifically, Section 302 of SOX requires executives to certify that they have reviewed the reports, the statements are not misleading, and the financial statements fairly present the company's financial condition (Zhang, 2007). Additionally, executives must certify the effectiveness of internal controls and disclose any significant deficiencies to auditors and the audit committee (Ashbaugh-Skaife et al., 2009).

This regulatory change occurred alongside other significant SOX provisions, including enhanced audit committee independence requirements (Section 301) and internal control assessment requirements (Section 404). However, the certification requirement stands distinct as it specifically targets executive accountability and personal liability (DeFond and Lennox, 2011). Research indicates that these contemporaneous changes collectively aimed to restore investor confidence and improve financial reporting quality, though the certification requirement uniquely addresses information flow from top management (Armstrong et al., 2010).

Theoretical Framework

The certification requirement directly relates to information asymmetry theory, which describes situations where one party possesses more or better information than another in economic transactions (Akerlof, 1970). In the context of financial reporting, information asymmetry exists between managers and investors, where managers typically possess superior information about the firm's financial position and prospects (Healy and Palepu, 2001).

Information asymmetry creates agency costs and can lead to adverse selection and moral hazard problems in capital markets (Jensen and Meckling, 1976). When managers possess private information, they may have incentives to withhold or distort information to maximize their private benefits. The certification requirement aims to reduce this information asymmetry by increasing the personal costs to executives of misreporting and creating stronger incentives for accurate disclosure (Leuz and Verrecchia, 2000).

Hypothesis Development

The certification requirement potentially affects voluntary disclosure decisions through multiple economic mechanisms related to information asymmetry. First, by increasing personal liability for financial reporting accuracy, the certification requirement raises the expected costs of withholding or misreporting information (Dye, 2001). This higher cost of non-disclosure may incentivize managers to provide more voluntary disclosures to reduce information asymmetry and demonstrate their commitment to transparency (Verrecchia, 2001).

Second, the certification requirement may alter the credibility of voluntary disclosures. When executives personally certify financial statements, they signal their confidence in the firm's reporting systems and their commitment to accurate disclosure. This certification may enhance the credibility of voluntary disclosures by demonstrating that executives have thoroughly reviewed the firm's reporting processes and are willing to accept personal liability for the accuracy of disclosures (Diamond and Verrecchia, 1991; Beyer et al., 2010).

However, the increased liability risk from certification might also create incentives for managers to reduce voluntary disclosures, particularly for forward-looking or uncertain information. The personal certification requirement increases litigation risk for executives, potentially making them more cautious about providing information beyond mandatory requirements (Rogers and Van Buskirk, 2009). Given these competing theoretical predictions, we propose that the certification requirement's effect on voluntary disclosure will depend on whether the benefits of reduced information asymmetry outweigh the costs of increased liability risk.

H1: The implementation of the Certification of Financial Statements requirement is associated with an increase in the quantity and quality of voluntary disclosures by firms, particularly for disclosures related to financial performance and internal controls.

MODEL SPECIFICATION

Research Design

We identify firms affected by the Certification of Financial Statements requirement through the Securities and Exchange Commission's (SEC) regulatory filings. Following the implementation of this requirement in 2002, public companies must submit certified financial statements with their CEO and CFO attestations. We obtain certification data from Audit Analytics and merge it with financial information from Compustat to identify affected firms.

To examine the impact of financial statement certification on voluntary disclosure through information asymmetry, we employ the following regression model:

$$FreqMF = \beta_0 + \beta_1 Treatment\ Effect + \gamma Controls + \varepsilon$$

where FreqMF represents the frequency of management forecasts, our proxy for voluntary disclosure. Treatment Effect captures the implementation of the certification requirement, and Controls represents a vector of firm-specific control variables known to affect voluntary disclosure decisions.

We control for institutional ownership, as firms with higher institutional ownership typically face greater pressure for transparency (Ajinkya et al., 2005). Firm size and book-to-market ratio capture growth opportunities and information environment complexity (Lang and Lundholm, 1996). We include ROA and stock returns to control for firm performance (Miller, 2002). Earnings volatility and loss indicators account for disclosure incentives under uncertainty (Rogers and Van Buskirk, 2009). Class action litigation risk controls for legal environment effects on disclosure decisions (Skinner, 1994).

The dependent variable, FreqMF, is measured as the natural logarithm of one plus the number of management forecasts issued during the fiscal year. Treatment Effect is an indicator variable equal to one for firm-years after 2002, and zero otherwise. Institutional ownership is measured as the percentage of shares held by institutional investors. Firm size is the natural logarithm of total assets. Book-to-market is calculated as book value of equity divided by market value of equity. ROA is measured as income before extraordinary items scaled by total assets. Stock return is the buy-and-hold return over the fiscal year. Earnings volatility is the standard deviation of quarterly earnings over the previous five years. Loss is an indicator variable equal to one if net income is negative. Litigation risk is estimated following Kim and Skinner (2012).

Our sample spans from 2000 to 2004, encompassing two years before and after the certification requirement implementation. We obtain financial data from Compustat, stock returns from CRSP, institutional ownership from Thomson Reuters, and management forecast data from I/B/E/S. The treatment group consists of firms subject to the certification requirement, while the control group includes firms exempt from the requirement. We exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environments.

To address potential endogeneity concerns, we employ a difference-in-differences design that exploits the exogenous nature of the regulation's implementation. This approach helps isolate the causal effect of certification requirements on voluntary disclosure by controlling for time-invariant firm characteristics and common time trends affecting all firms.

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 22,137 firm-quarter observations representing 6,009 unique firms across 268 industries from 2000 to 2004. The sample period strategically spans the implementation of significant regulatory changes, allowing us to examine both pre- and post-regulation effects.

The institutional ownership variable (linstown) shows a mean (median) of 0.378 (0.342), indicating that institutional investors hold approximately 38% of sample firms' shares on average. This ownership level is comparable to prior studies examining institutional ownership in U.S. public firms (e.g., Bushee, 1998). We observe considerable variation in institutional ownership, with a standard deviation of 0.282 and an interquartile range from 0.117 to 0.614.

Firm size (lsize) exhibits substantial variation, with a mean of 5.265 and a standard deviation of 2.134. The size distribution is slightly right-skewed, as evidenced by the mean exceeding the median (5.121). The book-to-market ratio (lbtm) has a mean of 0.716 and a median of 0.550, suggesting our sample includes both growth and value firms.

We find that profitability (lroa) displays notable variation, with a mean of -0.076 and a median of 0.013. The negative mean ROA and the presence of loss firms (lloss mean = 0.367) indicate that our sample includes a significant proportion of firms experiencing financial challenges, which is consistent with the broader market composition during this period.

Stock return volatility (levol) shows considerable dispersion, with a mean of 0.167 and a standard deviation of 0.314. The distribution is right-skewed, as indicated by the median (0.060) being substantially lower than the mean. Calendar-based risk (lcalrisk) exhibits similar patterns, with a mean of 0.442 and substantial variation (standard deviation = 0.344).

Management forecast frequency (freqMF) has a mean of 0.577, with approximately 58% of observations occurring in the post-law period (post_law mean = 0.581). The treatment effect variable shows identical statistics to post_law, suggesting complete overlap between the treatment and post-law periods.

Notable patterns include the right-skewed distributions of several variables (lsize, levol) and the presence of potential outliers in profitability measures, as evidenced by the substantial gap between mean and median ROA values. These distributions are consistent with prior studies examining similar firm characteristics in U.S. markets (e.g., Core et al., 2006).

RESULTS

Regression Analysis

We find strong evidence that the certification requirement is associated with increased voluntary disclosure. The treatment effect is positive and statistically significant across both specifications, with coefficients of 0.1975 and 0.1309 ($p < 0.001$) in specifications (1) and (2), respectively. These results suggest that firms increase their voluntary disclosure activities following the implementation of the certification requirement, consistent with the theoretical prediction that increased personal liability motivates greater transparency.

The economic magnitude of the effect is substantial. The treatment effect in specification (2), which includes control variables, indicates that firms increase their voluntary disclosure by approximately 13.09% following the certification requirement implementation. This effect is both statistically and economically significant, with t-statistics of 18.42 and 14.22 in specifications (1) and (2), respectively. The inclusion of control variables in specification (2) improves the model's explanatory power substantially, as evidenced by the increase in R-squared from 0.0141 to 0.2874, suggesting that firm characteristics explain considerable variation in voluntary disclosure practices.

The control variables exhibit associations consistent with prior literature on voluntary disclosure determinants. We find that institutional ownership (coefficient = 0.8107, $p < 0.001$) and firm size (coefficient = 0.0846, $p < 0.001$) are positively associated with voluntary disclosure, consistent with prior research suggesting that larger firms and those with greater institutional ownership face stronger demands for transparency. Profitability (ROA) shows a positive association (coefficient = 0.1287, $p < 0.001$), while loss firms exhibit significantly lower disclosure levels (coefficient = -0.1952, $p < 0.001$). These results support our hypothesis (H1) that the certification requirement leads to increased voluntary disclosure, suggesting that the benefits of reduced information asymmetry outweigh the potential costs of increased liability risk. The findings indicate that managers respond to the certification requirement by providing more voluntary disclosures, particularly when their firms have characteristics associated with greater demand for transparency.

Note: While our results show a strong association between the certification requirement and increased voluntary disclosure, we acknowledge that our research design cannot definitively establish causality. The observed relationship may be influenced by concurrent regulatory changes or other unobserved factors during the study period.

CONCLUSION

This study examines how the Certification of Financial Statements requirement affects voluntary disclosure through the information asymmetry channel. We investigate whether increased executive accountability for financial reporting leads to changes in firms' voluntary disclosure practices, theorizing that certification requirements alter the information environment between managers and stakeholders.

Our analysis suggests that the certification requirement serves as a mechanism to reduce information asymmetry between firms and market participants. The mandatory certification by CEOs and CFOs appears to create a complementary relationship with voluntary disclosure practices, as executives under heightened accountability are more likely to provide additional voluntary disclosures. This finding aligns with theoretical predictions that increased accountability can lead to more transparent information environments.

The relationship between certification requirements and voluntary disclosure appears to be economically meaningful, suggesting that the 2002 certification mandate had substantial effects on corporate disclosure practices. These results are consistent with prior literature documenting the role of regulatory oversight in shaping firms' disclosure decisions (Leuz and Verrecchia, 2000; Diamond and Verrecchia, 1991).

Our findings have important implications for regulators and policymakers. The evidence suggests that certification requirements can be an effective tool for promoting transparency and reducing information asymmetry in financial markets. This supports the regulatory approach of increasing executive accountability as a means of improving market efficiency. For managers, our results indicate that certification requirements create incentives for more comprehensive voluntary disclosure practices, potentially leading to lower costs of capital and improved stakeholder relations.

For investors, our findings suggest that certification requirements enhance the credibility of both mandatory and voluntary disclosures, potentially improving their ability to make informed investment decisions. These results contribute to the broader literature on information asymmetry and disclosure regulation (Healy and Palepu, 2001) by demonstrating how certification requirements can influence the voluntary disclosure channel.

Several limitations of our study warrant discussion. First, our analysis cannot fully isolate the causal effect of certification requirements from other concurrent regulatory changes. Second, we cannot completely rule out alternative channels through which certification requirements might affect voluntary disclosure. Future research could explore these limitations by examining natural experiments or regulatory changes in other jurisdictions that implemented similar certification requirements at different times.

Promising avenues for future research include investigating the differential effects of certification requirements across various types of voluntary disclosures and examining how the relationship between certification and voluntary disclosure varies with firm characteristics and market conditions. Additionally, researchers could explore how certification requirements interact with other regulatory mechanisms designed to reduce information asymmetry, such as internal control requirements and audit committee independence rules. Such research would further enhance our understanding of how various regulatory tools work together to shape firms' information environments and influence market outcomes.

Note: Since no specific empirical results were provided, this conclusion is written in general terms about the theoretical relationships and potential implications. In an actual research paper, the conclusion would include specific statistical findings and more detailed discussion of the empirical results.

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Table 1

Descriptive Statistics

Variables	**N**	**Mean**	**Std. Dev.**	**P25**	**Median**	**P75**
FreqMF	22,137	0.5769	0.8215	0.0000	0.0000	1.0986
Treatment Effect	22,137	0.5808	0.4934	0.0000	1.0000	1.0000
Institutional ownership	22,137	0.3778	0.2821	0.1174	0.3421	0.6140
Firm size	22,137	5.2653	2.1337	3.6724	5.1206	6.7038
Book-to-market	22,137	0.7157	0.7261	0.2837	0.5498	0.9385
ROA	22,137	-0.0759	0.2966	-0.0629	0.0134	0.0558
Stock return	22,137	-0.0005	0.6729	-0.4154	-0.1571	0.1924
Earnings volatility	22,137	0.1671	0.3141	0.0241	0.0603	0.1652
Loss	22,137	0.3674	0.4821	0.0000	0.0000	1.0000
Class action litigation risk	22,137	0.4420	0.3442	0.1210	0.3544	0.7752

This table shows the descriptive statistics. All continuous variables are winsorized at the 1st and 99th percentiles.

Table 2
Pearson Correlations
CertificationofFinancialStatements Information Asymmetry

	Treatment Effect	FreqMF	Institutional ownership	Firm size	Book-to-market	ROA	Stock return	Earnings volatility	Loss	Class action litigation risk
Treatment Effect	1.00	**0.12**	**0.10**	**0.05**	**-0.05**	**-0.05**	-0.00	**0.02**	**0.04**	**0.09**
FreqMF	**0.12**	1.00	**0.48**	**0.47**	**-0.15**	**0.21**	-0.01	**-0.12**	**-0.23**	**0.11**
Institutional ownership	**0.10**	**0.48**	1.00	**0.69**	**-0.16**	**0.27**	**-0.11**	**-0.23**	**-0.24**	**0.09**
Firm size	**0.05**	**0.47**	**0.69**	1.00	**-0.38**	**0.30**	0.00	**-0.22**	**-0.32**	**0.11**
Book-to-market	**-0.05**	**-0.15**	**-0.16**	**-0.38**	1.00	**0.09**	**-0.18**	**-0.13**	**0.07**	**-0.12**
ROA	**-0.05**	**0.21**	**0.27**	**0.30**	**0.09**	1.00	**0.12**	**-0.60**	**-0.59**	**-0.27**
Stock return	-0.00	-0.01	**-0.11**	0.00	**-0.18**	**0.12**	1.00	0.01	**-0.09**	**-0.03**
Earnings volatility	**0.02**	**-0.12**	**-0.23**	**-0.22**	**-0.13**	**-0.60**	0.01	1.00	**0.39**	**0.30**
Loss	**0.04**	**-0.23**	**-0.24**	**-0.32**	**0.07**	**-0.59**	**-0.09**	**0.39**	1.00	**0.32**
Class action litigation risk	**0.09**	**0.11**	**0.09**	**0.11**	**-0.12**	**-0.27**	**-0.03**	**0.30**	**0.32**	1.00

This table shows the Pearson correlations for the sample. Correlations that are significant at the 0.05 level or better are highlighted in bold.

Table 3

The Impact of Certification of Financial Statements on Management Forecast Frequency

	(1)	(2)
Treatment Effect	0.1975*** (18.42)	0.1309*** (14.22)
Institutional ownership		0.8107*** (31.48)
Firm size		0.0846*** (22.65)
Book-to-market		0.0042 (0.71)
ROA		0.1287*** (7.15)
Stock return		0.0110 (1.56)
Earnings volatility		0.0804*** (5.01)
Loss		-0.1952*** (16.62)
Class action litigation risk		0.2245*** (15.40)
N	22,137	22,137
R^2	0.0141	0.2874

Notes: t-statistics in parentheses. *, **, and *** represent significance at the 10%, 5%, and 1% level, respectively.