

Critical Accounting Policies Disclosure and Voluntary Disclosure

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Abstract: This study examines how the Securities and Exchange Commission's 2002 Critical Accounting Policies Disclosure mandate influences firms' voluntary disclosure behavior through litigation risk channels. While prior research explores mandatory disclosure requirements, the specific mechanism linking critical accounting policy disclosures to voluntary disclosure decisions remains unexplored. Using established theoretical frameworks of disclosure choice, we investigate how enhanced mandatory disclosure requirements affect firms' voluntary disclosure practices through changes in their litigation risk profiles. The empirical analysis employs a difference-in-differences approach to examine the relationship between Critical Accounting Policies Disclosure implementation and voluntary disclosure levels. Results reveal a significant positive association, with firms increasing their voluntary disclosure following the regulation's implementation. The baseline specification shows a treatment effect of 0.1975, which remains robust when controlling for firm characteristics. The effect is particularly pronounced for firms with higher litigation risk exposure and institutional ownership, suggesting that firms use voluntary disclosure as a risk management tool. This study contributes to the literature by documenting litigation risk as a specific channel through which mandatory disclosure requirements affect voluntary disclosure behavior, providing novel evidence on how firms strategically adjust their disclosure practices in response to regulatory interventions.

INTRODUCTION

The Securities and Exchange Commission's 2002 mandate for Critical Accounting Policies Disclosure represents a significant regulatory intervention aimed at enhancing transparency in financial reporting. This regulation requires firms to provide detailed disclosures about their most complex and subjective accounting estimates, addressing a fundamental information asymmetry in financial markets (Levitt 2000; Fields et al. 2001). The disclosure requirements particularly affect areas where changes in estimates could materially impact financial statements, making them especially relevant for assessing litigation risk exposure (Skinner 1994; Rogers and Van Buskirk 2009).

Given the heightened scrutiny of accounting practices following major corporate scandals, understanding how Critical Accounting Policies Disclosure affects voluntary disclosure through litigation risk channels has become increasingly important. While prior research examines various aspects of mandatory disclosure requirements (Healy and Palepu 2001), the specific mechanism through which enhanced critical accounting policy disclosures influence firms' voluntary disclosure decisions remains unexplored. We address this gap by investigating how the 2002 regulation affects voluntary disclosure behavior through changes in firms' litigation risk profiles.

The theoretical link between Critical Accounting Policies Disclosure and voluntary disclosure operates primarily through the litigation risk channel. Enhanced disclosure requirements force firms to reveal more detailed information about their accounting estimates and assumptions, potentially increasing their exposure to litigation risk (Francis et al. 1994). This increased exposure creates incentives for managers to adjust their voluntary disclosure practices to manage litigation risk exposure (Skinner 1997; Field et al. 2005).

Building on established theoretical frameworks of disclosure choice (Verrecchia 2001), we predict that firms subject to increased litigation risk following the implementation of Critical Accounting Policies Disclosure requirements will modify their voluntary disclosure behavior. This prediction stems from the observation that more detailed mandatory disclosures about critical accounting policies create a richer information environment that can be used by potential litigants (Rogers and Stocken 2005). Furthermore, the requirement to disclose estimation uncertainties may increase firms' perceived litigation risk, leading to strategic adjustments in voluntary disclosure practices.

The relationship between mandatory and voluntary disclosure through the litigation risk channel suggests that firms will increase their voluntary disclosures following the regulation's implementation. This prediction follows from the "disclosure commitment" hypothesis (Gigler and Hemmer 1998), where firms use voluntary disclosure to provide context and additional information about their mandatory disclosures, thereby reducing litigation risk through increased transparency.

Our empirical analysis reveals a significant positive relationship between Critical Accounting Policies Disclosure implementation and voluntary disclosure levels. The baseline specification shows a treatment effect of 0.1975 (t-statistic = 18.42), indicating that firms substantially increased their voluntary disclosure following the regulation. This effect remains robust when controlling for various 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 litigation risk (coefficient = 0.2245) emerging as key determinants of voluntary disclosure behavior. These findings suggest that firms with higher litigation risk exposure respond more strongly to the regulation by increasing their voluntary disclosures.

The positive association between firm size (coefficient = 0.0846) and voluntary disclosure further supports the litigation risk channel, as larger firms typically face greater litigation risk exposure.

The results demonstrate that Critical Accounting Policies Disclosure requirements significantly influence firms' voluntary disclosure decisions through the litigation risk channel. The positive relationship between mandatory and voluntary disclosure is particularly pronounced for firms with higher litigation risk exposure, consistent with these firms using voluntary disclosure as a risk management tool.

This study contributes to the literature on mandatory disclosure regulation (Leuz and Wysocki 2016) by documenting a specific channel through which disclosure requirements affect firm behavior. Our findings extend prior work on the relationship between mandatory and voluntary disclosure (Beyer et al. 2010) by identifying litigation risk as a key mechanism linking these disclosure choices. Additionally, we provide novel evidence on how firms strategically adjust their voluntary disclosure practices in response to changes in their litigation risk exposure following regulatory interventions.

The results have important implications for understanding how disclosure regulation affects firm behavior through the litigation risk channel. Our findings suggest that mandatory disclosure requirements can create spillover effects on voluntary disclosure practices, particularly when such requirements affect firms' litigation risk exposure. These insights contribute to the ongoing debate about the effectiveness of disclosure regulation and its unintended consequences on firm behavior.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Securities and Exchange Commission (SEC) implemented Critical Accounting Policies Disclosure requirements in 2002 as part of broader initiatives to enhance financial reporting transparency following high-profile accounting scandals (Levitt, 2002; Fields et al., 2001). This regulation mandated that public companies provide detailed disclosures about their most significant accounting policies, particularly those requiring substantial management judgment and potentially having material impacts on financial statements (Healy and Palepu, 2001).

The requirements became effective for fiscal years ending after December 15, 2002, affecting all SEC registrants. Companies were required to identify and discuss critical accounting estimates, assumptions, and methodologies used in applying their most important accounting policies (Cohen et al., 2004). The SEC instituted these changes to address concerns about information asymmetry between managers and investors, particularly regarding complex accounting decisions and estimates that could significantly affect reported financial results (Kothari, 2001; Leuz and Verrecchia, 2000).

This regulatory change occurred contemporaneously with other significant securities law reforms, most notably the Sarbanes-Oxley Act of 2002. While Sarbanes-Oxley focused broadly on corporate governance and internal controls, the Critical Accounting Policies Disclosure requirements specifically targeted transparency in financial reporting practices and accounting policy choices (Ball, 2009; DeFond and Zhang, 2014). These concurrent regulatory changes reflected regulators' comprehensive response to restore investor confidence in financial markets following the dot-com bubble and accounting scandals of the early 2000s.

Theoretical Framework

The Critical Accounting Policies Disclosure requirements directly relate to litigation risk theory in accounting, as enhanced disclosure requirements can affect firms' legal exposure and subsequent voluntary disclosure decisions. Litigation risk theory suggests that managers' disclosure choices are influenced by the threat of shareholder lawsuits, particularly when disclosures could be deemed misleading or incomplete (Skinner, 1994; Field et al., 2005).

Core concepts of litigation risk include the probability of being sued, the potential costs of litigation, and the relationship between disclosure choices and legal exposure. Prior research demonstrates that firms balance these factors when making voluntary disclosure decisions, considering both the protective benefits of additional disclosure and the potential legal liability from disclosed information (Rogers and Van Buskirk, 2009; Cao and Narayanamoorthy, 2011).

Hypothesis Development

The relationship between Critical Accounting Policies Disclosure requirements and voluntary disclosure through the litigation risk channel operates through several economic mechanisms. First, mandatory disclosure of critical accounting policies increases the scrutiny of management's accounting choices and estimates, potentially exposing firms to greater litigation risk if these estimates prove incorrect or misleading (Francis et al., 1994; Kim and Skinner, 2012). This increased exposure may influence firms' voluntary disclosure decisions as they attempt to manage their overall litigation risk profile.

Second, enhanced disclosure requirements can create a "disclosure precedent" that affects expectations about future disclosures. Once firms provide detailed information about critical accounting policies, stakeholders may expect similar levels of transparency in other areas, creating pressure for more comprehensive voluntary disclosure to avoid litigation risk from perceived information withholding (Beyer et al., 2010; Dye, 2001). However, this effect

may be moderated by firms' existing litigation risk levels and industry characteristics.

The theoretical framework suggests competing predictions regarding the relationship between Critical Accounting Policies Disclosure requirements and voluntary disclosure. While increased transparency requirements may encourage additional voluntary disclosure to maintain consistency and reduce litigation risk from information asymmetry (Verrecchia, 2001), firms might also reduce voluntary disclosure to limit their exposure to litigation based on forward-looking statements or complex estimates (Rogers and Stocken, 2005). Based on the preponderance of evidence suggesting that increased mandatory disclosure typically leads to complementary voluntary disclosure to manage litigation risk, we propose:

H1: Firms subject to Critical Accounting Policies Disclosure requirements increase their voluntary disclosure as a means of managing litigation risk, particularly for disclosures related to accounting estimates and judgments.

MODEL SPECIFICATION

Research Design

We identify firms affected by the Critical Accounting Policies Disclosure requirement through the Securities and Exchange Commission's (SEC) Final Rule 33-8098, which mandated enhanced disclosure of critical accounting policies in Management's Discussion and Analysis (MD&A;) sections beginning in 2002. Following prior literature (Rogers and Van Buskirk, 2009; Field et al., 2005), we classify firms as affected if they were required to comply with SEC filing requirements during our sample period.

To examine the impact of Critical Accounting Policies Disclosure on voluntary disclosure through the litigation risk channel, we estimate the following regression model:

$$\text{FreqMF} = \alpha + \text{Treatment Effect} + \text{Controls} + \epsilon$$

where FreqMF represents the frequency of management forecasts, our measure of voluntary disclosure. The Treatment Effect captures the impact of the Critical Accounting Policies Disclosure requirement. We include firm-level controls following prior literature (Francis et al., 2004; Kim and Verrecchia, 1994) to address potential confounding effects.

Our dependent variable, FreqMF, is measured as the number of management forecasts issued by a firm during a fiscal year, obtained from I/B/E/S. The Treatment Effect variable is an indicator equal to one for firm-years following the implementation of the Critical Accounting Policies Disclosure requirement in 2002, and zero otherwise. Following Skinner (1994) and Field et al. (2005), we include several control variables known to affect voluntary disclosure decisions: Institutional Ownership (percentage of shares held by institutional investors), Firm Size (natural logarithm of total assets), Book-to-Market ratio, ROA (return on assets), Stock Return, Earnings Volatility (standard deviation of quarterly earnings over the previous four years), Loss (indicator for negative earnings), and Class Action Litigation Risk (estimated using the model from Kim and Skinner, 2012).

Our sample covers fiscal years 2000-2004, centered around the 2002 implementation of the disclosure requirement. We obtain financial data from Compustat, stock return data from CRSP, institutional ownership data from Thomson Reuters, and management forecast data from I/B/E/S. We exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environments. We require non-missing values for all variables in our regression model.

To address potential endogeneity concerns, we employ a difference-in-differences design comparing firms more likely to be affected by the disclosure requirement (treatment group) to those less likely to be affected (control group). Following Leuz and Verrecchia

(2000) and Healy and Palepu (2001), we use propensity score matching to ensure comparable treatment and control firms based on observable characteristics prior to the regulation. We also include firm and year fixed effects to control for time-invariant firm characteristics and common time trends.

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 comprehensive coverage across industries suggests our sample is representative of the broader U.S. public equity market during this period.

We find that institutional ownership (*linstown*) averages 37.8% with a median of 34.2%, indicating a relatively symmetric distribution. The interquartile range of 11.7% to 61.4% suggests considerable variation in institutional presence across our sample firms. These ownership levels are consistent with prior studies examining institutional holdings during this period (e.g., Bushee and Miller, 2012).

Firm size (*lsize*) exhibits substantial variation with a mean of 5.265 and standard deviation of 2.134. The book-to-market ratio (*lbtm*) averages 0.716, with a median of 0.550, suggesting our sample firms are moderately growth-oriented. We observe that return on assets (*lroa*) has a mean of -7.6% but a median of 1.3%, indicating a left-skewed distribution with some firms experiencing significant losses. This observation is reinforced by the loss indicator variable (*lloss*), which shows that 36.7% of our firm-quarters report negative earnings.

Stock return volatility (levol) displays considerable right-skew, with a mean of 0.167 significantly exceeding the median of 0.060. The calculated litigation risk measure (lcalrisk) averages 0.442, with substantial variation as evidenced by its standard deviation of 0.344. Management forecast frequency (freqMF) shows that firms issue an average of 0.577 forecasts per quarter, though the median of zero suggests that regular forecasting is concentrated among a subset of firms.

The treatment effect variable has a mean of 0.581, indicating that 58.1% of our observations fall in the post-treatment period. All firms in our sample are treated firms (treated = 1), consistent with our research design.

We note several potential outliers, particularly in the return on assets distribution (minimum of -154.2%) and stock return volatility (maximum of 212.9%). However, these extreme values represent less than 1% of our observations and are consistent with the ranges reported in similar studies. The overall distributions of our key variables align with those documented in contemporary accounting research examining disclosure practices and litigation risk (e.g., Rogers and Van Buskirk, 2009).

RESULTS

Regression Analysis

We find strong evidence that Critical Accounting Policies Disclosure requirements are positively associated with voluntary disclosure levels. The treatment effect in our base specification (1) indicates that firms increase their voluntary disclosure by 0.1975 units following the implementation of these requirements. This positive association persists in specification (2) with a treatment effect of 0.1309 units after controlling for various firm

characteristics.

The treatment effects are highly statistically significant in both specifications (t-statistics of 18.42 and 14.22, respectively; $p < 0.001$), suggesting a robust relationship between mandatory and voluntary disclosure. The economic magnitude is substantial, particularly given the mean voluntary disclosure level in our sample. The inclusion of control variables in specification (2) substantially improves the model's explanatory power, as evidenced by the increase in R-squared from 0.0141 to 0.2874, indicating that firm characteristics explain considerable variation in voluntary disclosure choices.

The control variables in specification (2) reveal patterns consistent with prior literature on disclosure determinants. We find that institutional ownership (coefficient = 0.8107, $t = 31.48$) and firm size (coefficient = 0.0846, $t = 22.65$) are positively associated with voluntary disclosure, aligning with findings from prior studies suggesting that larger firms and those with greater institutional ownership tend to provide more voluntary disclosure. Profitability (ROA) shows a positive association (coefficient = 0.1287, $t = 7.15$), while loss firms exhibit significantly lower disclosure levels (coefficient = -0.1952, $t = -16.62$). Notably, litigation risk (calrisk) displays a strong positive association (coefficient = 0.2245, $t = 15.40$) with voluntary disclosure, supporting the theoretical framework underlying our hypothesis. These results strongly support H1, suggesting that firms respond to increased mandatory disclosure requirements by enhancing their voluntary disclosure, particularly when facing higher litigation risk. However, we note that our analysis identifies associations rather than causal relationships, and future research might employ additional identification strategies to establish causality more definitively.

CONCLUSION

This study examines how the 2002 Critical Accounting Policies Disclosure requirement affects voluntary disclosure behavior through the litigation risk channel. Our investigation centers on whether enhanced mandatory disclosure of critical accounting policies influences firms' broader disclosure decisions by altering their exposure to litigation risk. While prior literature has documented the direct effects of mandatory disclosure requirements on reporting quality, our study provides novel evidence on the spillover effects through the litigation risk mechanism.

Our analysis suggests that the Critical Accounting Policies Disclosure requirement serves as an important mechanism for shaping firms' voluntary disclosure decisions through its impact on litigation risk. The enhanced transparency mandated by the 2002 requirement appears to create a feedback effect whereby firms respond to changes in their litigation environment by adjusting their voluntary disclosure practices. This finding builds on previous work documenting the relationship between disclosure requirements and litigation risk (e.g., Field, Lowry, and Shu, 2005; Rogers and Van Buskirk, 2009) while highlighting the specific role of critical accounting policy disclosures in this dynamic.

The relationship between mandatory and voluntary disclosure through the litigation risk channel appears to be particularly pronounced for firms with higher ex-ante litigation risk and those operating in more litigious industries. This pattern suggests that managers consider the interaction between different types of disclosures when making voluntary disclosure decisions, consistent with the theoretical framework developed by Verrecchia (2001) and empirical evidence on strategic disclosure behavior (Skinner, 1994).

Our findings have important implications for regulators and standard setters. The evidence suggests that mandatory disclosure requirements can have significant spillover effects on firms' voluntary disclosure practices through their impact on litigation risk. This interaction effect should be carefully considered when designing disclosure regulations, as the

total impact on information environment may extend beyond the direct effects of the mandated disclosures themselves. For managers, our results highlight the importance of considering the broader implications of enhanced mandatory disclosures on their firm's overall disclosure strategy and litigation exposure.

For investors, our findings suggest that mandatory disclosure requirements can lead to meaningful changes in firms' voluntary disclosure practices, potentially affecting the total mix of information available in the market. This understanding is crucial for investment decision-making and risk assessment. Our study contributes to the broader literature on the relationship between mandatory disclosure, voluntary disclosure, and litigation risk (Healy and Palepu, 2001; Beyer et al., 2010) by providing evidence on how these elements interact in the specific context of critical accounting policies.

Several limitations of our study warrant mention and suggest directions for future research. First, the endogenous nature of voluntary disclosure decisions makes it challenging to establish definitive causal relationships. Future research could exploit exogenous shocks to litigation risk to better identify the causal effects of mandatory disclosure requirements on voluntary disclosure behavior. Additionally, our analysis focuses primarily on the litigation risk channel, but other mechanisms may also play important roles in mediating the relationship between mandatory and voluntary disclosure. Future studies could explore alternative channels such as proprietary costs, agency conflicts, or capital market pressures.

Further research could also examine how the relationship between mandatory disclosure requirements and voluntary disclosure through the litigation risk channel varies across different institutional settings and legal environments. Cross-country studies could provide valuable insights into how variations in legal systems and enforcement regimes affect this relationship. Additionally, future work could investigate how technological advances in information dissemination and processing affect the interaction between mandatory disclosure

requirements, voluntary disclosure, and litigation risk.

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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
CriticalAccountingPoliciesDisclosure Litigation Risk

	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 Critical Accounting Policies Disclosure 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.