

# **Information Content of Public Firm Disclosures and the Sarbanes-Oxley Act\***

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## **Abstract**

We find evidence that public firm disclosure, in the form of Management Discussion and Analysis (Sections 7 and 7a of annual reports), is more informative about the firm's future risk following the passage of the Sarbanes-Oxley Act of 2002. Employing a novel *text regression*, we are able to predict, out of sample, firm return volatility using the Management Discussion and Analysis section from annual 10-K reports, which contains forward-looking views of the management. Using the relative performance of the text model as a proxy for the informativeness of reports, we show that the MD&A sections are significantly more informative after the passage of SOX. We further show that this additional information is associated with a reduction in share illiquidity, suggesting that the information divulged was new to investors. Finally, we find that the increase in informativeness of MD&A reports is most pronounced for firms with higher costs of adverse selection.

# 1. Introduction

In the summer of 2002, the accounting scandals and subsequent bankruptcies of major US blue chip companies, along with the growing trend in accounting restatements, prompted Congress to pass the Sarbanes-Oxley Act (SOX). The Public Company Accounting Reform and Investor Protection Act of 2002, as it was otherwise known, did not enact new legislation as much as it attempted to reinforce existing laws that were not being satisfactorily enforced. This was done by requiring companies and their auditors to disclose and certify internal controls for the prevention of financial fraud and materially misleading financial statements, and by making auditors and officers of the companies they audited directly accountable for the accuracy of such disclosures. Various other provisions of the Act included the creation of a supervisory body to monitor auditors, the mandatory inclusion of a ‘financial expert’ on the audit committee, ‘whistle blower’ protection, and new regulations concerning conflict of interest between auditors and firms.

While, according to some studies, post-SOX mandatory disclosures of weakness in internal controls appear to affect stock prices (Hammersley, Myers, and Shakespeare, 2008), suggesting that such disclosures are material to investors, it is not clear whether SOX has contributed to more informative disclosure *outside* the narrow scope mandated by the Act.<sup>1</sup> We argue in this paper that the regulatory environment subsequent to the passage of the SOX legislation had an impact beyond the intended prevention of fraud and misrepresentation by public firms and their auditors. We are able to demonstrate that, post-SOX, the text data in annual reports contains more information about firm risk. Moreover, this additional forecasting power is not apparently related to governance and reporting issues that are the intended purview of SOX. Our conclusions run counter to those of Begley, Cheng, and Gao (2009) who associate the decreased accuracy of analyst forecasts in the post-SOX period to declining transparency.

In this paper we develop a new measure of text informativeness. We employ a novel *text regression* (discussed in Kogan, Levin, Routledge, Sagi, and Smith (2009)) to forecast firm return volatility using the text in the Management Discussion and Analysis (MD&A) and Quantitative

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<sup>1</sup>Ogneva, Raghunandan, and Subramanyam (2007) find no evidence that the types of disclosures discussed in Hammersley, Myers, and Shakespeare (2008) are associated with a change in the cost of capital of a firm. Bhattacharya, Groznik, and Haslem (2007) found no evidence that CEO certification impacted share prices.

and Qualitative Disclosures About Market Risk section (labeled section 7 and 7A) from annual 10-K reports. We focus our attention on these sections for a number of reasons. First, they contain forward looking information. In many cases, firms include a statement that explicitly addresses the forward looking nature of their disclosure: “statements in this discussion may be forward-looking. These forward-looking statements involve risks and uncertainties, including those discussed below, which could cause actual results to differ from those expressed.”<sup>2</sup> Second, these sections include disclosure that may help investors ascertain the risks a firm is exposed to. For example, the March 8, 2010 annual report released by Northern Oil and Gas, INC. (NOG) includes the following statements:

- “We are an oil and gas exploration and production company. Our properties are located in Montana, North Dakota and New York.”
- “Drilling capital expenditures are expected to increase in 2010 compared to previously published guidance due to the continued success of longer laterals and additional fractional stimulation stages. ”
- “Over the next 24 months it is possible that our existing capital, the Credit Facility and anticipated funds from operations may not be sufficient to sustain continued acreage acquisition.”
- “The oil and gas industry is very cyclical and the demand for goods and services of oil field companies, suppliers and others associated with the industry put extreme pressure on the economic stability and pricing structure within the industry.”
- “Our Credit Facility entered into an agreement with CIT on February 27, 2009, will, however, subject us to interest rate risk on borrowings under that facility.”

It is apparent from these short statements alone that the MD&A section not only contains forward looking statement about firm risk, but that the statements can allow one to identify the kinds of risks this firm is facing. For example, it is clear that the firm is exposed to oil and gas price risk, that it is expecting to make substantial capital expenditures, that the firm is exposed to financing uncertainty of these expenditures, and that it is exposed to changes in interest rates.

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<sup>2</sup>From Northern Oil and Gas, INC, annual reports, section 7, Feb 26, 2010.

The text regression model we develop for the purpose of forecasting return volatility borrows from the machine learning literature. It allows us to estimate forecasting weights for the appearance frequency of different words (or word combinations) in documents. On a rolling basis, we estimate these weights and then apply them to a new set of documents to forecast volatility *out of sample*. The ability of the text model to predict firm level annual volatility compared with a benchmark model of volatility is used as a measure of the amount of information in the report. That is, the more precise the text is in forecasting volatility, the more informative we consider it to be.

We find that our informativeness measure significantly improves after 2002. Increased informativeness appears to be positively and significantly associated with an increase in share liquidity, and we infer from this that the additional information appears to be new to investors. A surprising finding is that the firms showing the most improvement in informativeness post-SOX are small (under \$75M in market capitalization) and require only minimal compliance with SOX. Moreover, language one might expect to be associated with SOX compliance only marginally explains improvement in informativeness. From this we conclude that compliance with the legislation does not explain most of the post-SOX improvement in firms' informativeness. By examining the cross-section, we explore various explanation for this post-SOX effect. We find that firms in which information production is costly, such as firms with high book-to-market ration, low analyst coverage, or high analysts' forecast dispersion, experience the largest improvement in post-SOX informativeness. It appears that after the adoption of SOX, small firms and firms where asymmetric information might be highest divulged more information (in their MD&A reports) that is useful in predicting future return volatility.

The paper proceeds as follows. Section 2 provides a literature review. Section 3 discusses the research questions. Section 4 outlines the methodology of text regression and describes the dataset used in our empirical analysis. Section 5 reports the various results from our text regressions and the cross-sectional analysis vis à vis the hypotheses in Section 3. Section 6 concludes with a discussion about whether firms divulged more information because they learned more or whether it was because managers decided to reduce expected personal liability.

## 2. Background

This paper investigates the informational content in text disclosures pre- and post-SOX. As such, we overlap two distinct literatures. The first deals with the impact of SOX on US corporations. The second is concerned with reducing text-based information into cross-sectional and time-series variables that can be of use in financial economics.

### 2.1. *The Sarbanes-Oxley Act of 2002*

The Sarbanes-Oxley Act of 2002 was enacted on July 30, 2002, as a response to a number of accounting scandals (e.g., Enron). The act contains eleven “titles” that pertain to auditors, the firm executives, and analysts, and each title is divided into multiple sections. The sections most relevant for this paper are:

- *Section 302: Corporate responsibility for financial reports* — requiring that CEOs and CFOs certify that they have read the company’s financial reports, and that the latter depict a fair representation of the company’s financial situation and do not contain untrue or misleading information. This section also asserts that the signing executives are responsible for establishing and maintaining effective internal controls for fraud prevention, and reporting on the effectiveness of these controls.
- *Section 401: Disclosures in periodic reports* — requiring that firms disclose off-balance sheet transactions and attest to the completeness and accuracy of their pro forma financial statements.
- *Section 404: Management assessment of internal controls* — requiring annual reports to include a discussion on internal controls, highlighting any material weaknesses, over financial reporting. The discussion must be accompanied by an auditor attested assessment of the effectiveness of the company’s internal controls.
- *Section 906: Corporate responsibility for financial reports* — outlines the criminal penalties for executives who fail to comply with the requirements set forth by the act.

A number of academic studies have examined the impact of SOX. Piotroski and Srinivasan (2008) find no evidence that SOX imposed sufficient net costs on foreign firms to dissuade them from listing in the United States. This is corroborated by Doidge, Karolyi, and Stulz (2008). Another line of literature questions whether the net costs imposed by SOX have caused delisting within the US or have negatively impacted the value of public firms.<sup>3</sup> Leuz (2007) argues that evidence for these hypotheses is inconclusive.<sup>4</sup> The evidence on how SOX has affected firms' values is mixed.<sup>5</sup> Begley, Cheng, and Gao (2009), for instance, infer from the post-SOX increase in report size and declining analyst forecast accuracy that the act incentivized firms to reduce transparency. In terms of theoretical work on this topic, Goldman and Slezak (2006) state that when managers' compensation has an equity-stake component, disclosure requirements may lead to an increase in manipulation. This is somewhat orthogonal to our question because we are examining an increase in non-mandatory disclosure.

## 2.2. *Text analysis in financial economics*

The majority of research in finance exclusively employs quantitative information about firm attributes, usually gathered from annual reports or other public sources, and consolidated into databases such as CRSP and COMPUSTAT. Recently, various researchers in financial economics have explored the wealth of information available in text format. The most common approach is to reduce text material, such as a single report or an article, to a univariate measure by calculating the number of 'positive' words and subtracting from that the number of 'negative' words.<sup>6</sup> Such a measure has been shown to contain forecasting power for earnings, stock returns, return volatility, and trading volume (see Koppel and Shtrimberg, 2004; Tetlock, 2007; Tetlock, Saar-Tsechansky, and Macskassy, 2008; Gaa, 2007; Engelberg, 2007). In a similar spirit, Li (2005) measures the association

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<sup>3</sup>A 2005 survey by Charles River Associates suggests that Fortune 1000 companies spent about \$6 million in their first year of compliance with internal controls requirements of the Act.

<sup>4</sup>Leuz (2007) criticizes two other papers (published earlier in the same journal) that claimed to find significant negative repercussions to SOX. Engel, Hayes, and Wang (2007) claim that SOX caused firms to delist, while Zhang (2007) claimed that the market value of firms subsequent to the passage of SOX suffered a major loss.

<sup>5</sup>See the studies cited in the Introduction: Bhattacharya, Groznik, and Haslem (2007); Hammersley, Myers, and Shakespeare (2008); Ogneva, Raghunandan, and Subramanyam (2007).

<sup>6</sup>Words are typically assigned a positive or negative association based on a dictionary compiled by psychologists and linguists (e.g., the 'Harvard-IV-4 dictionary').

between frequency of words related to risk and subsequent stock returns. In a different application of text analysis, Das and Chen (2001) and Antweiler and Frank (2004) examine whether message board postings predict stock performance. Other researchers have found relationships between the attributes of text data and initial public offerings, investor sentiment and investor opinions (see Weiss-Hanley and Hoberg, 2008; Pang, Lee, and Vaithyanathan, 2002; Wiebe and Riloff, 2005; Lerman, Gilder, Dredze, and Pereira, 2008). Finally, Lavrenko, Schmill, Lawrie, Ogilvie, Jensen, and Allan (2000b) and Lavrenko, Schmill, Lawrie, Ogilvie, Jensen, and Allan (2000a) modeled influences between text and time series financial data (stock prices) using probabilistic language models.

One criticism of approaches to text data that pre-select words according to some valence criteria is that they potentially ignore other information that might be informative. In this regard, our approach is somewhat unique in this budding field because we allow for a higher dimensionality of text information and, in that respect, let the data ‘speak for itself’. The type of regression technique we introduce builds on the support vector regression model proposed by Drucker, Burges, Kaufman, Smola, and Vapnik (1997). Our approach follows considerable research in information retrieval and text categorization in representing the entirety of a document as a vector of (transformed) word counts, sometimes called a “bag of words.” While this is an obvious simplification of the meaning of a piece of text, it is known to work quite well for many applications. Further, the same learning method can be applied with text representations that aim to take more knowledge into account (e.g., by filtering words or emphasizing certain phrases) or deeper linguistic structure (e.g., predicate-argument relations between words or discourse markers). Indeed, the task of making a quantitative forecast (e.g., predicting volatility) can be seen as a new application of techniques in natural language processing for automatic understanding of text (see Manning and Schutze, 1999).

### **3. Research questions**

The annual reports that public firms in the United States are required to file with the SEC typically contain a section dealing with the management’s discussion and analysis of financial conditions and

results of operations, and a section containing quantitative and qualitative disclosures about market risk. These are, respectively, Sections 7 and 7A, and often contain forward looking information about a firm's financial and operational situation.

As Table 1 indicates, MD&A reports have nearly doubled in the years following SOX, growing from an average of roughly 5,000 words per document between 1996 and 2001 to over 10,000 per document between 2002 and 2006. The difference in a two-means test is highly statistically significant, even when accounting for a linear trend in the word count.

Part of this could be explained by an additional ruling in 2003 by the Securities and Exchange Commission (SEC) concerning SOX (Section 401) that mandates companies report off balance sheet transactions and obligations in Section 7 of the annual report.<sup>7</sup> However, it seems unlikely that such a new mandate would lead to a doubling in the size of MD&A. There are other rationales for the growth in report sizes. As noted by Wagner and Dittmar (2006),

...Sections 302 and 404...require CEOs and CFOs to attest personally to the effectiveness of internal control over financial reporting, and Section 906...makes willful failure to portray the true condition of the company's operations and finances a crime.

Because there may be several ways to interpret the increase in the size of Sections 7 and 7a we are led to ask the following questions:

1. *Is there any evidence that the increase in size was accompanied by an increase in informativeness?* The cynical view of the effect of SOX is that some or all of the increase in liability has simply caused management to pad Sections 7 and 7a with legalese. This view would suggest that post-SOX annual reports do not contain information that is useful *outside* of the narrow scope mandated by the Act (i.e., useful information that is not associated with internal controls and/or off balance sheet transactions).

2. *Is there any evidence that information new to the MD&A reports was new to investors?* Related to the previous question, one might suspect that "useful" additional information in MD&A sections that is not directly related to SOX is also not new to investors (i.e., such

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<sup>7</sup>See <http://www.sec.gov/news/press/2003-10.htm>.

information might have been available elsewhere before SOX). Rather, in order to avoid the possibility of legal action, managers include such information whereas they did not bother to do so before SOX.

3. *What type of firms chose to disclose more information?* Sections 401 and 404 effectively require that a greater degree of senior managerial resources be devoted to identifying and understanding various risks. Such an enterprise could lead to a greater understanding by managers of their companies' operational and financial risks that are not directly linked to internal controls. If investors expect managers to know more about their companies as a result of SOX, failure to disclose more information could lead to an adverse selection problem. Firms facing more internal opacity might stand to learn more from compliance with SOX and, to avoid an adverse selection problem, might choose to increase the informativeness of their reports.

On the other hand, Sections 302 and 906 require officer certification for the accuracy of statements made in the MD&A reports (and elsewhere), and threaten officers with criminal liability for failure to comply. This might have prompted managers of firms in which there is more asymmetric information between investors and insiders to improve disclosure in MD&A sections.

These observations suggest investigating the cross-sectional variation of MD&A informativeness with respect to proxies for internal opacity and asymmetric information.

### 3.1. *Approach*

To answer these questions, we first have to identify a measure of informativeness. The strategy we employ is to focus on a firm-specific variable that can be forecast using text data. We choose the firm's return volatility for various reasons. First, in a previous investigation we demonstrated MD&A text to have predictive power for volatility (Kogan, Levin, Routledge, Sagi, and Smith, 2009). Second, firms' return volatility was not directly targeted by the SOX legislation or its SEC implementation (i.e., the goal of the legislation is to reduce fraud and not to improve investors' abil-

ity to predict a firm's return volatility, per se). Finally, while volatility forecasting is known to be of great importance to market participants, the possibility of finding forecasting power for volatility in publicly available data is economically uncontroversial.<sup>8</sup> As such, the ability of MD&A text to predict return volatility allows us to ask whether MD&A informativeness has increased post-SOX, whether such an increase is associated with the narrow requirements set forth by SOX, whether or not increased informativeness appears new to (and therefore impacts) investors, and whether or not it is associated with a reduction in costs of asymmetric information.

We implicitly assume that disclosure itself does not affect or cause volatility. That is, the framework we have in mind employs the following timeline:

$t = 0$  The manager of the firm receives an informative signal about the volatility level that will be realized between date 2 and 3. This level may be influenced, for example, by the industry mix, hedging practices, and contracts with suppliers.

$t = 1$  After receiving the date 0 information, the manager chooses a disclosure policy in the form of text data that is released in annual reports at date 1.

$t = 2$  Volatility is realized between dates 2 and 3 (and excludes announcement effects from disclosure at date 1).

Our empirical approach is consistent with this framework. First, we look at long horizon volatility (realized over one year). Second, we exclude from our volatility measure the period immediately following the release of the annual report.

In the next section we review the technique we employ to predict volatility from text data. We follow that with a description of our data sources and an outline of the empirical tests we adopt to answer the questions above.

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<sup>8</sup>Our study is about the information content in text data, and not about efficient markets, per se. Thus, we wish to avoid variables for which market forces tend to work against attempts to forecast their direction (e.g., equity return forecasting and the "efficient markets hypothesis").

## 4. Text Regression Model

The text regression model we developed for the specific application used in this paper is related to a more widely known text processing problem called “text categorization.”

### 4.1. Text Categorization

Text categorization refers to a set of automatic techniques for labeling a piece of text (usually a document) using one of a small set of categories. Here we consider a simple example to convey the basic intuition; the reader interested in further details is referred to Sebastiani (2002).

The first assumption we make is that the categorization we wish to automate can be performed by humans (perhaps experts). Imagine a large collection of email messages, some of which have been manually labeled as “spam.” Although two human labelers might disagree in a small fraction of cases, we assume that the distinction between spam and non-spam messages is one that humans can make with high levels of agreement.

Let  $\langle\langle d_1, y_1 \rangle, \langle d_2, y_2 \rangle, \dots, \langle d_n, y_n \rangle\rangle$  denote a collection of  $n$  pairs, where each  $d_i$  is an email message and each  $y_i$  is a label, either “spam” or “not spam.” Our intent is to use this collection of examples to construct a function,  $h$ , that will label new examples (e.g.,  $d_{n+1}$ ) as “spam” or “not spam.” Ideally this function will be a good simulator of an expert human judge; i.e.,  $h$  will agree with human judgments. As a running example, we will consider the email messages in Figures 1, which exemplify non-spam and spam. There are four questions to consider:

1. How will we represent an input message  $d$  in the computational model?
2. How will we represent the function  $h$ ?
3. How will we use the data to automatically acquire the labeling function?
4. How will we evaluate the quality of the labeling function?

**Representation of the text.** A representation that is useful for text categorization is to represent a document  $d$  as a real vector. Let  $\mathbf{f}(d) \in \mathbb{R}^D$  denote this representation. That is, the function  $\mathbf{f}$

maps documents to points in  $\mathbb{R}^D$ . The usual starting point is to let each dimension in  $\{1, \dots, D\}$  correspond to one vocabulary term, a word or combination of words, and let the  $j$ th coordinate in  $\mathbf{f}(d)$ , denoted  $f_j(d)$ , be the number of times the word occurs in the document  $d$ .<sup>9</sup> The  $D$  dimensions of the vector representation might correspond to all words and/or various word combinations that appear in some large set of documents. This representation—often called a “bag of words”—is relatively compact (most documents have counts of zero for most words). It sacrifices information conveyed in the *order* of the words, but can still convey (to a human, at least) a sense of what a document is about. For our running example, word count vectors are shown in Table 2.

**Representation of the function  $h$ .** The most common approach to text categorization lets  $h$  take the form:

$$h(d; \mathbf{f}, \mathbf{w}) = \text{sign} \left( \sum_{j=1}^D w_j f_j(d) \right) = \text{sign} (\mathbf{w}^\top \mathbf{f}(d)) \quad (1)$$

This is called a *linear* model. Note that the function is defined in part by the representation  $\mathbf{f}$  and is *parameterized* by a vector  $\mathbf{w}$ , known as a “weight vector.” This approach makes sense for a two-class problem (e.g., “not spam” or “spam”) where we map the two classes to  $\{-1, 1\}$ ; it can be easily generalized to more than two classes, which is essentially what we do to forecast return volatility.

For our running example, consider the weight vector  $\mathbf{w}$  (shown as the last column in Table 2). Leaving aside the provenance of the weight vector, note that  $\mathbf{w}^\top \mathbf{f}(d_1) = -43$ , giving  $h = -1$  (not spam) and  $\mathbf{w}^\top \mathbf{f}(d_2) = 39$ , giving  $h = 1$  (spam). The model correctly classifies both of the examples.

**Learning the weights  $\mathbf{w}$ .** There are a variety of approaches to inferring a good weight vector  $\mathbf{w}$ , motivated by different mathematical interpretations of the function  $h$  (e.g., as different kinds of probabilistic models, or as a hyperplane-based separator in the  $d$ -dimensional space of the document representation). Usually the choice of  $\mathbf{w}$  is implemented by solving an optimization problem

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<sup>9</sup>In some instances, the word frequencies are transformed, e.g., into Boolean values (1 if the word occurs at least once, 0 otherwise) or based on more complex statistics drawn from the text collection.

that depends on a subsample or “training set” taken from the full data and taking the form

$$\min_{\mathbf{w} \in \mathbb{R}^d} \left\{ R(\mathbf{w}) + \sum_{i=1}^n \ell(\mathbf{f}(d_i), y_i, \mathbf{w}) \right\} \quad (2)$$

where  $\ell$  is a convex “loss” function measuring how well  $\mathbf{w}$  performs on a given document and  $R$  is a convex “regularization” function that inhibits overfitting. If  $D$  is very large, as is often the case,  $R(\mathbf{w})$  is chosen so that the objective function in Equation 2 assigns zero weight to most terms (except those to which  $\ell$  is highly sensitive). This process is analogous to (and often instantiates directly) the fitting of parameters in a probabilistic model.

In our running example, the weights  $\mathbf{w}$  shown in Table 2 were trained using a method called the perceptron, which does not use regularization ( $R(\mathbf{w}) = 0$ ) and has a simple loss function:

$$\ell(\mathbf{f}(d_i), y_i, \mathbf{w}) = \begin{cases} 0 & \text{if } h(d_i; \mathbf{f}, \mathbf{w}) = y_i \\ -y_i \mathbf{w}^\top \mathbf{f}(d_i) & \text{otherwise} \end{cases} \quad (3)$$

This example leads to a very simple iterative algorithm, guaranteed to converge, that often performs well, though more sophisticated approaches often work better. Normally the weights would be trained on far more than two examples, but for our illustrative example, we trained on  $\langle d_1, -1 \rangle$  (not spam) and  $\langle d_2, 1 \rangle$  (spam).

**Evaluating quality.** The standard methodology for measuring the quality of a learned  $h$  function is to use a collection of  $m$  out-of-sample pairs,  $\langle \langle d_{n+1}, y_{n+1} \rangle, \langle d_{n+2}, y_{n+2} \rangle, \dots, \langle d_{n+m}, y_{n+m} \rangle \rangle$ , called a held-out or test subsample of the dataset, to estimate the error rate:

$$\text{error}(h) \approx \frac{1}{m} \sum_{i=1}^m \begin{cases} 0 & \text{if } h(d_{n+i}; \mathbf{f}, \mathbf{w}) = y_{n+i} \\ 1 & \text{otherwise} \end{cases} \quad (4)$$

It is of extreme importance that error be estimated on a dataset that is distinct from the dataset used to learn  $h$ , so that we see how the model performs on examples it has not been exposed to previously. Further, it is considered good practice to perform multiple experiments with different

training and testing datasets to measure the extent to which variation in the training dataset affects the performance of the classifier. A message not seen by the model is shown in Figure 2; its vector is shown in Table 3. For this example, given the weights from Table 2,  $h(d_3; \mathbf{f}, \mathbf{w}) = \text{sign}(12) = 1$ , so that the message would (correctly) be classified as spam.

Beyond the quantitative measure of accuracy, when a text categorization model is being used as part of a research effort, it is helpful to demonstrate the face validity of the model. This can be accomplished by inspecting the weight vector  $\mathbf{w}$ . Weights with a large magnitude can show which words have a large effect on  $h$ 's output. Inspecting the weights of words known or believed *a priori* to be important for the classification task can provide a sanity check that the model has learned intuitively plausible patterns. In our running example (Table 2), note that # (any sequence of digits) and as are the strongest clues that a message is spam, while you is the strongest clue that a message is not spam. Our opinion is that the face validity of this model is not very high. We emphasize that face validity is neither necessary nor sufficient for good models, but visualization can be useful in intuiting how a model works and perhaps how to improve it.

## 4.2. Text Regression Model

Our approach in constructing a measure of the informativeness of an MD&A report is to use the text data in the MD&A of each firm to forecast a firm-related attribute (e.g., return volatility). The technique we use, a *text regression* model as introduced in Kogan, Levin, Routledge, Sagi, and Smith (2009), attempts to mimic human understanding of text data using objective statistical methods that do not require human judgment. Similar tools have been successfully applied to many complex problems including search engines, image retrieval, speech recognition, text categorization, and others.

The approach is similar to text categorization as presented in Section 4.1. First, we convert text data from each MD&A report into a vector whose elements are frequencies of words or word combinations (i.e., terms).<sup>10</sup> Next, we estimate firm return volatility as a linear function of this vector of frequencies. The weightings chosen for the ‘best’ estimate minimize an objective function that

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<sup>10</sup>See also Ghose, Ipeirotis, and Sundararajan (2007).

balances goodness of fit against the propensity to ‘over-fit’ (a procedure known as regularization).

The procedure starts by estimating this function’s weights using a large training set of reports (e.g., all available MD&A reports from the years 1996 and 1997). The weights obtained from the training set are subsequently used to produce forecasts of the firm return volatility *out of sample* (e.g., using reports from 1998). The squared error in the out-of-sample forecasts furnishes us with a measure of informativeness that we can benchmark to either non-text forecasts or to prior forecasts (e.g., comparing squared errors before and after SOX).

Let  $d_{i,t}$  denote a portion of text associated with firm  $i$  at date  $t$ . In our specific setting, each portion of text corresponds to Sections 7 and 7A of firm  $i$ ’s annual report—which we collectively refer to as the ‘MD&A’ section. Let  $D$  be the number of one or two word combinations appearing in the training sample.<sup>11</sup> We index terms by integers from 1 to  $D$ . Let  $f_j(d_{i,t})$  be the frequency of the  $j$ th term in document  $d_{i,t}$ . In many instances,  $f_j(d_{i,t})$  will be zero because the  $j$ th term does not appear in  $d_{i,t}$ . We ignore punctuation, digits, and letter cases in calculating  $f_j(d_{i,t})$ . As before, we let  $\mathbf{f}(d_{i,t}) = \langle f_1(d_{i,t}), f_2(d_{i,t}), \dots, f_D(d_{i,t}) \rangle$ . We consider the following forecasting model:<sup>12</sup>

$$\text{LOGIP} \quad \hat{y}_{i,t+1} = h(d_{i,t}; \mathbf{f}, \mathbf{w}, b) = b + \sum_{j=1}^D w_j \log(1 + f_j(d_{i,t})). \quad (5)$$

where  $\hat{y}_{i,t+1}$  is a forecast of the log of firm  $i$ ’s return volatility in period  $t + 1$ , and the  $w_j$ ’s correspond to weights.  $b$  is a bias term; it is essentially another weight.

To estimate the weights, we follow Drucker, Burges, Kaufman, Smola, and Vapnik (1997) and

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<sup>11</sup>Combinations of two words are referred to as *bigrams*.

<sup>12</sup>We also experimented with the following forecasting models:

$$\begin{aligned} \text{TF} \quad \hat{y}_{i,t+1} &= b + \sum_{j=1}^D w_j \frac{f_j(d_{i,t})}{|d_{i,t}|}, \\ \text{TFIDF} \quad \hat{y}_{i,t+1} &= b + \sum_{j=1}^D w_j \frac{f_j(d_{i,t})}{|d_{i,t}|} \log\left(\frac{n}{Q_j}\right). \end{aligned}$$

where  $b$  is a constant,  $|d_{i,t}|$  is the length of the document  $d_{i,t}$  in words,  $\hat{y}_{i,t+1}$  is a forecast of  $y_{i,t+1}$ , and  $|d_{i,t}| = \sum_j f_j(d_{i,t})$ ; while  $n$  is the number of documents in a ‘training set’ (used to estimate the weights) and  $Q_j$  is the number of documents in the training set that contain at least one instance of the  $j$ th word. Overall, the LOGIP model performed the best (in sample).

minimize the following function with respect to a training set of documents:

$$\min_{\mathbf{w} \in \mathbb{R}^D} \left\{ \frac{1}{2} \sum_{j=1}^M w_j^2 + \frac{C}{n} \sum_{i=1}^n \underbrace{\max(0, |y_{i,t} - \hat{y}_{i,t}| - \epsilon)}_{\epsilon\text{-insensitive loss function}} \right\} \quad (6)$$

where  $n$  is the number of documents in the training set, the  $y_{i,t}$  corresponds to the *realized* value of the variable to be forecasted, and the estimation is performed using a subsample (the training set). The first sum corresponds to  $R(\mathbf{w})$  in Eq. (2) and serves to ‘regularize’ the estimated weights so as to prevent over-fitting. The regularization is controlled by  $C$ . The second sum corresponds to the loss function in Eq. (2). When  $\epsilon > 0$ , words whose frequency has little relation to the forecasted variable will tend to be assigned zero weight. We used a freely available implementation of this procedure, called SVM<sup>light</sup> (Joachims, 1999).<sup>13</sup> In our estimation, we set  $C$  using the default choice in SVM<sup>light</sup>, while  $\epsilon$  is set at 0.1.<sup>14</sup>

### 4.3. Data description

The text data consists of 40,865 MD&A sections (corresponding to Sections 7 and 7a) taken from the annual reports of 8,393 publicly traded U.S. firms over the years 1996-2006. The MD&A text was collected automatically using a Perl script that attempts to identify the beginning of Sections 7, 7a, and 8, and subsequently captures the text between Sections 7 and 8 if it consists of more than 1,000 words.<sup>15</sup> From each captured MD&A section, we remove all HTML ‘mark-up’ code (e.g., “<P>” and “<A HREF=”). We also remove all punctuation (commas, etc.). All words are converted to lowercase (e.g., “Enron” becomes “enron”). All numbers are collapsed to the character ‘#’ (e.g., “\$5,000” and “\$150” both become “\$#”).<sup>16</sup> This procedure, referred to as

<sup>13</sup>Available at <http://svmlight.joachims.org>.

<sup>14</sup>Experimenting with other values did not yield significant gains with in-sample forecasting.

<sup>15</sup>In some instances, the main body of the MD&A section was incorporated by reference. In these cases our filter yielded very short reports that contained mainly routine text. For that reason, we require that reports contain at least 1,000 words.

<sup>16</sup>We eliminate numbers from the reports because our focus is on information content in *text* data. We take the view that better sources for quantitative data exist in consolidated formats (e.g., the COMPUSTAT datasets, etc.).

tokenization of the text, is standard and was performed with a short Perl script.<sup>17</sup> We do not employ ‘stemming’ (e.g., collapsing words like “looking” and “looks” to the same stem word, “look”.) Not all annual reports downloaded from the SEC pass the filter imposed by our Perl scripts to yield an MD&A report. In some instances, the reports were too short, while in others they were only available separately (i.e., not in the main body of the annual report available online). We estimate that over 80% of the annual reports available from the SEC for the years studied pass the Perl script filter.

We further restrict the set of firms in this study to include only those for which return data is available from CRSP and firms with market capitalization higher than \$10M (i.e., we exclude ultra micro-cap firms). Table 1 summarizes the text documents, in their final (tokenized) format, that we include in this study.

In addition to the text data, we also use the CRSP daily return database, COMPUSTAT for accounting data, IBES for analyst coverage and forecasts, and the RiskMetrics Governance Data for the corporate governance index.<sup>18</sup> Share illiquidity information in the form of the Amihud-ratio (Amihud, 2002) is taken from Joel Hasbrouck’s publicly available database.<sup>19</sup>

#### 4.4. *Empirical methodology*

We begin by applying the model in Eq. (5) to predicting the log-volatility of each firm and using this forecast to construct a measure of the informativness of an MD&A section. Specifically, take  $y_{i,t} = \log(\sigma_{i,t})$ , where  $\sigma_{i,t}$  is the daily return volatility for firm  $i$  over 12 months. To estimate  $b$  and the weights in (5) for the purpose of forecasting the volatility of firms at year  $t$ , we use training data from the two previous years. When estimating the model, or forecasting, we use volatility realized after the release of the 10K report for the given year (e.g., if the report was released January 16, 2000, we calculate volatility for the year 2000 starting on January 31, 2000). To assess the forecasting power, we calculate the mean of the squared error (MSE) over all firms in a given

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<sup>17</sup>The Perl script used to extract and tokenize the text data, as well as the original, extracted, and tokenized data, are available at <http://www.ark.cs.cmu.edu/10K>.

<sup>18</sup>We thank Ilan Guedj, Jennifer Huang, and Johan Sulaeman for providing us with the data on firms’ Herfindahl index and analyst data.

<sup>19</sup>See <http://pages.stern.nyu.edu/jhasbrou/>.

year:

$$\text{MSE}_t = \frac{1}{n_t} \sum_{i=1}^{n_t} (y_{i,t} - \hat{y}_{i,t})^2, \quad (7)$$

where  $n_t$  is the number of firms for which data exists at date  $t$ .

The MSE obtained from the text model can be compared to other log-volatility forecasts. We use the past year’s realized log-volatility as a forecast of the following year’s volatility. This is consistent with the acknowledged persistence of realized volatility (i.e., past volatility contains information about future volatility) and serves as a benchmark forecast.<sup>20</sup> Following Kogan, Levin, Routledge, Sagi, and Smith (2009), we document in Table 4 the out-of-sample MSEs in the years 1998-2006 for the benchmark forecast and for the text-based forecast.

Table 4 establishes several key things. First, keeping in mind that the forecasts are out of sample, it is apparent that the text-based forecasts are comparable to forecasts based solely on past volatility. This provides evidence that MD&A sections contain information about future stock return volatility. Thus, such a text-based forecast may be a suitable instrument for investigating changes in the informativeness of MD&A sections pre- and post-SOX. Second, the average volatility and the benchmark forecast MSE have decreased from the pre- to the post-SOX period. One may therefore be concerned that a decrease in the post-SOX MSE of the text-based volatility forecast may be due to something other than increased informativeness of the MD&A reports.

To control for the possibility that volatility might be easier to forecast in some periods, for reasons other than better disclosure, we define a *relative* measure of MD&A informativeness, which we henceforth refer to as “**Informativeness**”, as follows:

For firm  $i$  at date  $t$ ,

$$\mathcal{J}_{i,t} \equiv (y_{i,t} - y_{i,t-1})^2 - (y_{i,t} - \hat{y}_{i,t})^2. \quad (8)$$

The first term in Eq. (8) is the squared error from using the benchmark forecast, while the second term is the squared error from using the out-of-sample text-based forecast. The measure  $\mathcal{J}_{i,t}$  increases as the text-based forecast improves relative to the benchmark forecast. Thus,  $\mathcal{J}_{i,t}$

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<sup>20</sup>We also used a GARCH(1, 1) model (Engle, 1982; Bollerslev, 1986) and found that, at the horizon of one year, it was not significantly better than past realized volatility at forecasting.

captures the informativeness in an MD&A report net of that present in past volatility. It should be clear that  $\mathcal{J}_{i,t}$  will be noisy. Ideally, one would want to take an expression such as the right side of Eq. (8) and average over a long time-series in order to reduce the noise. Because we do not have a long time-series or a balanced panel, we instead opt for a more noisy measure, hoping that the large size of the cross-section will allow for statistical discrimination.<sup>21</sup>

Using  $\mathcal{J}_{i,t}$  as a measure of informativeness, we can address the questions posed in Section 3. To answer the first question we compare the informativeness pre- and post-SOX. We also examine the words with the highest weight magnitudes to see whether the text-based model is driven primarily by SOX related words. Finally, we compare the change in informativeness (pre- and post-SOX) for firms that were required to comply with all of the provisions set out by SOX versus firms that had minimal compliance requirements.

To address the second question in Section 3, we look to see whether increases in informativeness were accompanied by a reduction in asymmetric information. To do this, we examine the relationship between changes in the illiquidity measures of publicly traded shares and changes in the informativeness measure. As proxies for share illiquidity, we select the Amihud ratio, a measure of price impact (Amihud, 2002).<sup>22</sup>

The third question in Section 3 essentially asks about the role of asymmetric information in prompting firms to divulge more information. To explore this, we identify a set of variables that may proxy for the presence of asymmetric information and investigate the relationship between these variables and changes in MD&A informativeness in the pre- versus post-SOX periods.

#### 4.5. *Face validity*

Our modeling approach departs from the extant literature in finance which uses an *ex-ante* classification of words. These papers either count the frequency of words that are considered to signify a particular meaning (e.g., count risk-related words) or sentiment (e.g., positive vs. negative words). Notably, we do not start out with an *ex-ante* categorization of words based on their suggested link

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<sup>21</sup>Because  $\mathcal{J}_{i,t}$  is noisy, and to prevent bias that might arise because of extreme outliers, we censor the right tail of the informativeness measure in all of our empirical analyses.

<sup>22</sup>In results not reported in the paper we find that using the Gibbs measure, a measure of the bid-ask spread (Hasbrouck, 2006), leads to qualitatively similar conclusions

with volatility.

There are a number of advantages to our approach. First, it is objective and does not require any human judgment. Given that there are hundreds of thousands of unique terms in our dataset, one would have to either ignore a large number of terms or else go through a very lengthy and subjective process of deciding what influence each of the terms would have on firm volatility. Second, our approach implicitly recognizes the importance of context. Some papers (e.g., Tetlock, 2007) use standard dictionaries to assign a sentiment to words. While this has been shown to work well in some contexts, it is not clear whether generally positive words are necessarily associated with higher or lower volatility. Further, the meaning of words depends on the context in which they are used. For example, the word “oil” is likely to have one meaning when showing up in financial reports and a different meaning on a spa’s website. Second, our estimation takes into account that some terms would tend to co-occur with others. This allows us to reduce the weight on the term “growth” if it tends to co-occur with “expansion”. Third, managers might be careful and strategic in their usage of words directly related to risk. Our approach is capable of capturing the effect of more nuanced terms used in discussing the firm’s prospects. For instance, suppose that for some reason most managers abstained from using the words “volatility” and “risk” except in neutral contexts, but used the terms “difficult” and “predict” (as in “difficult to predict”) in situations where they expected future revenue volatility to be high. Then our algorithm would justifiably assign zero weights to “volatility” and “risk”, and high weights to “difficult” and “predict”.

To empirically assess the two approaches, we benchmark the text regression model’s performance against a model that uses ex-ante identification of words. Specifically, we follow Li (2005) and identify a set of words that denote risk, such as “risk” (including “risk”, “risks”, “riskiness” and “risky”), “uncertainty” (including “uncertain”, “uncertainty”, “uncertainties”). To avoid confounding words that include the string “risk”, we exclude any words in the format of risk- (e.g., “risk-free” and “asterisk”). Next, following the same procedure used when applying the text regression model, we estimate a linear relation between these words and realized log volatility using two years of data, and apply the intercept and coefficient to forecast volatility for the subsequent year.

The results are presented in Table 5. Using panel regressions (with firm random effects) we

regress realized log volatility on the forecast derived from the risk-related word-count (RRWC) model, the text regression model, and the historical volatility model. First, we find that the simple count of risk-related words is related to out-of-sample firm-level volatility. The coefficient is economically and statistically different from zero. However, it is also clear that the ability of the RRWC model to forecast volatility is substantially inferior to that of the text regression model.

Comparing columns 1 and 2, we see that the explanatory power of the text regression model is much higher than that of the RRWC model – 60% vs. 11%. Next, we compare the change in the coefficient of the RRWC model’s forecast when including historical volatility as an explanatory variable. That is, we compare the drop in the RRWC model forecast coefficient when going from column 1 to column 3, with the drop in the text regression forecast coefficient when going from column 2 to column 4. The relationship between realized volatility and RRWC model predictions drops much more when including historical volatility than it does with the text regression model. Finally, when we include both models (columns 5), we find that the coefficient on the text regression is substantially higher than on the RRWC model. When we include all three forecasts (column 6), the RRWC model coefficient becomes indistinguishable from zero. That is, the RRWC model’s forecasting power is subsumed by the text regression model and historical volatility.<sup>23</sup>

Table 6 lists the words associated with the highest magnitude weights resulting from the text regression model with bigrams.<sup>24</sup> While the most impactful terms may not correspond to synonyms of risk, there does appear to be an intuitive connection between impactful words and volatility. Words associated with financial distress (e.g., loss, expenses, going concern, financing) lead to a high volatility forecast while words associated with financial security (e.g., dividends, income, properties) lead to a low volatility forecast.

Finally, Figure 3 provides visual reassurance that the model estimation is not driven by outliers. The figure plots the forecast errors of the text regression model against the forecast errors of the historical volatility model. It is evident that the two forecasts are highly correlated and, while the data is noisy, it does not appear as if outliers drive the relationship. Moreover, the plot shows that

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<sup>23</sup>We repeated the analysis when including all the synonyms to the words “risk” and “uncertainty” and the conclusions are unchanged.

<sup>24</sup>Recall that positive (negative) weights are associated with higher (lower) forecasted volatility.

the post-SOX text-based forecasts are less dispersed (black versus red symbols).

To summarize, we believe that our text regression model exhibits face validity. The estimation procedure does not appear to be driven by outliers and impactful words identified by our text regression are, for the most part, sensible. In fact, a model based on an ex-ante identification of risk related words (as in Li, 2005) is subsumed by our approach.

## 5. Empirical analysis

### 5.1. *Did the informativeness of MD&A sections improve after SOX?*

Consider the simple panel regression with firm random effects,

$$\mathcal{J}_{i,t} = \text{const} + b_i \text{SOX}_t + c_i \text{LnMDA}_t + \epsilon_{i,t}. \quad (9)$$

where  $\text{SOX}_t$  is a dummy variable taking the value of 0 before 2003, and the value of 1 in the years 2003 and beyond. The variable  $\text{LnMDA}$  is the log-frequency of the words in the MD&A document. The  $t$ -stat on the dummy variable in this regression is positive and highly significant ( $t \sim 11$ ), indicating that, in aggregate, the informational content in MD&A reports has increased in the post-SOX period along with the size of the reports.<sup>25</sup> In fact, we find that the text model underperforms the historical volatility model pre-SOX but significantly outperforms it post-SOX. Our proxy for informativeness,  $\mathcal{J}_{i,t}$ , is indeed noisy as evidenced by the low regression  $R^2$  (0.003), which underscores the importance of employing a large cross-section in our study. As mentioned earlier, and as evidenced by Figure 3, it is unlikely that the results are likely to be driven by outliers.

Is the change due to disclosure requirements specified by the legislation? We address this question by looking at SOX related words. Table 7 shows the frequency of occurrence of different SOX related words. As expected, we see that the usage of these words increases dramatically after 2002. This is also the case for words that do not include “Sarbanes” or “Oxley” explicitly, such

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<sup>25</sup>The results of this regression are reported in the first column of Table 8 along with the results of other regressions discussed in this section.

as “Internal Control”, “Compliance”, “Fraud”, and “Off Balance Sheet”.<sup>26</sup> At the same time, as Table 6 shows, these words do not appear to be particularly important in forecasting volatility. As the table suggests, SOX-related words are not strongly weighted either before or after the legislation.

Further, we show that the frequency of SOX related words does not explain the performance of the text model. Table 8 reports a series of panel regressions using the log-frequency (i.e.,  $\log(f_j(d_{i,t}))$ ) of the SOX-related words as independent variables and  $\mathcal{J}_{i,t}$  as the dependent variable. We include a SOX dummy and, for some specifications, a variable corresponding to the logarithm of the number of words in a report and/or the logarithm of the total number of SOX-related words in the report. While the frequency of these words explains some of the improvement in the forecasting power of the text-based model, the SOX dummy remains strongly significant. Further, the explanatory power of the regressions increases only marginally when including the frequencies of the SOX related words. This suggests that much of the increase in informativeness is not directly related to the reporting requirements of the legislation, narrowly defined.

Finally, we use a natural experiment imposed by the SEC implementation of SOX to show that the informativeness of firms which were not required to include new information in their reports was affected in the post-SOX era. Until 2007, the SEC exempted smaller public companies (those with market cap lower than \$75M) from having to provide an assessment of their internal controls over financial reporting.<sup>27</sup> Moreover, to our knowledge, an auditor’s attestation for this assessment of internal controls is still not required for smaller companies. In effect, the only impact of SOX on smaller companies has been the requirement that their executive officers certify that the financial statements are not misstated. Thus, narrowly read, the act only requires substantial additional disclosure in the MD&A report from larger companies. If firms only responded to the letter of the act, one would expect to find more post-SOX improvement in the informativeness of MD&A reports of larger companies.

To test this, we construct a dummy variable that equals one whenever a firm’s market capitaliza-

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<sup>26</sup>The names “Sarbanes” and “Oxley” appear a few times in annual reports before 2002 but not related to the (future) passage of the Sarbanes-Oxley Act.

<sup>27</sup>For reference, see: <http://www.sec.gov/info/smallbus/404guide.pdf>

tion is above \$75 million and zero otherwise.<sup>28</sup> We then regress each of the log MD&A document size (word count) and  $J_{i,t}$  on the SOX dummy, a larger firm dummy, the interaction between these two dummies, and the firm's log market capitalization. The results are presented in Table 9. First, we find that even firms that were not required to include new information in their reports ended up with larger reports post-SOX. Second, while larger firms are unconditionally more likely to submit more informative reports, smaller firms experienced the largest post-SOX improvement in informativeness. Thus, the firms with the least onerous compliance requirements were also those that exhibited the greatest improvement in their informativeness.

In summary, the data suggest that the informativeness of MD&A reports did improve after SOX, and that much of that improvement is not directly related to the information disclosure mandated by SOX.

## 5.2. *Did the increase in MD&A informativeness affect investors?*

The second question we pose raises the possibility that the additional information in the post-SOX MD&A reports was not new information to investors (i.e., this information was available elsewhere). For example, it is possible that the firm disclosed this information in other sections of their reports (not the MD&A) or through analyst calls. To investigate this, we ask whether improvements in our informativeness measure are related to a reduction in a proxy for asymmetric information. Such a reduction could be interpreted as evidence that the additional information in the MD&A reports was new to investors. Because share illiquidity is theoretically linked to adverse selection, we focus on the Amihud ratio, which is a measure of price impact (Amihud, 2002).

Table 10 reports the results of panel regressions testing to see whether, everything else being equal, changes in informativeness predict changes in *illiquidity*. The dependent variable is the change in the Amihud illiquidity measures (i.e., increases in the dependent variable are associated with deterioration in liquidity). We attempt to control for alternative explanations for changes in liquidity by including changes to a firm's book-to-market ratio and changes to its market capi-

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<sup>28</sup>To interpret what defines a "smaller public company," consult <http://www.sec.gov/rules/interp/2007/33-8810.pdf>. This, in turn, refers to a report in <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>. From the latter, it seems that one can safely interpret \$75M in market capitalization as a cutoff (the cutoff between accelerated and non-accelerated filers—see footnote 34 in the last link).

talization, which are known to be related to liquidity. Overall, we can reject the hypothesis that changes to informativeness are unrelated to changes in liquidity. Instead we find that improvement in informativeness, as measured by the relative performance of the text model, is associated with improvement in liquidity. This lends support to the conjecture that the improvement in MD&A informativeness corresponds to new information revelation.

### 5.3. *Did firms with higher agency costs increase their MD&A informativeness?*

To address this question, we introduce a set of cross-sectional variables that might proxy for the presence of internal opacity and asymmetric information (see the discussion in Section 3). Below, we discuss each variable and loosely conjecture what its relationship to asymmetric information might be.

1. **Market capitalization:** Smaller firms may be subject to higher agency costs (e.g., because fixed monitoring costs might be too high relative to the benefits monitoring brings). Alternatively, smaller firms might be more opaque.
2. **Herfindahl Index and number of reporting segments:** These variables proxy for the complexity of the firm (although they are also related to firm size). These measures could be correlated with both internal opacity and asymmetric information.
3. **Book-to-market:** Companies with a low book-to-market ratio may be associated with more intangible assets or products and thus subject to higher internal opacity or adverse selection costs. This prompts many studies to include book-to-market as a proxy for the presence of asymmetric information. On the other hand, firms with extremely high book-to-market might be in financial distress and, given the unusual circumstances (even to insiders), subject to greater internal opacity or adverse selection costs.
4. **Governance:** SOX also stipulated on governance issues. Although many of these stipulations echoed what was already required from listed companies by the NYSE and NASDAQ (e.g., a majority of independent directors, financial literacy on the part of at least one audit committee member), SOX did add to this marginally by requiring that audit committee

members of listed companies be ‘independent’ and control the firm-auditor relationship.<sup>29</sup> Thus, an improvement in governance could conceivably be linked to a decrease in asymmetric information. We use the G-Index of corporate governance (Gompers, Ishi, and Metrick, 2003) to proxy for the overall strength of corporate governance.

5. **Financial and operating risk:** Firms with more risky operations might experience greater internal opacity. We proxy for operational risk with financial leverage (debt-to-asset ratio) and operating leverage (year-over-year change in EBIT divided by year-over-year change in sales). On the other hand, these variables could also be correlated with size.
6. **Analyst coverage:** One might expect less information to be available for firms with lower analyst coverage, thus associating such firms with greater asymmetric information. This measure could be correlated with size.
7. **Analyst dispersion:** Likewise, greater disagreement between experts concerning a firm’s prospects may signal greater potential for asymmetric information.
8. **Idiosyncratic volatility:** One might expect that private information about a firm would be of an idiosyncratic nature. Firms whose volatility is largely driven by idiosyncratic noise might therefore afford more scope for the presence of asymmetric information. On the other hand, greater idiosyncratic volatility may create more scope for internal opacity.

We emphasize that the relationship between these variables, adverse selection costs, and internal opacity is not always clear. What guides us to select these variables is more a suspicion that they may be related to internal opacity and/or asymmetric information. By including them in a cross-sectional regression we hope to learn more about which firms might have been more likely to experience an improvement in their post-SOX informativeness.

The summary statistics for the cross-sectional variables and the liquidity measures we use are reported in Table 11. The table suggests that compared with the pre-SOX period, firms in the post-SOX period are larger, have lower book-to-market, are somewhat less leveraged, have wider

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<sup>29</sup>SOX introduced a ban on loans to executive officers, but this does not preclude close substitute such as an increase in short-term compensation coupled with a decrease in long-term compensation.

analyst coverage, exhibit less idiosyncratic volatility (though not in relation to total volatility which also declines), and are more liquid.

Rather than guess at the relationships between the cross-sectional variables listed above and asymmetric information, it might be useful to let the data suggest the relationship. To this end, we first investigate how the cross sectional variables are related to share illiquidity, before and after the passage of SOX. We use share illiquidity as a proxy for asymmetric information because the two are theoretically connected and the former is readily observable. We begin by regressing the illiquidity measure on a dummy indicating whether the firm falls into the top or bottom quintile of a given cross-sectional variable, a SOX dummy, and the interaction of the two.<sup>30</sup> Table 12 reports the results. We confirm that illiquidity declined in the post-SOX period, because the SOX dummy is negative and significant in all the regressions. In addition, it appears that save for the Herfindahl Index (second column in Table 12), all of the variables have some significant relationship with the share illiquidity measure. It is also clear from the table that not all variables are related to the illiquidity measure in the manner suggested by our earlier discussion. Specifically, analyst forecast dispersion has the opposite sign relative to what we might expect. Finally, it appears that, to the extent that the relationship between illiquidity and each of the cross-sectional characteristics changed after SOX, the relationship weakens (the sign of the “High” coefficient is generally opposite to the sign of the “SOX x High” coefficient). Specifically, for each of size, book-to-market, governance, financial leverage, analyst coverage and analyst dispersion, the absolute difference in liquidity between the high and low quintile shrinks after SOX.

Next, we ask what firm characteristics are associated with greater disclosure. As posited earlier, firms with greater asymmetric information might choose to disclose more. This could be because they learned more through the implementation of SOX and investors, anticipating this learning process, expect greater informativeness. Alternatively, managers might be more concerned about the greater liability introduced by SOX and therefore seek to reduce asymmetric information. We create a dummy variable,  $H_{i,t}$ , which takes the value of 1 if a firm is in the top quintile of the proxy (in a given year), the value of 0 if the firms is in the bottom quintile of the proxy, and treated

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<sup>30</sup>Each year, we assign firms into quintiles based on that year’s distribution. The illiquidity measure assigns higher values to less liquid firms.

as ‘missing’ otherwise. Then, to test whether the post-SOX improvement in forecasting power of MD&A reports is related to the proxy, we run the following panel regressions with firm random effects:

$$J_{i,t} = \alpha + \beta_1 SOX_t + \beta_2 H_{i,t} + \beta_3 SOX_t H_{i,t} + \epsilon_{i,t}, \quad (10)$$

where  $H_{i,t}$  is the dummy corresponding to the cross-sectional variable being investigated. Panel A in Table 13 reports the results from this regression and provides an indication of how our measure of MD&A informativeness varies with the proxies.<sup>31</sup> The first row in Panel B reports the average informativeness across firms in post-SOX years (2003-2006). The coefficient is positive, consistent with our earlier finding that the text-based model forecasts are better than the past year’s volatility in predicting future volatility after SOX. The second and third rows in Panel B report the average informativeness in the top and bottom quintiles, respectively, of the associated cross-sectional variable. The fourth and fifth rows test to see whether the informativeness of the top and bottom quintiles are significantly different from the unconditional informativeness. Thus Panel B is another way to test for a post-SOX relationship between the cross-sectional variables and MD&A informativeness and can be viewed as a non-parametric “test” of the robustness of Panel A.

In Panel A, we find that firms with low book-to-market ratios, high financial leverage, and high share illiquidity were unconditionally more likely to have informative MD&A reports. On the other hand, we find that firms with small market value, high book-to-market ratio, low analyst coverage, and high analyst forecast dispersion experienced the greatest increase in informativeness post-SOX. What is striking about these results is that in every case, the significant coefficient has the opposite sign as the analogous coefficient in Table 12. In other words, a significant unconditional predictor of informativeness is also a significant unconditional predictor of share liquidity. Likewise, a significant predictor of post-SOX improvement in informativeness is a significant predictor of improvement in liquidity. This is consistent with our findings from Table 10, and lends further support to the notion that the degree of asymmetric information is related unconditionally to the degree of informativeness.

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<sup>31</sup>Given the time trends in some of these variables (e.g., market capitalization) we sort observations into quintiles separately for each year.

As described earlier, the level of a firm's idiosyncratic volatility can proxy for both the potential of asymmetric information and internal opacity. To see whether idiosyncratic volatility and informativeness are related, we regress our measure of informativeness on total volatility, idiosyncratic volatility, and systematic volatility while separating the sample into pre- and post-SOX years. We compute systematic volatility with respect to the CRSP Value Weighted Index using an annual correlation estimate that is robust to infrequent stock trading (see Dimson, 1979). Table 14 shows the results for leading (columns 1-4) and contemporaneous (columns 5-8) dependent variables. Pre-SOX, there is no relation between past volatility (either total, systematic, or idiosyncratic) and subsequent informativeness. However, post-SOX we see that past total volatility is positively related to subsequent model improvement. Moreover, this relationship appears to reside entirely with the idiosyncratic component of volatility, consistent with the hypothesis. Similar results are obtained when we examine the relation between model improvement and contemporaneous volatility.

## **6. Conclusions**

By now, a vast literature exists about the effects on firms of the Sarbanes-Oxley Act (SOX) of 2002. It is a fact that mandatory disclosure documents have ballooned in size since the passage of SOX. What is not clear is whether this increase in disclosure document size has been accompanied by more transparency (or alternatively, has been associated with more information being disclosed). We provide evidence that annual reports have become more informative in the post-SOX era. Our evidence suggests that this is not related to the degree or type of compliance with SOX. The information disclosed does appear to be new in the sense that it is associated with a reduction in illiquidity. Moreover, examining how the increased informativeness is related to firm-specific characteristics suggests that the increased informativeness is driven by the degree of information asymmetries—firms characterized by more asymmetric information appear to disclose more in the post-SOX period than they did in the pre-SOX period.

There might be several reasons why adverse selection costs might induce firms to divulge more information in the post-SOX period. Firms might have learned more through the implementation of SOX provisions, or because of the increased liability to senior executives and auditing firms, might

be paying more attention to financial and operational aspects of their company. Those firms that learn more would disclose more, lest investors believe that the absence of an increase in disclosure signals something bad that was learned about the firm. This rationale presupposes that the post-SOX regulatory environment somehow induced firms to learn more.

An alternative hypothesis is that managers became frightened by the increased liability, and those in companies with higher adverse selection costs had greater reason to be frightened. Such firms might not have learned anything about their operations or financial situation through SOX but the fear might have induced disclosure that spilled over beyond the narrow transparency requirements of SOX.

While we are unable to clearly separate the causes for disclosure (because our proxies may be correlated with both internal opacity and adverse selection costs), there appears to be some suggestive evidence that “fear”, and not just “learning” played an important role in the increased informativeness post-SOX. Specifically, the cohort of firms exhibiting the largest increase in informativeness is the group to which SOX applied minimally (firms with market capital under \$75M).

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## 7. Tables and Figures

### Panel A

Hi Noah,  
Carlos Guestrin referred me to you. I'm an assistant professor of finance at Tepper working with two other finance faculty (Bryan Routledge and Jacob Sagi) on using decision theory together with intelligent text retrieval to understand how investors use non-numeric information released by companies.  
I'd really appreciate the opportunity to talk to you about this over coffee. My schedule is fairly flexible so let me know what time(s) work best for you.  
Thanks,  
Shimon

### Panel B

Attn: Sir/Ma,  
This is to bring to your notice that we are delegates from the United Nations UN and World Bank to Central Bank of Nigeria (CBN) to pay 150,000 scam victims the sum of \$7,500,000.00 (SEVEN MILLION FIVE HUNDRED THOUSAND UNITED STATE DOLLAR) each. You are listed and approved for this payment as one of the scammed victims to be paid this amount, get back to us as soon as possible for the immediate payments of your \$7,500,000.00 compensations funds.

Figure 1: Email message examples. Panel A shows an example email message that is not spam, denoted  $d_1$  in the text, and Panel B shows an example email message that is spam (only the first paragraph is shown), denoted  $d_2$  in the text.

I am Mrs. Mrs.Aisha Smith, Ag. Director, General Administration of the Federal Ministry of Finance Ghana The Board of the ministry hereby bring to you, noticed of your compensation / inheritance payment (\$1,200. 000.00 MILLION UNITED STATE DOLLARS) After the meeting held on 30th of July 2009. His Excellence the PRESIDENT OF FEDERAL REPUBLIC OF GHANA PROFESSOR JOHN E A MILLS has instructed the remittance department of WESTERN UNION MONEY TRANSFER (GLOBAL ACCESS LIMITED) here in Accra Ghana to commence transfer immediately to you without any further delay to avoid you paying money to any fraudulent characters. Please take note.

Figure 2: A new email message not used to build the model, denoted  $d_3$  in the text. Only the first paragraph is shown.

# Correlated Prediction Errors

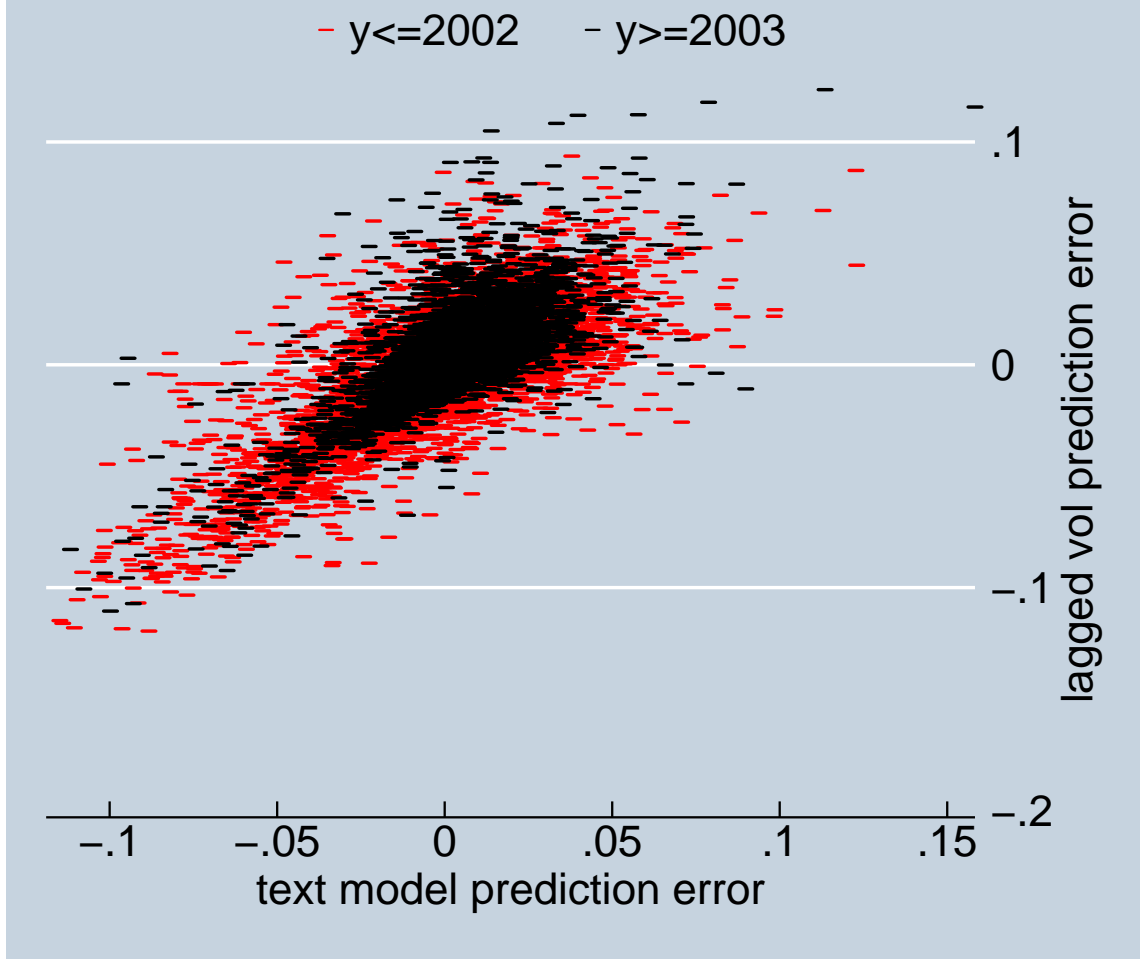


Figure 3: Scatter plot of the estimations errors pre-SOX (red) and post-SOX (black) for the text regression model (x-axis) against the historical volatility model (y-axis).

Year	(1) No. of documents	(2) Ave. words/doc.	(3) Med words/doc.	(4) Max words/doc.
1998	2,357	4,913	3,972	29,721
1999	2,391	5,921	4,912	36,273
2000	2,323	5,691	4,578	30,260
2001	2,419	6,108	5,083	33,600
2002	2,652	8,220	6,963	102,145
2003	3,410	10,045	8,589	56,940
2004	3,500	11,191	9,672	107,783
2005	3,420	12,255	10,642	92,198
2006	3,280	11,857	9,905	207,049
Pre-SOX	12,142	6,221	5,044	102,145
Post-SOX	13,610	11,332	9,674	207,049

Table 1: Characteristics of the reports (Sections 7 and 7a from annual reports) used in this paper. ‘Pre-SOX’ refers to years 1998-2002 and ‘Post-SOX’ refers to years 2003-2006.

word type	count in Fig. 1 Panel A ( $f(d_1)$ )	count in Fig. 1 Panel B ( $f(d_2)$ )	example of weights $w$
#	0	3	3
and	1	2	0
are	0	2	2
as	0	3	3
bank	0	2	2
finance	2	0	-4
for	1	2	0
is	1	1	-1
me	2	0	-4
of	1	4	2
the	1	4	2
this	1	3	1
to	4	6	-2
united	0	2	2
victims	0	2	2
with	2	0	-4
you	3	1	-5
your	0	2	2

Table 2: Word count vectors for messages in Figure 1. The full vector of  $d$  words is not shown (only words occurring twice or more in the combined messages, after downcasing and removal of non-alphanumeric characters, are shown). All sequences of digits were replaced by #. The last column is a vector of weights learned using a standard learning method from the two email messages,  $d_1$  and  $d_2$ .

word type	count in Fig. 2 ( $f(d_3)$ )
#	3
and	0
are	0
as	0
bank	0
finance	1
for	0
is	0
me	0
of	8
the	6
this	0
to	5
united	1
victims	0
with	0
you	3
your	1

Table 3: Word count vector for the message in Figure 2. Only words used by the model (Table 2) are included.

Year	(1) Mean daily vol.	(2) Mean log daily vol.	(3) Historical vol. MSE	(4) Text model MSE
1998	3.71%	-3.20	0.234	0.229
1999	4.61%	-3.14	0.154	0.164
2000	4.89%	-3.08	0.153	0.162
2001	5.34%	-3.23	0.175	0.212
2002	4.45%	-3.29	0.157	0.200
2003	4.04%	-3.60	0.188	0.178
2004	3.19%	-3.72	0.143	0.143
2005	2.70%	-3.78	0.135	0.128
2006	2.53%	-3.83	0.147	0.145
Pre-SOX	4.60%	-3.19	0.174	0.194
Post-SOX	3.12%	-3.73	0.153	0.148

Table 4: Summary statistics of daily volatility and Mean Squared Errors (MSEs) for the benchmark volatility forecast and for the text-based forecast. The benchmark forecast is the past year’s realized volatility. The text-based forecast is described in Eq. (5). Volatilities are quoted as daily (a daily volatility of 3% corresponds to roughly 50% annualized volatility).

	Future Realized Volatility (ln)					
RRWC Model Forecast	0.838*** [0.010]		0.186*** [0.011]		0.065*** [0.014]	0.013 [0.014]
Text Model Forecast		0.789*** [0.006]		0.476*** [0.010]	0.763*** [0.008]	0.472*** [0.011]
Historical Volatility Forecast			0.695*** [0.006]	0.376*** [0.010]		0.373*** [0.010]
Constant	-0.553*** [0.034]	-0.766*** [0.021]	-0.446*** [0.033]	-0.550*** [0.020]	-0.626*** [0.039]	-0.527*** [0.038]
Observations	36226	25733	34439	25733	25733	25733
Number of Clusters	7952	6498	7595	6498	6498	6498
Pseudo R-squared	0.105	0.595	0.627	0.642	0.593	0.641

Table 5: Panel regressions with firm random effects. The dependent variable is (log) realized volatility in the following year. The independent variables include a volatility forecast using a count of risk-related words (“RRWC Model Forecast”), a volatility forecast using the text regression model (“Text Model Forecast”), and (log) historical volatility.

	1996–2000	1997–2001	1998–2002	1999–2003	2000–2004	2001–2005	
net loss	0.026	year #	loss	0.026	loss	loss	0.026
year #	0.024	net loss	net loss	0.020	net loss	net loss	0.018
loss	0.020	expenses	expenses	0.017	year #	going concern	0.014
expenses	0.019	loss	year #	0.015	expenses	expenses	0.014
covenants	0.017	experienced	obligations	0.015	going concern	a going	0.014
diluted	0.014	of \$#	financing	0.014	a going	personnel	0.013
convertible	0.014	covenants	convertible	0.014	administrative	financing	0.013
date	0.014	additional	additional	0.013	personnel	administrative	0.012
longterm	-0.014	merger agreement	unsecured	-0.012	distributions	policies	-0.011
rates	-0.015	dividends	earnings	-0.012	insurance	by the	-0.011
dividend	-0.015	unsecured	distributions	-0.012	critical accounting	earnings	-0.011
unsecured	-0.015	dividend	dividends	-0.012	lower interest	dividends	-0.012
merger agreement	-0.017	properties	income	-0.013	dividends	unsecured	-0.012
properties	-0.018	net income	properties	-0.015	properties	properties	-0.013
income	-0.021	income	net income	-0.019	rate	rate	-0.014
rate	-0.022	rate	rate	-0.022	net income	net income	-0.018

high  $\hat{y}$   
↑

↓  
low  $\hat{y}$

Table 6: Most strongly-weighted terms in models learned from various time periods (LOGIP model with unigrams and bigrams). “#” denotes any digit sequence. This table is reproduced from Kogan, Levin, Roulledge, Sagi, and Smith (2009).

Year	Sarbanes Oxley	Internal Control	Deficiency	Weakness	Balance Sheet	Compliance	Fraud	Off Balance Sheet
1998	0	1,403	70	106	585	1,508	56	124
	0	3,322	133	148	1,141	4,409	109	258
1999	1	1,964	84	127	878	2,087	62	170
	1	6,910	141	195	1,704	10,077	110	360
2000	0	1,451	82	122	921	1,390	60	196
	0	3,579	165	186	1,822	3,645	116	430
2001	2	1,116	69	142	1,107	1,003	64	187
	2	2,511	139	206	2,324	2,121	113	389
2002	24	1,383	101	330	1,517	1,360	113	495
	34	3,511	170	531	3,919	3,392	223	835
2003	196	1,979	198	525	2,253	2,003	200	1,028
	313	5,375	380	974	6,751	5,811	462	1,891
2004	633	2,286	216	546	2,572	2,237	254	1,957
	1,028	7,001	407	1,019	8,664	7,195	710	3,925
2005	2,231	3,011	273	629	2,583	2,625	350	2,138
	4,042	13,681	541	1,280	8,861	9,849	1,008	4,291
2006	2,086	2,674	217	402	2,509	2,486	287	2,268
	3,582	11,117	471	726	8,732	8,957	765	4,645

Table 7: Frequencies of SOX-related words appearing in the MD&A reports. The first row corresponds to the total number reports (in a given year) where the words appear, and the second row corresponds to the total number of occurrences. We use “\_” to denote a whitespace between two words. The column labeled “Sarbanes Oxley” adds up the frequencies of the terms “sarbanes”, “oxley”, “sarbanesoxley”, “sarbanes\_oxley” and “sox”; the column labeled “Internal Control” adds up the frequencies of the terms “internal”, “controlsystem”, and “internalcontrol”; the column labeled “Deficiency” adds up the frequencies of the terms “deficiency” and “materialdeficiency”; the column labeled “Weakness” adds up the frequencies of the terms “weakness” and “materialweakness”; the column labeled “Balance Sheet” adds up the frequencies of the terms “balancesheet”, “balance\_sheet”; the column labeled “Off Balance Sheet” adds up the frequencies of the terms “offbalance”, “offbalancesheet”, “offbalance\_sheet”, and “off\_balancesheet”.

	Informativeness (J)				
SOX	0.029***	0.030***	0.029***	0.031***	0.030***
	[0.003]	[0.003]	[0.003]	[0.004]	[0.004]
LnMDA	0.007**		0.003	0.006	0.005
	[0.003]		[0.004]	[0.004]	[0.004]
LnSOX		0.006***	0.005*		0.018***
		[0.002]	[0.002]		[0.006]
sarbanes				0.096*	0.097*
				[0.050]	[0.050]
oxley				-0.016	-0.012
				[0.120]	[0.120]
sarbanesoxley				0.002	0.000
				[0.005]	[0.005]
sarbanes_oxley				-0.080	-0.091
				[0.116]	[0.116]
internal				0.005*	-0.004
				[0.003]	[0.004]
controlsystem				-0.001	-0.003
				[0.015]	[0.015]
officer_certification				0.018	0.003
				[0.319]	[0.319]
deficiency				0.009	0.006
				[0.008]	[0.008]
weakness				-0.008	-0.012**
				[0.006]	[0.006]
balancesheet				-0.018	-0.022
				[0.059]	[0.059]
balance_sheet				0.002	-0.005
				[0.003]	[0.004]
compliance				0.000	-0.009**
				[0.002]	[0.004]
fraud				-0.001	-0.002
				[0.007]	[0.007]
sox				-0.038***	-0.037***
				[0.014]	[0.014]
internalcontrol				-0.002	-0.002
				[0.006]	[0.006]
materialweakness				-0.021	-0.017
				[0.016]	[0.016]
materialdeficiency				-0.098	-0.090
				[0.165]	[0.165]
offbalance				-0.006	-0.010
				[0.008]	[0.008]
offbalancesheet				0.004	0.001
				[0.012]	[0.012]
offbalance_sheet				-0.005	-0.010**
				[0.004]	[0.004]
off_balancesheet				0.034	0.032
				[0.110]	[0.110]
Constant	-0.033***	-0.058*	-0.058*	-0.077**	-0.079**
	[0.004]	[0.031]	[0.031]	[0.033]	[0.033]
Number of Obs.	25,752	25,752	25,752	25,752	25,752
R <sup>2</sup>	0.003	0.003	0.003	0.004	0.004

Table 8: The table reports panel regressions (with firm random effects) using MDA informativeness as the dependent variable. “SOX” is a dummy variable taking the value of 1 for the post-SOX years (2003 and on). “LnMDA” is the log frequency of MDA words, “LnSOX-Words” is the log frequency of SOX related words in the MDA. All other independent variables are computed as the log frequencies of the corresponding words.

	Ln(MD&A Size)	Informativeness (J)
SOX	0.467*** [0.011]	0.043*** [0.006]
Above \$75M	-0.079*** [0.012]	0.017*** [0.006]
SOX x Above \$75M	0.098*** [0.013]	-0.016** [0.007]
Ln(Market Cap)	0.064*** [0.004]	-0.002 [0.002]
Constant	7.844*** [0.041]	-0.007 [0.019]
Number of Obs.	24,893	24,893
$R^2$	0.246	0.003

Table 9: The table reports panel regressions (with firm random effects) of MDA word count and informativeness as the dependent variables. “SOX” is a dummy variable taking the value of 1 for the post-SOX years (2003 and on), “Above \$75” takes on the value of 1 if the firm had a market capitalization of more than \$75M and was therefore required to comply with all of SOX requirements.

	(1)	(2)	(3)	(4)
	$\Delta$ Amihud Illiquidity Measure			
$\Delta J_{i,t}$	-0.858** [0.344]	-0.325** [0.152]	-0.262 [0.160]	-0.322** [0.152]
$\Delta$ Book-to-Market		0.317*** [0.038]		0.319*** [0.038]
$\Delta$ Market Cap			-0.803*** [0.082]	-0.606*** [0.073]
SOX	-1.504*** [0.177]	-0.603*** [0.073]	-0.803*** [0.082]	-0.606*** [0.073]
Constant	1.188*** [0.147]	0.490*** [0.071]	0.651*** [0.074]	0.491*** [0.071]
Number of Obs.	12,149	9,190	11,531	9,190
$R^2$	0.71%	2.00%	1.04%	2.01%

Table 10: The table reports panel regression results (with firm random effects) of (negative) changes in the Amihud illiquidity measure on changes in informativeness, change in book-to-market, and change in market cap. All changes are measured year-over-year.

	Market Cap in (\$1,000)	H Index	Number of Segments	Book-to Market	G Index	Debt-to Assets	Operating Leverage	Analyst Coverage	Analyst Forecast Disp	Idiosync. Volatility	Amihud Illiquidity
						Pre-SOX					
Mean	1,399,812	0.361	2.28	0.87116	8,549	0.194	3.12	3.97	0.25	0.042	2.843
Standard Dev.	8,682,356	0.350	0.55	1.41822	2,654	0.233	92.48	5.34	1.31	0.024	16.103
25% percentile	53,554	0.030	2.00	0.29213	7,000	0.003	0.72	0.00	0.02	0.026	0.012
50% percentile	168,478	0.237	2.00	0.56732	8,000	0.109	0.98	2.00	0.05	0.038	0.119
75% percentile	611,490	0.670	2.00	1.03622	10,000	0.320	1.21	6.00	0.17	0.054	1.069
						Post-SOX					
Mean	1,951,613	0.369	2.34	0.75522	8,939	0.173	2.67	4.97	0.21	0.029	1.074
Standard Dev.	8,100,837	0.357	0.62	0.84886	2,498	0.221	56.95	6.02	1.14	0.018	9.134
25% percentile	104,630	0.026	2.00	0.33121	7,000	0.001	0.81	0.00	0.02	0.017	0.002
50% percentile	334,266	0.248	2.00	0.56710	9,000	0.094	1.00	3.00	0.05	0.024	0.019
75% percentile	1,189,965	0.718	3.00	0.91570	11,000	0.271	1.23	7.00	0.14	0.036	0.212

Table 11: Summary statistics of the different cross-sectional proxies for information asymmetry in the pre-SOX period (1998-2002) and the post-SOX period (2003-2006).

	Market Cap in (\$1,000)	H Index	Number of Segments	Book-to Market	G-Index	Debt-to Assets	Operating Leverage	Analyst Coverage	Analyst Forecast Disp
					Amihud Illiquidity Measure				
SOX	-4.564*** [0.370]	-2.814*** [0.969]	-1.417*** [0.505]	-0.330** [0.167]	-0.003 [0.044]	-1.542*** [0.391]	-1.745*** [0.649]	-4.068*** [0.535]	-0.119* [0.062]
High	-7.461*** [0.393]	0.476 [1.537]	-1.43 [2.052]	1.688*** [0.233]	-0.096 [0.094]	-1.657** [0.654]	-0.01 [0.675]	-7.933*** [0.637]	0.399*** [0.076]
SOX × High	4.551*** [0.522]	1.626 [1.381]	0.87 [2.063]	-0.821*** [0.237]	-0.024 [0.074]	0.907 [0.608]	-0.62 [0.909]	4.013*** [0.820]	-0.270*** [0.092]
Constant	7.482*** [0.272]	3.279*** [1.157]	1.290*** [0.192]	1.290*** [0.192]	0.158*** [0.054]	3.938*** [0.481]	4.006*** [0.528]	8.076*** [0.409]	0.323*** [0.062]
Number of Obs.	7,208	1,562	3,182	5,803	2,637	7,169	4,704	8,487	4,621
R <sup>2</sup>	7.24%	0.39%	0.50%	2.60%	0.23%	0.36%	0.60%	3.32%	2.15%

Table 12: We presents panel regression results (with firm random effects) where the dependent variables are measures of the Amihud measure in of illiquidity. The independent variables are the SOX dummy, a dummy for a cross sectional variable's top-quintile, and the interaction between the two. The cross-sectional dummy takes on the value of 1 if the observation is in the top quintile, 0 if the observation is in the bottom quintile, and missing value otherwise. We estimate the model for one cross-sectional measure at a time.

	Market Cap in (\$1,000)	H Index	Number of Segments	Book-to Market	G-Index	Debt-to Assets	Operating Leverage	Analyst Coverage	Analyst Forecast Disp	Amihud Liquidity
Panel A										
SOX	0.045*** [0.007]	0.019 [0.015]	0.027*** [0.007]	0.017** [0.007]	0.028*** [0.009]	0.039*** [0.006]	0.023*** [0.007]	0.048*** [0.006]	0.01 [0.007]	0.027*** [0.007]
High	0 [0.009]	0.004 [0.017]	-0.00 [0.026]	-0.024*** [0.009]	-0.005 [0.019]	0.015* [0.008]	0.00 [0.008]	0.020*** [0.008]	-0.003 [0.007]	0.01 [0.007]
SOX x High	-0.024** [0.010]	-0.001 [0.021]	-0.00 [0.029]	0.025** [0.010]	0.002 [0.016]	-0.010 [0.009]	-0.01 [0.010]	-0.031*** [0.010]	0.019** [0.010]	-0.003 [0.010]
Constant	-0.025*** [0.006]	-0.023** [0.012]	-0 [0.006]	-0 [0.006]	-0.022** [0.011]	-0.037*** [0.006]	-0.012* [0.006]	-0.037*** [0.005]	-0.010* [0.005]	-0.024*** [0.005]
Number of Obs.	9,954	1,932	3,863	7,210	3,497	10,018	6,171	11,770	6,073	7,567
R <sup>2</sup>	0.32%	0.13%	0.23%	0.37%	0.08%	0.45%	0.26%	0.40%	0.45%	0.30%
Panel B										
Unconditional	0.024*** [0.003]	0.024*** [0.003]	0.024*** [0.003]	0.024*** [0.003]	0.024*** [0.003]	0.024*** [0.003]	0.024*** [0.003]	0.024*** [0.003]	0.024*** [0.003]	0.024*** [0.003]
Top Quintile	0.013** [0.006]	0.015 [0.014]	-0.00 [0.026]	0.038*** [0.008]	0.013 [0.015]	0.028*** [0.007]	0.019** [0.008]	0.014** [0.006]	0.032*** [0.008]	0.020** [0.008]
Bottom Quintile	0.037*** [0.008]	0.014 [0.016]	0.021*** [0.007]	0.00500 [0.007]	0.012 [0.011]	0.031*** [0.006]	0.024*** [0.007]	0.040*** [0.007]	0.008 [0.006]	0.024*** [0.005]
Top = Unconditional	0.070	0.567	0.430	0.054	0.428	0.533	0.497	0.076	0.298	0.572
Bottom = Unconditional	0.067	0.351	0.679	0.005	0.282	0.237	0.947	0.001	0.003	0.9918

Table 13: In panel A, we present panel regression results (with firm random effects) where the dependent variable is our informativeness measure. The independent variables are the SOX dummy, a dummy for the cross sectional dummy, and the interaction between the two. The cross-sectional dummy takes on the value of 1 if the observation is in the top quintile, 0 if the observation is in the bottom quintile, and missing value otherwise. We estimate the model for one cross-sectional measure at a time. Panel B reports the average informativeness in the post-SOX period unconditionally and in the top and bottom quintile of the cross-sectional variable. The last two rows report the  $p$  values associated with testing the difference between the unconditional average informativeness and average in each of the quintiles.

	$J_{t+1}$				$J_t$			
	Pre-SOX	Post-SOX	Pre-SOX	Post-SOX	Pre-SOX	Post-SOX	Pre-SOX	Post-SOX
Total Volatility	0.004 [0.03]	0.690 [3.48]**			0.445 [1.92]	3.623 [9.02]**		
Systematic Volatility			-0.038 [0.13]	0.319 [1.30]			-0.224 [1.11]	0.129 [0.30]
Idiosyncratic Volatility			0.049 [0.30]	0.593 [2.48]*			0.563 [2.20]*	3.731 [7.79]**
Constant	-0.009 [1.15]	-0.015 [2.17]*	-0.011 [1.54]	-0.013 [1.97]*	-0.045 [4.00]**	-0.111 [9.11]**	-0.045 [4.11]**	-0.107 [9.53]**
Observations	6433.000	11101.000	6312.000	10928.000	12142.000	13610.000	11887.000	13411.000
$R^2$	0.001	0.012	0.001	0.011	0.002	0.062	0.002	0.061

Table 14: Panel regressions with firm random effects. The dependent variable is informativeness and independent variables include total firm volatility, systematic volatility, and idiosyncratic volatility.