
The Effect of Qualified Audit Report on Share Prices and Returns: Evidence of Iran

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Abstract

Audit report is the consequence of auditing process and it is a major instrument of communication between auditor and financial statements' user. This study attempts to examine the correlation between qualified audit report and share prices and returns in order to test information content of qualified audit report. A market-based study conducted on the qualified audit reports of the shareholding companies in Iran during the period 2004-2008. The changes in share prices and returns during the test period which represents one week before and as well one week after the announcement's data were measured and analyzed. The result of the survey indicated that qualified audit opinion has no significant effect on share prices and returns. In other word, there is no information content in qualified audit opinion in Iran. This conclusion may suggest that the audit report's users' do not understand its meaning or appreciate its value.

Keywords: Qualified auditors' opinions, Information content, Shares' prices and returns, Share prices, and Tehran Stock Exchange.

Introduction

Audit report is a media of communication between auditor and financial statements' users; it shows the most important part of auditors' activity and expresses the result of financial statements' assessment to users (Salehi and Abedini, 2008). A considerable reason for demanding auditing is expected effects on decision making, and demanding for audit services is generated by many causes like (1) the expecting gap between the financial statements' users and preparers (Salehi and Nanjgowda 2006; Salehi, 2007; Salehi and Azary, 2008; and Salehi and Rostami, 2009); (2) the conflict of interest between kinds of financial statements' users (Salehi, 2008); (3) the complicated economic environment (Salehi, Mansoury, and Pirayesh, 2008); and (4) effects of the financial statements on decision making (Salehi, Mansoury, and Azary, 2008).

If the audit report is objective and comprehensible, it can be a communicative media between the auditor and the audit reports' users, and because of its relevance it can make difference in decision making, otherwise, the users of the financial statements will not use the

report in the decision-making process (Thuneibat, Khamees, and Al-Fayoumi, 2007; Salehi, 2009).

If the financial statements' users do not understand the effect of audit reports, auditing is not valuable, however, the prospected effect of the auditor's report is not obvious due to inconclusive previous studies. This means that it is important to conduct a survey of information content in situations and environments.

Research Problem and Research Question

Skepticism for auditing process and value of audit report motivated to conducting study. Since the auditing is mandatory, researchers have debated over its importance and necessity. Nowadays, there is a wide criticism of the audit profession within the context of business and audit failures; the value of the audit report continues to be scrutinized. This study tries to answer the following questions:

Does the audit report in Tehran Stock Exchange (TSE) have information content? Or do financial statements' users emphasize auditing result as an information source

In other words, is audit report (especially qualified opinion) relevance for decision making?

Importance of the Study

In a sense, the role of auditing is control, monitoring and useful services to the public as a background of public welfare (Salehi, 2008 b). In other word, this control and monitoring can affect the economic activities, because individuals have to response against their affairs. Mautz and sharaf (1961) believe that the purpose of auditing is accrediting to the claims of those who invest by others assets and provide information for them.

Different groups of users use audited financial statements. Increasing in audit report quality causes better decision making upon financial statements which means relevant financial statement helps its users to make better economic decisions.

The importance of this study originates from the importance of relevant information for the process of decision making. If the audit report has no information content, there is no need for the audit process. Therefore, this study is expected to be of importance to the audit profession, investors, creditors and other users, as it is expected to provide them with useful information about the value of the audit report and the audit process. In particular, it is expected that the study will be very beneficial to the users of the financial statements in Iran as a result of the increasing demand there for audit services and the increasing expectations from auditors (Salehi, 2008 c). Regarding to the importance of audit report Salehi and Abedini (2008) conducted a survey which the results of the study revealed that totally audit report is very important to Iranian environment; however, the lack of qualified audit report usefulness study is the main importance of this study in Iranian environment.

Review of Literature

The audit report has been one of the most important areas for many researchers. However, the conclusions

provided by the studies which have been undertaken in the area of audit reporting have been opposing and inconsistent. Most of these studies have been classified into "market based" and "experimental studies" (Craswell, 1985). This section of the study will concentrate on those studies that can be classified as an experimental or market-based because these studies are involved with the effect of the auditor's opinion on share prices or readers perceptions, which is the subject of this study.

Baskin (1972) used the market model to investigate the information content of "consistency exception" type of qualifications and to discover whether the nature of the "exception" affected investors' decisions. He indicated that there was little effect, and that the consistency exception type audit report possessed no information content.

Firth (1978) in order to evaluate the impact of releasing qualified audit reports on share prices on the date of the release of the report and their impact on investment decisions and concluded that share prices responded to certain types of qualifications and therefore the type of qualification influences investors' decisions. He also added that investors react differently to various types of audit qualifications.

In another survey, Firth (1980) used questionnaires, so that he could find out whether qualified and unqualified audit reports have information content to discover whether bank lending decisions and credit analysts' reactions were affected by qualifications and the type of qualification. He also implied that these results indicate the audit report should contain more detail in this situation so as to help readers of the report to appraise the importance of the qualification for their decision making.

Houghton (1983) in an experimental study, investigate the impact of the audit opinion on the decision-making process and the decision outcome of the lending process of Australian bank in order to understand

whether there is a difference in the information content between different types of audit reports and between the presence and the absence of the report in general. He designed a set of hypothetical information consisting of a balance sheet and income statement; fund statement; notes to financial statements; and bank loan application. Similar sets of this information were given to three groups, included (1) qualified audit report; (2) unqualified audit report and (3) without a report. The results indicated that there was no significant influence in each of the three cases on the decision results. However, he stated that the results indicate that the presence of the report influenced the loan-decision process, as he put it ". . . whilst the audit opinion may form part of the decision process, its contents may not have an impact on the decision outcome so as to significantly alter that outcome" (p. 19). He attributed the results to the respondents not being fully aware of the significance of the report; the report language becoming overused, the conveyed information in the report was not important to the lending banks; and other information given to the respondents was more important than the audit report.

For the same purpose, Robertson (1988) investigated that whether the terminology of report qualifications influence the reactions of financial analysts to the audit report by using the same methodology. He sent an identical set of financial statements from a hypothetical company to the respondents and each set was joined with one type of qualified audit report. The respondents were asked for three questions (1) whether they felt that the audit report added credibility to the financial statements ;(2) whether they relied on this information when making financial investment decisions; and (3) whether they felt that this information satisfied their needs when zoning the analysis. The results indicated that the financial analysts did not make any significant distinctions among different types of audit report qualifications.

Gul (1990) investigated the influence of the unqualified audit report and the "except for" qualified audit report

on the estimated price of shares by using experimental approach. He use bank officers as respondents and sent them a hypothetical set of identical financial information, each set of accounts being accompanied by either unqualified or "except for" audit reports. Respondents were requested to estimate the appropriate shares' price of the hypothetical company. He used statistical techniques such as ANOVA to analyze the data. The results indicated that the "except for" qualified audit report affected the share prices negatively.

Miller et al, (1993) conducted an experimental study in the USA to compare ability of the new audit report - introduced by SAS 58 "Reports on Audited Financial Statements" - in banks' Accreditation decisions with the old audit reports. Respondents were divided into groups given either a new or old form of audit report, joined by a set of questions asking them about their comprehensions of the reports. They suggested that the US Auditing Standards Board (ASB) had successfully refined the ability of the audit report to communicate between independent accountants and the financial statements' users. The study concluded that the new report was able to enhance the communication process in some areas, such as the differentiation between the auditor's and management's responsibilities; and the intensification of the communications belonging to the audit scope limitations. However, the results also indicated the perception of the respondents in respect of the scope limitations could be influenced by the size of the bank.

Ameen et al, (1994) investigated the information content of the qualified audit opinions for the "over-the-counter" firms in the USA. They used an event study to investigate whether the share prices of small-sized companies were influenced by the qualified audit. The investigation covered 177 qualified audit reports that issued during the period 1974-1988. The researchers calculated the normal and abnormal returns using market model and then the average and the cumulative abnormal returns were calculated. The results of the

study indicated a negative reaction of the market during the period preceding the date of the declaration of the qualified opinions, but there was no market reaction during the event period.

Chen et al, (2000) investigated an emerging market's reaction to initial modified audit opinions. The researchers studied the effect of the qualified and unqualified audit opinions on share prices and returns during the period 1995-1997 in Shanghai Stock Exchange. Due to the shares of the companies that received qualified audit opinions showed negative abnormal returns, the results of the study indicated that the market reacted negatively and also showed that there were no significant differences between the reactions to the qualified audit opinion and the unqualified audit opinions with explanatory paragraph.

Bessell et al, (2003) used an experimental study to investigate the information content of going concern "modified audit reports" in Australia. They distributed various types of audit reports include unqualified, qualified and unqualified with explanatory paragraph attached with questionnaires to the 500 members of the Australian Institute of Banking. The researchers showed that if there is no financial trouble, an "Emphasis of matter" and an "Except for report" has information content.

Guillamon (2003) used experimental methodology to investigate the importance of the audit report in Brokerage companies and credit institutions' decisions making. The researcher used questionnaire through which the respondents were asked about the source they consider relevant when making decisions. The findings of the study showed that the auditor's opinion represents a useful source of information when making investment and financing decisions.

Martinez et al, (2004) investigated the reaction of the Spanish capital market to qualified audit reports. They used event study methodology to investigate the relationship between audit report qualifications and

stock prices during the period 1992-1995. The results of the study indicated that there was no relationship between stocks prices and qualified audit opinions, In other words, qualified audit opinions had no information content.

Mong and Roebuck (2005) investigated the effect of audit report disclosure on auditor litigation. They concluded that a modified audit report effectively acts as a "Warning sign" and reduces litigants' propensity to initiate litigation.

Guiral Contreras et al, (2007) examined the significance of the audit report in loan rating decisions using the belief revision model using an experimental design. They distributed financial statement accompanied Auditors' opinion to 106 loan officers from international financial institutions. The result of survey showed that the qualified audit report appears to be an independent and useful piece of evidence when it is contrary to desirable financial expectations.

Sandra and Whittington (2008) examined how differences in opinions on the material weaknesses identified in the auditor's assessment of the financial statements, and the auditor's assessment of internal control affect investment analysts' assessment of the financial strength of the company and willingness to recommend the stock for purchase to clients after approval of the Sarbanes-Oxley Act. The findings indicated that adverse audit opinions on the effectiveness of internal control result in investment analysts making a higher assessment of company risk, a lower assessment of the strength of internal control over financial reporting, and a marginally significant difference in the likelihood of recommending stock to their client.

Elfouzi and Zarai (2009) examine the effect of the nature of the audit opinion and the reputation of the audit firm on the earnings management we investigate whether abnormal accruals are influenced by modified audit opinions and the presence of auditors Big Four,

they found that the probability to manage earnings management to the increase is related to the issuance modified audit opinion and the presence of No-Big Four auditors.

Hussainey (2009) investigated the impact of audit quality, measured by financial statements audited by the big four accounting firms, on the investors' ability to predict future earnings for profitable and unprofitable firms. And found that investors are able to better anticipate future earnings when financial statements are audited by the big four accounting firms.

O'Reilly (2010) conducted an experimental study to examine whether investors view the going-concern opinion as providing information that is useful in valuing companies' stocks. The results showed that investors perceive the going-concern opinion as relevant for valuing a company's common stock.

Research Methodology and Hypotheses

This is a practical survey that investigates the effect of the qualified audit reports on share prices of the share-holding companies listed in TSE. In order to investigate the influence of Auditors' qualified opinions on share prices and returns, we need to measure changing in share prices and returns as a result of the qualified opinions effect. Data were collected from TSE reports.

Based on the previous studies and research problem, the following hypothesis was postulated in this study.

H1: The qualified audit report has significant effect on share prices of the listed companies in TSE.

H0: The qualified audit report has no significant effect on share prices of the listed companies in TSE.

Sampling

In this study, we examined the effect of qualified audit opinion on share prices and returns for share-holding companies listed in TSE during 2004-2008 (1383-1387 Hejri Shamsi).

For sampling between listed companies in TSE, the

companies which had following features were selected:

- 1) Have the same fiscal year (according to Hejri Shamsi)
- 2) Available share prices for a 5 year's period
- 3) Have qualified audit report for a 5 year's period

Variables and Research Model

This study tries to examine whether the audit report has information content as same as financial statement. It is necessary to survey the share prices and returns changes created by audit report so as to examine their reactions against auditors' opinion. So, first we should choose a suitable date to peruse the effect of audit report on share price. Balance sheet's date in Iran is often 19 March that is not a convenient date because auditing process will continue after that and we are not able to survey the effect of audit report. The date in which audit process complete is not so, same as the time of writing the report and is not good too. Also, in the date of writing the report, it is not public yet. So, the best date for testing hypothesis is the declaration date of audited financial statements that the result of audit process announces to public and can influence on share prices.

It is necessary to measure the share price changes on the date of audit report declaration in order to determine the effect of the qualified audit reports on share prices and returns. Existence of an abnormal return on that date is the consequence of information content of the qualified audit report. If there is no abnormal return, then there is no information content of the qualified audit report.

The following equations were used so as to analyze the collected data:

Actual return

Actual stock returns of the companies were calculated using the following formula:

Where:

$R_{i,t}$ - actual return of stock i on day t

$P_{i,t}$ - closing price of stock on day t

$D_{i,t}$ - dividends on stock i on day t

$P_{i,t-1}$ - closing price of stock on time $t-1$

Because of the time differences of dividends declarations and the unavailability of these dividends, the following formula will be used in calculating actual stock returns:

Return on the Market Portfolio

The returns on the market portfolio were calculated using the following equation:

Where:

$R_{m,t}$ - return on the market portfolio

$MPI_{i,t}$ - market price index on day t

$MPI_{i,t-1}$ - market price index on day $t-1$

Regression line parameters ()

The stocks prices and indices during the estimation period which is 100 days were used. The regression line parameters () for each company indicate in Appendix.

Expected Return

The expected returns $R_{i,t}$ were calculated using the following formula:

Where:

$ER_{i,t}$ - return on share (i) on time (t)

- Constant

- Systematic risk (b) of stock i

$R_{m,t}$ - return on market portfolio.

Abnormal Return

Abnormal return (unexpected return) was calculated as actual return minus expected return:

Arithmetic Mean of the Abnormal Return

The daily arithmetic mean of the abnormal (unexpected) return for the sample was calculated using the following equation in order to avoid the effect of noise surrounding share price movement:

$AAR_{i,t}$ - average abnormal return of stock i on day t
 n - Number of firms.

The Cumulative Average Abnormal Return (CAAR)

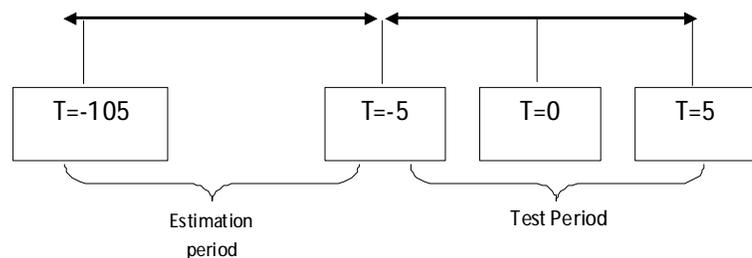
CAAR was calculated in order to find the total effect of the qualified auditor's opinion during the period surrounding the issuance of the audit report:

In this research, t-test was used so as to test the research hypothesis.

Estimation and Test Periods

The estimation period used to estimate the parameters of the regression line to calculate the expected returns including a period of 100 day before the starting date of the test period. The test period is 11 including 5 days before and after the date of disclosing the financial statements that is a reasonable period. The following chart shows the estimation and test periods.

Chart1. Estimation and test periods



Results of the Study

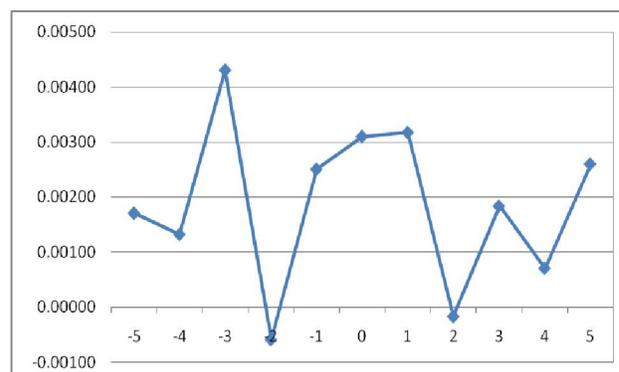
As mentioned above, Arithmetic mean of the abnormal return (AAR) was used in order to investigate the effect of qualified audit report on share prices and returns, table1 shows in test period and before and after audit report announcement day that some of the AAR is positive and others are negative. This means that there is no clear pattern of stock reactions. Also, according to test results, p-scores for test period (11 days) are more than 0.05. It means that so in Confidence level of 95%, the main hypothesis cannot be accepted. In other words, the effect of the qualified audit reports on share prices and returns is not significant during all days of the event period. The conclusion conforms to the Martinez et al, (2004).

Table - 1 T-test results of the average abnormal return during the test period

Sig	SD	AAR	Days
0.9913	0.001897	0.001711	-5
0.3409	0.002975	0.001326	-4
0.9772	0.005381	0.004306	-3
0.512	0.002238	-0.000582	-2
0.9706	0.001244	0.002508	-1
0.4129	0.00206	0.003102	0
0.496	0.001658	0.003174	1
0.5557	0.003135	-0.000164	2
0.0392	0.001798	0.001838	3
0.0122	0.001559	0.000711	4
0.9808	0.001285	0.002603	5

Chart 2 presents the pattern of the AAR during the test period. The Chart shows that the AAR is changing before and after the announcement's date without a specific pattern. This is the consequence of some negative and positive signs before and after announcement day.

Chart-2 AAR's pattern during the during the test period



As indicated in Table 2, the p-value for AAR is 0.6026. It means that there is no significant difference between the days of the test period in the effect on share prices and returns.

Table-2. T-test results for the daily average abnormal return

	N	Mean	SD	Sig
AAR	11	0.001867	0.00148	0.6026

As noted in the methodology section, in order to avoid the noise surrounding the announcement date, the cumulative average abnormal return (CAAR) is calculated and tested by T-test. Table 3 indicates that p-score for CAAR in test period and for all companies is 0.8443 that is greater than 5%. So conform to previous results, in Confidence level of 95%, the hypothesis cannot be accepted.

Table3. T-test results for the CAAR for all companies for the test period

	N	Mean	SD	Sig
CAAR	103	0.001867	0.00148	0.8443

Summary and Conclusions

Audit report, is the result of auditing process and actually auditor's opinion about conformity of financial statements with generally accepted accounting

principles and correlation between auditor and financial statements' users. Auditors' opinion can be evaluated by the amount of effect on decision making. However several researches were done about influence of audit report on decision making process, but there is no obvious conclusion about that.

In order to determine the effect of the qualified audit reports on share prices and returns, the researchers used a market-based study for five years (2004-2008). The changes in share prices and returns during the test period which represents one week before and another after the announcement's date were measured and analyzed. If there is an abnormal return on that date or around it, it could be a sign of existence of information content of the qualified audit report and unless there is abnormal return, lacking of information content could be demonstrated.

Results of the study Shows that some of the Arithmetic mean of the abnormal return before and after announcement's date are positive and others are negative without any pattern. also, results of p-values in Confidence level of 95% indicates that there is no clear or significant effect of the qualified audit opinion on share prices and returns on the date of the announcement. So the main hypothesis of the survey (H1) is not accepted. This conclusion may suggest that the audit reports' users do not perceive their information or appreciate its value.

Recommendations

Researcher suggest that this kind of studies extend for other types of reports or maybe compare all kind of reports for their effect on share price and returns. In addition, due to survey's conclusion, examining the confidence of users about audit report might be helpful, because one of the reasons for lack of information content of audit reports may be misgiving of users about auditing process. Also, users need to be educated about audit reports' role in their decision making.

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