

A survey on relationship between reported condition note in audit report and stock returns of firms in Tehran Stock Exchange

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ABSTRACT

Dividend yield plays an important role for decision-making in the stock market. Stock returns alone are informational content used by investors in financial analysis and forecasting. The purpose of the current study is to evaluate the effect of different types of notes and conditions on the performance audit report on the Tehran Stock Exchange over the period 2005-2011 for 65 selected firms. We have used statistical tests to examine the effects of disagreement, restriction and ambiguity issued by auditors. The results show that there is no relationship between stock returns and audit reports provided and capital market does not respond to the audit report. This could be due to unfamiliarity with the terminology of the users of the audit report to be audited.

1. Introduction

Most investors use financial reports to predict outlook and in case auditors make some limitation or ambiguity in qualified audit report, they may take a closer look at reports especially when there are some correlations between conditions and firms' returns (Craswell et al., 2000). Some of the warnings issued by auditors could be changed to some alarming news, which could influence financial statements, significantly. Balvers et al. (1988) investigated on underpricing of new issues and the choice of auditor as a signal of investment banker reputation. Beattie and Fearnley (1995) studied the importance of audit firm characteristics and the drivers of auditor change in UK listed companies. Casterella et al. (2000) modeled the audit opinions issued to bankrupt companies based on a two-stage empirical analysis. Choi and Jeter (1992) investigated the impacts of qualified audit opinions on earnings response coefficients. Lenard et al. (2001) presented a decision-making capabilities of a hybrid system applied to the auditor's going-concern assessment.

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According to Cullinan et al. (2012) many companies have learned to report positive information more quickly than they report negative news. They studied the potential impact of audit opinion change on the timeliness of financial disclosures, with improvements in audit opinion considered to be “good news.” They used both the direction and the magnitude of audit opinion change, with magnitude measuring how far the idea was from an unqualified opinion. They reported that firms experiencing an improvement in their audit opinions could disclose their financial results faster and these effects were associated with the magnitude of the opinion change. What's more, there was an asymmetric response to good audit opinion news vs. bad audit opinion news, with bad audit opinion news having a larger effect on earnings timeliness than the impact on earnings timeliness of good audit opinion news. Based on their survey, results support the “good news early, bad news late” notion. They concluded that overall earnings timeliness had improved in China since the enactment of new reporting regulations in 2006.

Bhimani et al. (2009) investigated the impact of the independent auditor's going-concern evaluation by studying default following the release of the auditor's report. They implemented a proprietary sample maintained by the Portuguese Central Bank on 12,199 audit reports associated with nearly 2000 firms, which were liable by law to have their accounts audited on an annual basis. Investigations on robustness across various asset classes, age, industries, and regions indicated that firms received a going-concern opinion on average default more than those that receive a clean opinion.

Autore et al. (2009) investigated the relationship between information uncertainty and auditor reputation revealed by the failure of Arthur Andersen (AA). AA's reputation deteriorated substantially when it announced on January 10, 2002, that it had shredded documents associated with its audit of Enron. Autore et al. (2009) reported that on these dates the clients of AA and other Big Five auditors that were characterized by higher information uncertainty experience larger share price declines compared with clients with lower information uncertainty. The findings recommended that the market relied more heavily on auditor reputation for higher information uncertainty firms, which implied that the value of an audit was greater when a firm was harder to value. Their results marked the importance of information uncertainty in financial markets: where there was a shock to auditor reputation, firms with greater information uncertainty could suffer the largest losses.

Ashbaugh-Skaife et al. (2007) implemented internal control deficiency (ICD) disclosures before mandated internal control audits to study economic factors, which expose firms to control failures and managements' incentives to discover and report control problems. They reported that, relative to non-disclosers, firms disclosing ICDs had complex operations and organizational changes, bigger accounting risk, more auditor resignations and had fewer resources available for internal control.

In this paper, we study the impacts of three kinds of notes on financial performances on some selected firms in Tehran Stock Exchange. The organization of this paper first presents details of the survey in section 2 and section 3 presents details of the hypotheses and the results. Finally, concluding remarks are given in the last to summarized the contribution of the paper.

2. The proposed method

The proposed study of this paper considers selected firms whose stocks were actively traded over the period of 2005-2010 but we do not include holding firms and they must have equal fiscal year starting from March. In addition, any interruption in stocks' trades must not take more than three months and, at least, the stock shares must be traded, at least, 70 business days and all necessary information must be publically available. Based on these conditions, we have selected 65 companies for this study. Table 1 shows some basic statistics associated with the data.

Table 1

Basic statistics associated with firms some disagreements in their reports

Firms' return	min	max	mean	Std dev.	Skewness	Kurtosis
With agreement	-8.61	12.79	41062	4.86	-0.11	0.41
With disagreement	-15.92	7.90	0.92	4.69	-1.55	0.41

Number of observations = 32

Table 2

Basic statistics associated with firms some restricting conditions in their reports

Firms' return	min	max	mean	Std dev.	Skewness	Kurtosis
Acceptable	-12.80	12.79	0.55	5.04	0.50	0.30
With some restrictions	-7.68	11.16	0.24	4.14	0.50	0.45

Number of observations = 21

Table 3

Basic statistics associated with firms some vague remarks in their reports

Firms' return	min	max	mean	Std dev.	Skewness	Kurtosis
Acceptable	-12.80	12.79	0.55	5.04	0.50	0.30
With vague notes	-7.68	11.16	0.24	4.14	0.50	0.45

Number of observations = 12

Based on the results of Tables 1-3, we can conclude that the number of firms received condition or restrictions have been reduced. However, we see a reduction in their returns as well. The proposed study of this paper investigates whether there is a difference between the returns of firms whose annual reports are accepted with no conditions and those whose annual reports are met with some disagreements, restrictions or some ambiguities. Next, we present details of hypotheses along with statistical observations.

3. The results

As explained earlier, we study the relationship between auditors' concerns on financial reports.

3.1. The first hypothesis: The relationship between disagreement and financial reports

The first hypothesis of this survey is associated with disagreement issue in financial reports.

$$\begin{cases} H_0: & \text{There is no difference between the return of firms with no agreement and firms with some disagreements.} \\ H_1: & \text{There is a difference between the return of firms with no agreement and firms with some disagreements} \end{cases}$$

In our survey, Pearson correlation value is equal to 0.02 and p-value is equal to 0.91 when the number of observations is equal to 32. Therefore, we do not have enough evidence to believe that there is any difference between the return of two groups of firms and we can conclude that there is no difference between return of firms with no agreement and firms with some disagreements. Now, there are cases where some firms receive some disagreement and these issues are resolved in the following year.

Table 4

The results of testing the hypothesis: Difference between firms' returns after disagreement is resolved using paired differences

Mean	Standard Deviation	Deviation from mean	95% Confidence limit		t-student	P-value
			Lower limit	Upper limit		
1.14	6.69	1.18	-1.27	3.55	0.96	0.34

Degree of freedom = 31

We wish to know whether there is any difference between the return of these firms when they receive disagreement and the return of these firms after one year when the disagreement is resolved. Therefore, the null hypothesis is that such difference does not exist. Table 4 demonstrates the results of our survey. As we can observe from the results of Table 4, we cannot reject the null hypothesis and conclude that the return could be improved when disagreement is resolved.

3.2. The second hypothesis: The relationship between restriction issues and financial reports

The second hypothesis of this survey is associated with restriction issue in financial reports.

$$\begin{cases} H_0 : \text{There is no difference between the return of firms with no restriction and firms with some restrictions.} \\ H_1 : \text{There is a difference between the return of firms with no restriction and firms with some restrictions.} \end{cases}$$

In our survey, Pearson correlation value is equal to -0.26 and p-value is equal to 0.23 when the number of observations is equal to 21. Therefore, we do not have enough evidence to believe that there is any difference between the return of two groups of firms and we can conclude that there is no difference between return of firms with no restrictions and firms with some restrictions.

Now, there are cases where some firms receive some restrictions and these issues are resolved in the following year. We wish to know whether there is any difference between the return of these firms when they receive restrictions and the return of these firms after one year when the restriction is resolved. Therefore, the null hypothesis is that such difference does not exist. Table 5 demonstrates the results of our survey.

Table 5

The results of testing the hypothesis: Difference between firms' returns after restriction is resolved using paired differences

Mean	Standard Deviation	Deviation from mean	95% Confidence limit		t-student	P-value
			Lower limit	Upper limit		
0.30	7.34	1.60	-3.03	3.64	0.19	0.85

Degree of freedom = 20

As we can observe from the results of Table 5, we cannot reject the null hypothesis and conclude that the return could be improved when restriction is resolved.

3.3. The third hypothesis: The relationship between ambiguities and financial reports

The third hypothesis of this survey is associated with the existence of some ambiguities in financial reports.

$$\begin{cases} H_0 : \text{There is no difference between the return of firms with no ambiguity and firms with some ambiguities.} \\ H_1 : \text{There is a difference between the return of firms with no ambiguity and firms with some ambiguities.} \end{cases}$$

In our survey, Pearson correlation value is equal to 0.12 and p-value is equal to 0.71 when the number of observations is equal to 12. Therefore, we do not have enough evidence to believe that there is any difference between the return of two groups of firms and we can conclude that there is no difference between return of firms with no ambiguity and firms with some ambiguities. Now, there are cases where some firms receive some ambiguities and these issues are resolved in the following year. We wish to know whether there is any difference between the return of these firms when they receive ambiguities and the return of these firms after one year when the ambiguity is resolved. Therefore, the null hypothesis is that such difference does not exist. Table 6 demonstrates the results of our survey.

Table 6

The results of testing the hypothesis: Difference between firms' returns after ambiguity is resolved using paired differences

Mean	Standard deviation	Deviation from mean	95% Confidence limit		t-student	P-value
			Lower limit	Upper limit		
-0.82	2.92	0.84	-2.68	1.04	-0.97	0.35

Degree of freedom = 31

As we can observe from the results of Table 6, we cannot reject the null hypothesis and conclude that the return could be improved when ambiguity is resolved.

4. Conclusion

In this paper, we have presented an empirical study to measure the relationship between auditors' concerns including disagreements, on financial performance. The first hypothesis of this survey is associated with disagreement issue in financial reports. Pearson correlation value was equal to 0.02 and p-value was equal to 0.91 when the number of observations was equal to 32. Therefore, we did not have enough evidence to believe that there was any difference between the return of two groups of firms and concluded that there was no difference between return of firms with no agreement and firms with some disagreements.

We also concluded that the return did not improve when disagreement was resolved in the following year. The second and the third hypotheses examined the impacts of restriction an ambiguity with returns and reached the same conclusion. In other words, we did not see any meaningful change on firms' returns after these two issues are resolved.

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