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The Effect of Audit Report Type and Audit Report Paragraphs on Abnormal Stock Return Using Earnings Response Coefficient Model

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ABSTRACT

Abnormal stock return is the difference between actual and expected return of one share and there are many researches which are investigated to determine effective factors on abnormal stock return acquisition. Earning response coefficient model is a criterion for stock market reaction to unexpected earnings and effective factors on stock return. The main purpose of this research is to investigate the effects of audit report types, pre-opinion paragraphs, special emphasis paragraphs, and other explanatory paragraphs on financial statements quality using earning response coefficient model. In fact, market reaction to adjusted audit report and explanatory paragraphs are also investigated. The research period is from 2010 to 2017 and the sample consists of 107 companies listed on Tehran Stock Exchange. The results of multiple regression analysis show that there is a significant relationship between abnormal stock return acquisition and unexpected earnings and also with the number of pre-opinion paragraphs. However, audit report type, special emphasis paragraphs and other explanatory paragraphs have no effect on financial statements quality and abnormal stock return acquisition.

Keywords:

Audit Report Type, Audit Report Paragraphs, Financial Statements Quality, Earning Response Coefficient

1. Introduction

Decision-making process is the most important part of investing procedure where the investors attempt to maximize their benefits and wealth. In order to obtain best decisions, it is important to have timeliness information. In stock market, investors' decisions may affect by some resources such as media news, analysts information and corporate financial reports. Moreover, positive and negative information about one share may leads to various reactions of investors and abnormal return acquisition (Nazaraliloo and Zamani, 2016). Abnormal return is the difference between actual return and expected return of one share. In many researches, the earning response coefficient model is used to assess the market reaction to unexpected earnings and effective factors on stock return and also this model is a measurement for financial statements' quality.

Balsam et al. (2003) believe that there is a positive relationship between earning response coefficient and earning quality and auditor can detect and prevent earning management, therefore, the quality of financial statement will increase. Chen et al (2000) and Chow and Rice (1982) show that investors reaction to adverse audit opinion is negative and these kind of reports are bad news about company's performance. They believe that investors prefer unqualified audit reports and this kind of report convey good news about company's performance. Moreover, publishing good news and bad news about firms has effect on stock price and the volume of transactions. Sweeney (1994) states that based on signaling theory, companies are required to do auditing with high quality. In this case, market perception of audit quality in one company may affect the stock price and managers try to ensure investors about their benefits. Thus, according to signaling theory, request for high quality audit is increased and also the quality of earning is increased. Positive effects of high reliability of financial reports which are signaling to the market propose the positive relationship between stock market price and audit quality (Okolie, 2014).

Soltani (2002) believes that companies with unqualified audit opinion report their earnings more quickly compare to companies with adjusted audit opinion. Thus, changing the audit opinion will affect the market and audit opinion enhancement has positive effect on stock price and the volume of transactions. Therefore, the main objective of this research is to investigate the effect of audit report type, pre-opinion paragraphs, special emphasis paragraphs, and other explanatory paragraphs on financial statements quality through abnormal stock return acquisition using earning response coefficient model. In fact, this study attempts to ascertain whether market reaction to publishing adjusted audit report or explanatory paragraphs is rational. In next sections, the relevant literature and conceptual framework to develop research hypotheses are discussed. Then, the research methodology including research population and sample selection are explained. The research results are analyzed in next section and finally the conclusions of study and suggestions for future researches are discussed in final section.

2. Conceptual Framework and Literature Review

According to Auditing Standard No.700, auditors are responsible to assess the adequacy of accounting procedures disclosure, coordination of accounting procedures with accounting standards, rationality of accounting estimations by management, reliability and comparability of information provided in financial statements and the adequacy of information revealed in financial statements to help users. In fact, the auditor should provide unqualified opinion, when financial statements are favourable and from all important aspects are prepared according to accounting standards. According to the audit standard No. 705, the purpose of the auditor by providing adjusted audit report is to express that based on the evidence, financial statement is not free of material misstatements or the auditor is unable to obtain sufficient and suitable evidence to conclude about the favourability of financial statements. In other words, the adjusted audit report represents a doubt about the information content of financial statements and allows the users of financial statements to be aware about the existence of a risk in financial statements (Chen et al., 2014). Fields and Wilkins (1991) argue that the auditors' motivation to publish a qualified report is to express their doubts about the truthfulness of management claims and prevent lawsuits that may be brought against them by external users. In other words, qualified audit reports tell the users that there is an abnormal risk associated with the accuracy and quality of information in financial statements.

In addition, according to the audit standard No. 706, the purposes of auditors from placing special emphasize paragraphs and other explanatory paragraph is to attract the attention of users to the issue that, in spite of the appropriate disclosure in financial statements, it is important to understand by users. If the auditor has ambiguity about future consequences of unusual legal claims or specific actions of regulatory authorities, or an event that has a major impact on financial status of the business unit or other significant uncertainty about the persistence of firm's activity, the special emphasize paragraph must be used. Moreover, the auditor can only use other explanatory paragraphs in his report when financial statements are prepared with specific purposes and the use of them to the public has limitations. Audit standard No. 706 emphasize that the multiplicity of special emphasize paragraphs reduce the information effectiveness of these issues, and thus, the auditors

should avoid presenting these paragraphs in their report as far as possible. Feng et al. (2016) argue that during financial crisis, auditor become more conservative and publish more adjusted audit report and attempt to aware users that there is an unusual risk about quality of financial statements' information with giving qualified audit opinion.

The value of audit report information has been the interest of researchers for about 30 years. Particularly after year 2001, the audit profession has been under high pressure and investors expect the auditors to provide warning signs in their report (Geiger et al., 2005) in order to estimate the risks and make rational decisions regarding the maintenance or sale of their shares by investors and users of financial statements. Choi and Jeter (1992) compare the earnings response coefficient for the three months prior to the announcement of audit report and three months after publishing qualified audit report for investigating the effect of qualified audit report on earnings response coefficient. They conclude that earnings response coefficient after qualified audit report is smaller than the earnings response coefficient prior to the qualified audit report. They argue that if there is a major uncertainty about reported earnings, the market sensitivity will be reduced to the announcement of earnings. This study revealed that market sensitivity to the declaration of earnings decreases significantly after the publication of the qualified audit reports. Thus, the audit reports will reduce the market sensitivity to the announcement of earnings by changing market perception of earning or persistence of earning or both. As a result, the earnings response coefficient also will be decreased.

Teoh and Wang (1993) believe that if audit quality is perceived as high level by shareholders, they can respond quickly to the reported earnings and earnings response coefficient will be increased. Furthermore, Teoh and Wang (1993) argue that the earnings response coefficient is different between large and small audit firms, as earnings response coefficient is significantly greater in Big 8 compare to small audit firms. Balsam et al. (2003) conclude that customers who have industry specialization auditors have a higher earnings response coefficient than customers who have no industry specialization auditors. Malek and Saidin (2014) conclude that the earnings response coefficient for the companies that change their auditor is higher than the companies that do not change their auditor. Okolie (2014) argues that there is a significant relationship between audit quality and earnings response coefficient, but according to the results of Du and Zhou (2014), in the United States, the earnings response coefficient of firms audited by big audit firms is higher compared to other firms, but this result is weaker in China.

In Tehran Stock Exchange, Khajavi and hoseininiya (2014) examine the relationship between audit quality and earnings response coefficient and the results indicate that there is a significant negative relationship between audit tenure and earnings response coefficient, meaning that, as auditor tenure increases, earnings response coefficient decreases. The results also indicate that there is no significant relationship between the size of the audit firm and earnings response coefficient. The results obtained from the study of Poorzarandi et al. (2012) show that there is a negative and significant relationship between earning management and earnings response coefficient and earnings response coefficient in firms that manipulate earning is higher than those that do not manipulate earning. Hajiha and Ebrahimi (2016) conclude that the type of audit opinion has a positive relationship with the stock price and volume of transactions, as well as improving the auditors' opinion positively affect the stock price and volume of transactions. Moreover, bens et al (2019) examined the usefulness of changes in the form of the external audit report after adaption of ISA 700 in UK. They predicted that the adaption of new rule in the UK leads to audit reports which are perceived as more useful by stock market participants. They found that financial reporting quality appears to improve in the new rule; lower discretionary accruals; a higher perception of earnings quality by an independent financial firm; fewer accounting restatements; and a higher likelihood of a going concern opinion. Also, following the concern about this issue that audit reports do not contain sufficient variation to provide useful information to the market, Kaplan et al (2019) investigated whether information uncertainty is affected by three different types of audit reports. They found that audit report type and audit report disclosures provide useful information to the market by finding a significant reduction in information uncertainty.

Reviewing the literature shows that the impact of audit report type and different paragraphs before and after audit opinion paragraphs on stock abnormal return is rarely investigated and some studies only investigated the effect of the type of audit report on stock prices. Therefore, due to the importance of different explanatory paragraphs in audit report that auditors using them attempt to inform users about the problems in financial statements, in this research this issue is investigated. Therefore, in order to investigate the effect of audit report type and different audit report paragraphs on financial statements' quality among companies listed on Tehran Stock Exchange, the research hypotheses are as follows:

H_1: There is a significant relationship between audit report type and financial statements' quality using earning response coefficient model. **H_2:** There is a significant relationship between the number of pre-

opinion paragraphs and financial statements' quality using earning response coefficient model.

H3: There is a significant relationship between special emphasis paragraphs and financial statements' quality using earning response coefficient model. **H4:** There is a significant relationship between other explanatory paragraphs and financial statements' quality using earning response coefficient model.

3. Methodology

This research is an applied and a post-event research type because past information is used to test hypotheses. Multiple regression models are used to analyze the data using Eviews software. The research population is all companies listed on Tehran stock exchange during 2010 to 2017 and research sample includes 107 companies from different industries. In order to choose samples, purposeful *sampling is used.* This means that companies considering the following features are selected:

- Selected companies are not financial institutions, banks and leasing.
- They listed on Tehran Stock Exchange until the end of 2017.
- During the research period their stock trading has not stopped more than 6 months.
- In terms of increase comparability, their fiscal year ends to march.

Based on these limitations, 107 companies are selected as research sample and the research data are collected using Rahavard Novin database and www. Codal.ir website. The research model is as follow:

$$AR_{it} = \alpha_0 + \alpha_1 UE + \alpha_2 AUDOPN + \alpha_3 AUDATT + \alpha_4 AUDEMP + \alpha_5 AUDOTH + \alpha_6 \frac{B}{M} + \alpha_7 INFA + \alpha_8 LEV + \alpha_9 LOSS + \alpha_{10} MKT + \alpha_{11} ROA + \alpha_{12} SIZE + \alpha_{13} TURN + \alpha_{14} BIGAUD + \varepsilon$$

Where:

Abnormal return (AR) is dependent variable and it is measured by the difference between actual return and expected return of one share. Usually there are different models for calculating expected return of one share. In this research, the adjusted market return model is used. Based on this model, it is suggested that market expected return is same as market return for all securities (Moradi et al. 2010):

$$E(R_{it}) = E(R_m)$$

Therefore, abnormal return is calculated as follows:

$$AR_{it} = R_{it} - R_m$$

And also, market return is calculated as follows:

$$E(R_m) = \frac{I_1 - I_0}{I_0}$$

Where:

I_0: Total market share index at the beginning of year

I_1: Total market share index at the end of year

Moreover, actual return of one share is calculated as follows:

$$R_{it} = \frac{P_1(1+\alpha) + D - [P_0 + \alpha(1000)]}{P_0 + \alpha(1000)}$$

Where:

R_{it}: Return of share i in year t

P_1: Share price at the end of year t

D: Dividend of pare share P_0: Share price at the beginning of year t

α: Stock increase percentage

Unexpected earnings (UE) is independent variable and it is the difference between earnings per share of this year (t) and earnings per share of last year (t-1) and for scaling the variable it is divided by market per share at the end of last year.

$$UE_{it} = \frac{EPS_t - EPS_{t-1}}{MPS_t}$$

Where:

EPS_t: Earnings per share i in this year

EPS_{t-1}: Earnings per share i in last year

MPS_t: Market per share i in this year

Audit report type (AUDOPN) is independent variable and it is a dummy variable taking a value of 1 if audit report is qualified report and 0 if audit report is unqualified report.

Pre-opinion paragraph (AUDATT) is independent variable and it is calculated by the number of paragraphs before opinion paragraph.

Special emphasize paragraph (AUDEMP) is independent variable and it is calculated by the number of special emphasize paragraphs after opinion paragraph.

Other explanatory paragraph (AUDOTH) is independent variable and it is calculated by the number of other explanatory paragraphs.

Control variables are:

Firm size (SIZE): log of total assets

Leverage (LEV): total liabilities divided by total assets

Auditor switch (TURN): it is a dummy variable taking a value of 1 if audit firm is changed and 0 otherwise.
Loss (LOSS): it is equal 1 if the firm has loss and 0 otherwise.
Market value of firm (MKT): log of market value of firm at the end of year.
Audit firm size (BIGAUDIT): it is equal 1 if the audit firm is audit organization and 0 otherwise. **Return on assets (ROA):** net profit divided by total assets.
Market value to book value (B/M): market value of firm divided by book value of firm. **Inflation index (INFA):** inflation index.

4. Data Analysis and Research Results

4.1. Descriptive Statistics of Variables

Table 1 shows the descriptive statistics of research variables.

Table 1: Descriptive Statistics of Research Variables

Variables	Mean	Max	Min	SD
AR	0/147	7/51	-1/406	0/938
UE	0/012	4/798	-4/115	0/460
AUDOPN	0/546	1	0	0/498
AUDATT	1/481	16	0	1/942
AUDEMP	1/274	9	0	1/416
AUDOTH	0/557	9	0	1/019
LEV	0/638	3/06	0/013	0/30
MKT	11/935	14/19	10/04	0/78
ROA	0/104	2/10	-0/492	0/16
SIZE	13/996	19/15	10/03	1/58
B/M	0/440	7/82	-17/04	1/34
INFA	0/194	0/347	0/09	0/092
BIGAUD	0/21	1	0	0/40

Source: Compiled by author

As table 1 shows abnormal return is between -140% to 751% and the mean is 14% during the financial period and companies have 1% unexpected earning. Moreover, 55% of companies received adjusted audit opinion and the mean for pre-opinion paragraphs is 1. The maximum of special emphasize paragraph is 9 and the mean is 1. Moreover, 21% of companies are audited by audit organization and firm's liabilities are 63% of firm's assets and average return of companies is 10%.

4.2. Testing Research Hypotheses

4.2.1. Testing Assumptions of Regression

To analyse research data, assumptions of multivariable regression model are investigated through normality test, multicollinirity test and variance homogeneity test which confirm the assumptions of the classical model. First, for the purpose of testing the normality of the data, the Jarque-Bera test is used. According to the results of this test, the Jarque statistic with a probability of 0.00 indicates that data is normal. Also, Brosh-GadFerry test is used to detect heterogeneity of variance. The results of this test show that the variances are heterogeneous. The Brosh-GadFerry test is also used to test the multicollinirity between variables. If the probability value is more than 5%, then the assumption zero of the test for multicollinirity is rejected and, conversely, if the probability of the statistics is less than 5%, multicollinirity is not rejected. Due to the result which is greater than 5% and is 0.146, there is no multicollinirity.

4.2.2. Testing the Type of Data

For determining the type of data, f-limer and hasman test is used. The results show that the data are panel and the fixed effect should be used. Table 2 shows the results of f-limer and hasman test.

Table 2: The results of f-limer and hasman test

Model	Statistic	prob	result
F-limer	2/273	0/00	Panel
Hasman	176/13	0/00	Fixed Effect

4.2.3. Results of Testing Research Hypotheses

For testing research model, F-statistics analysis and for testing coefficient of regression model, tstatistic analyses are used. Moreover, the adjusted R^2 is used to test the relationship between dependent and independent variables. The results of testing hypotheses (multiple regression analyses) are presented in table 3.

Table 3: The results of data analysis for testing research hypotheses

variables	Coefficient	Z-statistic	P-value
c	-17/951	-5/706	0/00
UE	0/189	3/273	0/00

AUDOPN	-0/033	-0/398	0/69
AUDATT	-0/040	2/160	0/03
AUDEMP	-0/044	-1/231	0/21
AUDOTH	0/033	1/075	0/28
B/M	-0/043	-0/909	0/36
INFA	1/745	4/017	0/00
LEV	0/303	1/205	0/228
LOSS	0/045	0/502	0/615
MKT	2/263	5/416	0/00
ROA	-0/328	-1/143	0/253
SIZE	-0/673	-3/037	0/002
TURN	-0/020	-0/370	0/711
BIGAUD	0/136	1/168	0/243
Adjusted R^2: 0/26		Durbin Watson: 2/350	
Prob: 0.00			

Source: Compiled by author

Table 3 shows that the LR is 0 and it is less than 0/05 error level and the research model is meaningful and reliable. Durbin-Watson statistic is 2/35 and it is show that the multicollinearity problem does not exist. Regarding the first hypothesis, based on the results in table 3, the p-value is more than 0.05 (p-value, 0.69) for audit report type. Thus, there is not significant relationship between audit report type and financial statements' quality using earning response coefficient model. Also, regarding the second hypothesis, the pvalue is less than 0.05 (p-value, 0.03) for the number of pre-opinion paragraphs. Thus, there is significant relationship between the number of pre-opinion paragraphs and financial statements' quality using earning response coefficient model. Moreover, regarding the third hypothesis, the p-value is more than 0.05 (p-value, 0.21) for special emphasize paragraphs. Thus, there is not significant relationship between special emphasize paragraphs and financial statements' quality using earning response coefficient model. Finally, regarding the forth hypothesis, the pvalue is more than 0.05 (p-value, 0.28) for other explanatory paragraphs. Thus, there is not significant relationship between other explanatory paragraphs and financial statements' quality using earning response coefficient model. The R^2 is 0.26 which show that 26 percent of changes in dependent variable are explained by changes in independent variables.

5. Conclusion and Suggestions

In this research the effect of audit report type, preopinion paragraphs, special emphasize paragraphs and other explanatory paragraphs on financial statements' quality using earning response coefficient model is investigated. According to signalling theory, receiving positive news and information by market about management performance leads to abnormal return acquisition. Moreover, receiving negative news about management performance leads to negative reaction by market and stock return will decrease. In Iran stock market, financial statements with audit report is an important informational source about companies listed on Tehran Stock Exchange. This information is published at least once a year and many users make decisions based on these information. Thus, the type of published audit report about one company can transfer good or bad news about that company to users of financial reports. If the audit report is unqualified report without any explanatory paragraph, the quality of financial reporting is good and users can make decisions with assurance. Otherwise, if audit report is qualified or adjusted audit report with many explanatory paragraphs, the quality of financial information is under question and the risk will increase and stock return will decrease. In other words, adjusted audit reports convey bad news about the company which will affect the stock price and stock transactions volume.

However, based on results, only the number of preopinion paragraphs has effect on financial statements' quality and audit report type, special emphasize paragraphs and other explanatory paragraphs have no effects on financial statements' quality. In fact, users of audit report with many pre-opinion paragraphs become sensitive about financial statements' quality and consider high degree of risk in their making decision process. Other research results show that users are not sensitive to explanatory paragraphs after opinion paragraph and they are not considers these factors in their decision making process. One reason for this result is that there are lots of adjusted audit reports among companies listed on Tehran Stock Exchange. According to descriptive statistics more than half of published audit reports are adjusted audit report (55%), therefore, these kinds of audit reports are normal for financial statements' users and receiving adjusted audit report does not make users sensitive to the published information. This result is not consistent with Choi and Jeter (1992) who states that in US more than 99% of audit reports are unqualified reports and receiving qualified audit report represent a problem in company's financial statements and make market sensitive to published financial information.

It is expected that companies with less numbers of special emphasize paragraphs and other explanatory paragraphs have more return which is not proved. Maybe, one reason for this result is the auditors' covering needs against probable risks and complaints regarding financial statements. In fact, some auditors attempt to cover their responsibilities with putting more explanatory paragraphs after the opinion paragraph. Therefore, if there is any objection about quality, they can cover themselves. Moreover, based on Mohamadrezaee (2017) results, busy auditors publish unqualified audit report more than other auditors and the numbers of explanatory paragraphs in their report are less than other reports. He concludes that there is not

significant relationship between number of qualified paragraphs and financial statements' quality. In addition, Mohamadrezaee and faraji (2019) believe that investors have not suitable understanding of audit reports and act unprofessionally in Tehran Stock Exchange and this is the reason that audit report type and audit report paragraphs have no effect on abnormal return acquisition. Another reason is that the loan's rate of interest is imperative. In Iran, loan's rate of interest is announced by central bank and private financing is not used by companies listed on Tehran Stock Exchange. Consequently, when banks are required to give loans based on those rates, they do not consider the type of audit report and explanatory paragraphs and equity cost is not affected by risk and has no effect on stock return.

There are inconsistent results about the effect of audit reports on stock price and stock return in Iran. For example, Hajiha and Ebrahimi (2016) and Hasas Yeganeh and Yaghoobimanesh (2000) confirm the relationship between audit report type and stock price but Mahdavi and Ghayorimoghadam (2010) and Moradi et al (2011) reject this hypothesis. Dolatabadi and Jadiri Naghashkar (2015) conclude that although numbers of qualified audit report is more than unqualified audit report, but there is not significant relationship between audit report type and stock turnover. The reason for this inconsistency between different research results is economic conditions in Iran in recent years. Economic condition is not stable and considering the inflation effects may change the results. In fact, based on the results, there is a significant relationship between inflation index and abnormal return acquisition and it is normal that in year 2013 that dollar rate is increased, stock return also is increased abnormally.

Considering the results, it can be recommended to Tehran Stock Exchange in order to give more attention to adjusted audit reports and explanatory paragraphs. In fact, they can consider the paragraphs for confirming the companies' board of directors and financial transparency reports. Moreover, based on Hamidiyan and Taghizadeh (2018), audit quality will increase with investors' protection. It is suggested to consider audit report type and information in paragraphs for audit firms rating by audit organization. In addition, it is suggested to stockholders to obtain knowledge about audit report types and different paragraphs and explanatory information which are published in audit report in order to know about companies' financial statements problems and future risks about their investments. Furthermore, it can be suggested to central bank and other banks to use different interest rate of loan based on assessing firms' risk, their financial statements and also their audit report type and explanatory paragraphs. Therefore, companies with unqualified audit report may have less equity costs and companies with qualified audit report and many paragraphs may fine with higher interest rate and companies may become interested to have reliable financial statements with unqualified audit report.

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