

THE EFFECT OF AUDITORS' REPORT ON STOCK RETURNS: EVIDENCE FROM LISTED ENTITIES IN SRI LANKA

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ABSTRACT

Past literature shows inconsistent results when analyzing the impact on the external auditors' report (AR) and stock returns. Similarly, it was observed that there is less literature that examined the significance of the relationship between each type of five main categories of AR on stock returns. The purpose of this paper is to examine the stock return's reaction to different types of AR in Sri Lanka. The standard event study methodology, aiming on a short event window, was used to determine whether there is a significant reaction in stock returns to the announcement of audit report. The Average Abnormal Returns (AARs) and the Cumulative Average Abnormal Returns (CAARs) were analysed with t-test analyses to test the significance, for the five different categories of AR. The findings show that in the event study that AR with adverse opinion and disclaimer opinion have a significant positive impact on the stock returns where the positive direction is a novel finding which is a significant contribution to the literature. Nevertheless, there were no significant effects found from other opinions. Overall, this analysis concludes that the auditors' report has a less informative value to investors in the Sri Lankan context. The findings of this paper show the value of information content of the auditors' reports to investors, differentiating the various reactions based on each type of audit report issued.

Keywords: Auditors' Report, Stock Returns, Event Study, Sri Lanka

INTRODUCTION

AR is the channel of communication between the external auditor and the users of the financial statements (Al-Thuneibat, Khamees, & Al-Fayoumi, 2008). It will enhance the assurance level of the audited financial statements which provides the basis for investors to make their investment decisions. Since the management is different from the ownership of public limited companies, shareholders are keen on to see whether the financial statements provide actual figures relating to financial position and performance of the company. In order to facilitate such, AR plays a major role. According to Sri Lanka Auditing Standard 705 (SLAuS 705) auditors modify their opinion when they find problematic issues such as scope limitation, going concern ability, uncertainties and disagreement in accounting applications. Hence, theoretically an unmodified opinion (UMO) may provide a positive signal to the investors resulting in a positive market returns and vice versa (Choi & Jeter, 1992).

Even though the AR is a vital document it is doubtful whether the users pay adequate attention to the AR when they are making decisions. Anulasiri et al. (2015) also found that there is less informational value in AR to investors in Sri Lankan Context. Similarly, Gwilliam (1987) argued that a number of studies have suggested that the average investor pays little attention to the AR. Less attention on AR may be the reason for the recent corporate collapses that happened over the globe including Sri Lanka¹. For example, Freddie Mac scandal in 2003 December, American International Group scandal in 2005 can be seen as global failures of the companies in the recent past which provides evidence for the poor attention users pay towards AR.

Although considerable empirical work has been published regarding the relationship between AR and stock returns since 1970 (i.e., Baskin, 1972; Chow & Rice, 1982; Dodd et al., 1984; Dopuch et al., 1986; Elliott, 1982; Firth, 1978; Loudder et al., 1992; Soltani, 2000), the scopes of the above were to examine the audit opinions with going concern issues and modified opinion² as a whole, but not separately. Limited literature was found which examined each type of main five categories of AR to examine the significance of the relationship between each type³ of AR on stock returns. Further, significantly less recent studies were found in connection to the current scope of each type of AR was found. Hence the present study contributes to the literature by investigating the impact of each type of AR on the stock returns in Sri Lanka. It will help the decision makers to take investing decisions based on the AR as it provides a signal to the market representing whether the entity's financial statements are in line with the reporting regulations of the country. Further this study attempts to marginally contribute to the methodological knowledge as well by conducting the event study under Risk Adjusted Return (RAR) model where market models has been used in the literature. Further it addresses the limitations of the previous studies by considering the other price sensitive information which may have an impact on the stock returns such as dividend and right issue announcements.

¹ Trading suspension of Entrust Securities PLC in 2016, Swarnamahal Financial Services PLC in 2018, and PC Pharma PLC in 2018 (Colombo Stock Exchange [CSE], 2019)

² Qualified AR (QAR), Adverse AR (ADAR), and Disclaimer AR (DAR).

³ Unmodified AR (UMO), Unmodified AR with Emphasis of Matter (UEM), Qualified AR (QAR), Adverse AR (ADAR), and Disclaimer AR (DAR).

LITERATURE REVIEW

The Sri Lankan capital market, known as The Colombo Stock Exchange (CSE) has 285 companies listed representing 19 Global Industry Classification Standard (GICS) industry groups as at 30th June 2021, with a market capitalization of Rs. 3,470.24 billion (CSE, 2021). It has been given mixed conclusion by previous empirical studies that Sri Lankan capital market is efficient in the semi-strong form. Dharmasena and Bessler (2004) have studied a fundamental issue related to the efficient price discovery process using time series data from seven international black tea markets including Sri Lanka. Even though it is relating to the commodity market, the result suggests the non-Indian markets including Sri Lanka are both weak-form and semi-strong form efficient.

Samarakoon (2004) investigated autocorrelations of market and industry returns in both short- and long-term holding periods in CSE using a longer sample period to test the efficiency of stock prices. Consistent with observed price reversals in the Sri Lankan market, the long horizon returns exhibit large negative autocorrelations suggesting not only that they are predictable but also that they contain a large mean reverting component. The average predictable variation in 1-4-year returns is 56 percent for market returns, and 49 percent for industry returns. These results rejected the random walk behavior of prices and the weak form market efficiency in the Sri Lankan stock market.

Dissabandara and Perera (2001) have examined the informational content of dividend announcements and test the semi strong form of market efficiency in the Sri Lankan stock market. It asserted that current stock prices reflect not only historical price information but also all publicly available information. This study confirmed that the significant anticipatory response to dividend announcements one week before the event and price adjustment process have been enhanced. Further, delayed market response was also significant and it showed the behavior of the market followers due to information asymmetry or lack of access to new information. Further delayed response on forgone response would be due to lack of capital market education; or in other words financial literacy. Finally, it confirmed that overall samples are not consistent with the semi-strong form of the efficient market hypothesis.

Dharmarathne (2013) has attempted to examine the stock price reaction to subsequent dividend announcements and information efficiency in the CSE with a sample of 61 leading listed companies for the period of 1999-2005. The event study method was used. More specifically, it employs the market model in generating abnormal returns surrounding subsequent dividend announcements. Findings show that there is a considerable informational content of dividend announcements in the CSE as favorable news. In addition, the results in this study too have supported the semi-strong form of EMH, that is, on the average; the stock market adjusts in an efficient manner to new dividend information. Therefore, this study has concluded that on average, Sri Lankan Capital Market is efficient in the semi-strong form sense subsequent to the cash dividend announcements.

Anulasiri et al., (2015) examined the effect of qualified opinion on share prices in Sri Lankan context and the examination was carried out to see whether the Sri Lankan market is efficient in the semi-strong form of the EMH using event study methodology. The result is not consistent with the semi-strong form of EMH and concluded that it is irrational to determine Sri Lankan Capital Market is efficient in semi-strong form of EMH. Hence reviewing the literature, Sri Lankan context did not provide any support for the strong form efficient market, but mixed evidence with weak and semi-strong form efficiencies.

When analyzing the empirical evidences relating to the AR and stock returns, many early studies have been conducted with regard to the auditor's report impact on stock returns. Some of the studies (Baskin, 1972; Chow & Rice, 1982; Dodd et al., 1984; Dopuch et al., 1986; Elliott, 1982; Firth, 1978) were carried out in the markets of Australia, Canada and the United Kingdom, the majority were carried out in the USA market in late nineties. However as per the literature it was found that the results were inconsistent with regard to the impact on audit report and stock returns.⁴ This has been summarized in Annexure 1.

Ittonen (2012) has identified three different approaches used to examine the existence of abnormal stock returns to qualified AR disclosures. Traditional short window event study, long event window approach and indirect approach can be seen as those approaches and the author emphasized strengths and weaknesses in each approach. Firth (1978) examined the relationship between going concern audit opinions with "subject to opinions" and market returns in UK. He found that significant and negative returns after the event day. Chow and Rice (1982) in the context of the US market found that issuing a qualified audit report reveals unfavorable information, which managers intend to hide, and concluded that issuing a qualified audit report has a negative impact on a company's stock price. Elliott (1982) also studied the relationship between qualified reports and the abnormal performance of company share prices and reached the conclusion that for certain types of qualifications expressed, there is a significant drop of company share prices for 45 weeks prior to the announcement of income. When considering the media disclosure of qualifications, it was revealed that media disclosures of "subject to qualified opinions" are associated with significant and negative stock price effects (Dopuch et al., 1986). Gul (1990) has used the experimental approach to investigate the influence of both the unqualified audit reports and the "except for" qualified audit report on the estimated price of shares, and the results have shown that the 'except for' qualified audit reports have a negative influence on the share price. Soltani (2000) examined the relationship between the opinion expressed by a company's auditors and its stock prices in France. The study concluded that significant negative abnormal returns appear in company stocks, for which qualified audit reports have been issued both prior to and following the announcement of their contents, thus proving that those have an informational value to investors. The same stands for "clean" certificates that contain a paragraph with "remarks and notes" with similar content to that of qualified audit reports.

⁴ Negative relationship was found by Firth (1978), Chow and Rice (1982), Elliott (1982), (Dopuch et al., 1986), Gul (1990), Soltani (2000), O'Reilly (2010). No relationship was found by Dodd et al. (1984), Benau (2004), Al-Thuneibat et al. (2008), Moradi et al. (2011), Anvarkhatibi et al. (2012), Samudera (2017), Muslih and Amin (2018), Anulasiri et al. (2015).

Considering US market, 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. Financial analysis in the study estimated significant stock price reductions when the target company received a going concern opinion. This result supports the findings of archival studies that found market reactions to going concern opinions (Jones, 1996). The outcomes showed that investors perceive the going concern opinion as relevant for valuing a company's common stock.

In contrast to the above results, Dodd et al. (1984) had investigated whether announcements of 'except for' audit opinions and disclaimers of opinions affected stock prices, and concluded that many firms experience negative abnormal performance prior to the release of qualified opinions while the public announcements of both 'except for' audit opinions and disclaimer of opinions had little impact on stock prices. The study by Martinez et al. (2004) is one of the first empirical studies that took place in Spain which examined the audit report and their informational content and how it affects decisions of investors. The findings show that the qualified audit reports do not have any informational value to investors and do not affect company stock prices.

When analyzing available literature in the Middle Eastern context, several studies have been conducted in developing countries. Al-Thuneibat et al. (2008) also investigated the effect of the qualified audit reports on share prices and returns in Jordan through the market-based event study method. They concluded that there is no clear or significant effect of the qualified audit opinion on share prices and returns on the date of the announcement or during the measurement window. They also further suggested that the readers of the audit report do not understand its meaning or appreciate its value. Accordingly, there is a need for further educating the users of audit report to appreciate the information content of it. Moradi et al. (2011) investigated the effect of qualified audit reports on share prices and returns in Iran. The market-based study was for five years (2005-2009). The results indicated that there is no clear or significant effect of the qualified audit opinion on share prices and returns on the date of the announcement. Examination of the effect of AR on share prices and returns in Tehran Stock Exchange (TSE) by Anvarkhatibi et al. (2012) during the period 2002-2008 found that there is no significant relationship between auditor's opinion and stock returns and concluded that, there is no information content of the audit opinion in decision making.

Evaluating the Asian results of developing countries, Samudera (2017) examines the effect of investors' reaction towards the issuance of modified audit opinion. The research used 56 sample companies listed in Indonesian Stock Exchange from year 2010 until 2015. The stock return was calculated by using abnormal returns, meanwhile trading volume was calculated by using abnormal volume. The regression result showed that there was significant market reaction relating to the issuance of modified audit opinion when measured by abnormal volume. The significant reaction occurred on the day after the issuance of modified AR. However, there was no significant impact when measured by using abnormal return.

Muslih and Amin (2018) examined the Indonesian context and showed that the influence of audit opinion on stock prices is not significant. Reports of the audit results turned out to be underutilized by potential investors in the decision-making process and it does not provide useful information to potential investors. Further they emphasized that this situation may be due to the condition of the Indonesian stock market where most of the potential investors do not understand the meaning of the auditor's opinion. Conversely, corporate earnings have a very significant effect on stock price movements.

Anulasiri et al. (2015) examined the effect of qualified opinion on share prices in Sri Lankan context and the examination was carried out to see whether the Sri Lankan market is efficient in the semi-strong form of the EMH. Only the first-time qualification of listed companies in the CSE during 2010- 2014 were examined in the study and concluded that there is no significant effect of qualified audit report on share prices and returns. Similar results were found by Wickramasingha and Nanayakkara (2015) upon investigating different opinions in manufacturing sector in CSE during the time period of 2008 to 2013. However the study was limited to one sector in CSE which comprised only 31 companies.

RESEARCH METHODOLOGY

Considering the methodology, this study investigates the impact of each type of AR on stock returns in Sri Lanka. As mentioned in the previous studies, standard event study methodology has been used to investigate the relationship between Auditors' Report on stock returns. Hence, appropriate parameters of these local empirical studies were adjusted when required to match the event study methods to present this study.

EVENT STUDY METHODOLOGY

The standard event study methodology is used to evaluate the reaction of the stock returns to AR publication announcement. It is based on the work of Brown and Warner (1980, 1985) and Campbell et al. (1997). Defining the event, selection of event, investigation, and estimation windows will be discussed in detail under this section. Table 1 shows the selection of expected return model, event date, selection of event window, and estimation period used in previous studies.

Table 1: Event Study Methodologies used in testing AR and Stock Returns.

Author (s)	Expected Return Model	Event date	Event window in days	Estimation Period	Type of data used
Soltani (2000)	Market Model	15 days before the AGM	(-30 to +30)	120 days	AARs & CAARs calculated on daily stock prices.
Al-Thuneibat et al. (2008)	Market Model	AR upload date to Amana Stock Exchange	(-7 to +7)	100 days	AARs & CAARs calculated on daily stock prices.
Moradi et al. (2011)	Market Model	Date of disclosing the financial statements	(-5 to +5)	100 days	AARs & CAARs calculated on daily stock prices
Ianniello and Galloppo (2015)	Market Model	AR signing date by auditors	(-1 to +5), (-1 to +3), (-1 to +1), (0 to 0)	120 days	AARs & CAARs calculated on daily stock prices
Anulasiri et al. (2015)	Market Model	Following working date to the submission of annual reports to CSE	(+ 4 to -4)	60 days	AARs & CAARs calculated on daily stock prices
Salim (2016)	Market Model	Date of disclosing the financial statements	(+10 to-10)	110 days	AARs & CAARs calculated on daily stock prices

UMO being a positive signal to the market is assumed to have a positive stock return. A clean opinion will reflect a clear presentation of financial statement of an entity which will encourage investors to react in positive manner. Less literature has been found in relation to previous studies on testing the UMO. Since we expect to have a finding consistent to the theory in relation to UMO in Sri Lankan context as per SLAus 700 (CASL, 2016).Therefore, the first alternative hypothesis is provided as:

H1 : Firms with UMO will have positive stock returns.

In contrast to unmodified opinion, emphasis of matter and modified opinion may raise concerns about the reliability of the firm's financial information which need user's attention. As per SLAuS 705, modification is issued based on the materiality and persuasiveness of the issues found by the external auditors. Sundgren (2009) reveals that different types of audit modifications have positive relations with the likelihood of bankruptcy level. Therefore, having a modification in the AR theoretically provides a negative signal to the investors. Accordingly the rest four alternative hypotheses are provided as:

H2 : Firms with UEM will have negative stock returns.

H3 : Firms with QAR will have negative stock returns.

H4 : Firms with ADAR will have negative stock returns.

H5 : Firms with DAR will have negative stock returns.

When conducting the event study methodology, it is essential to decide the event date which is the AR announcement date. In theory, the correct event date is the date when the AR information reaches investors. In the AR literature several alternative event dates have been used. Table 2 has summarized the alternative event dates used by the several studies from 1972 to 2012.

Table 2: Alternative Event Dates Used in Literature

Author (s)	Selected Event Date
Louder et al.(1992); Jones (1996)	Financial year end date
Soltani (2000); Ittonen (2012)	Audit Report issued date
Elliott (1982)	Earnings announcement date
Baskin (1972); Firth (1978), Chow and Rice (1982); Dodd et al (1984)	SEC filing date of annual report
Dopuch et al. (1986)	Media coverage date
Martínez et al. (2004)	AGM date
Chen et al. (1996)	Filing of related event
Anulasiri et al. (2015)	Following working date to the submission of annual reports to CSE
Salim (2016)	Date of disclosing the financial statements

Hence with the support of the literature, the date of which a specific audited annual report announcement appears in the official publication of CSE was taken as the event date. Consistent with this view, the empirical studies conducted by Ittonen (2012), Ianniello (2015), Anulasiri et al. (2015), a short event window has been taken to reduce the potential effects of other relevant events and circumstances that may occur with a larger event window. Accordingly, event window is consisted of nine days, the annual report publication date in CSE ($t=0$) and four days preceding ($t=-4$) and four days succeeding the publication ($t=+4$) days has been chosen for the study since Sri Lanka has an emerging capital market. When deciding the investigation window, considering the suggestions of Brown and Warner (1985), a 41-day investigation window is defined for this study, which extends from -20 through day +20 relative to day of the AR announcement day (That is, day 0).

DATA COLLECTION SAMPLING

When collecting the secondary data for the study, all the audited annual reports issued by the companies listed in the CSE uploaded in the official Websites of the CSE (www.cse.lk) during the period 2012 to 2018 were used to examine the type of AR and the announcement date of the AR. Daily prices of companies' securities for the period from 2012 to 2018 were obtained to compute the stock returns on each security where a similar presentation can be founded in the financial statements with the International Financial Reporting Standards (IFRS) adoption. To compute the daily market return, daily All Share Price Index (ASPI) of securities prices for the period surrounding the date of delivering the financial statements to CSE for a period of 100 days preceding the starting date of the investigation window and 20 days after the investigation window was obtained from data library CD of CSE. Share prices for the non-trading days, it was decided to substitute the immediately preceding working day's available price. Further, 91 days Treasury bill rates were obtained from the annual central bank reports from 2012 to 2018 and those rates were converted in to daily continuous compounding rates and taken for the computation. All the daily reports issued by CSE from 01st January 2011 to 31st December 2018 were obtained from data library CD of CSE in order to get the details of announcement of dividends, right issues, scrip dividend announcements, bonus issues and stock splits as to identify and exclude the multiple events from the population.

The original sample consists of 1,889 annual reports and after removing those companies with incomplete data, sample is reduced to 1,735 annual reports. The final sample consisted with 1516 number of UMOs and 219 number of modified audit reports. A summary of the composition of the final sample is shown in Table 3.

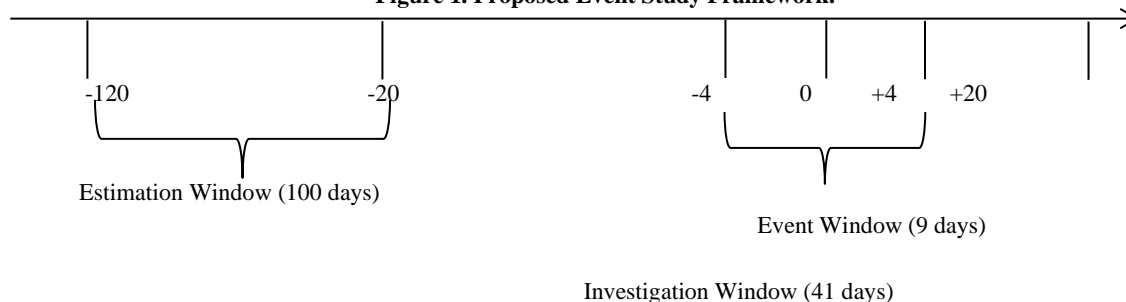
Table 3: Selection of sample for the Event Study

Description	No. of firm-year observations	
Total audited annual reports		1889
Less: Exclusion		
No clear publication date	13	
Multiple events	32	
Unavailability of share prices through estimation and investigation period	19	(64)
The Final Sample		1735
UMO		1516
UEM	130	
QAR	69	
ADAR	2	
DAR		219
	18	
The Final Sample		1735

CONCEPTUALIZATION

With the support of the literature, it is decided to have 100 days estimation window and 41 days investigation window. Event window will be nine days which includes four days before and after the event date. As stated in the literature review the following event study framework is used.

Figure 1. Proposed Event Study Framework.



MODEL SPECIFICATION

On the basis of the work of Brown and Warner (1980, 1985) and Campbell et al. (1997), the standard event study methodology is used to evaluate the reaction of the stock prices to audit report publication announcement. It is necessary to measure the share price changes on the date of audit report declaration in order to determine the effect of the audit reports on share prices and returns. Existence of an abnormal return on that date is the consequence of information content of the AR. If there is no abnormal return, then there is no information content of the audit report. The following equations were used so as to analyze the collected data.

ACTUAL RETURN

The actual stock returns of the companies are calculated using the following formula:

$$R_{i,t} = \left(\frac{P_{i,t} - P_{i,t-1}}{P_{i,t-1}} \right) \times 100 \quad (01)$$

When computing the actual returns, for the non-trading days, the closing price of the immediate previous working day was substitute in order to overcome the absence of returns of the non-trading days.⁵

RETURN ON THE MARKET PORTFOLIO

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

$$R_{m,t} = \left(\frac{ASPI_{i,t} - ASPI_{i,t-1}}{ASPI_{i,t-1}} \right) \times 100 \quad (02)$$

Where:

- $R_{m,t}$ - Return on the market portfolio;
- $ASPI_t$ - Value of All Share Price Index at the end of day t
- $ASPI_{t-1}$ - Value of All Share Price Index at the end of day $t-1$

EXPECTED RETURNS

As the researcher used RAR model in order to compute the expected returns using following formula, Alpha and Beta values were estimated for each event date during the estimation period of 100 days.

$$E(R)_{it} \equiv R_{ft} \pm \beta(R_{mt} - R_{ft}) + \varepsilon \quad (03)$$

Where:

- $E(R)_{it}$ - Expected Return on day (t)
- R_{mt} - Return on the market portfolio (ASPI)
- R_{ft} - Risk free rate of return i.e. 91 days Treasury bill rate (daily continuous compounded) at day (t)

The Alpha (α) is the intercept estimation from the regression analysis and the Beta (β) is the estimation of the slope for the market risk premium variable. The slope measures how much the dependent variable (company's excess return over 91 treasury bill rates in this case) varies with one unit increase in the independent variable (market risk premium). This regression is run for each event where 1735 Alpha's and Beta's are estimated, which is then used in the calculation of abnormal returns.

⁵ Dividend has not been taken in to account when computing the stock return due to the time difference of dividend declaration.

The parameters α and β , for each event date and the returns on the market portfolio (R_{mt}) together with the 91-day treasury bill rate which is converted to daily compounding rate (R_{ft}) were entered into excel spreadsheet and the expected returns (ER_i) were calculated using the above CAPM formula under RAR model.

ABNORMAL RETURN

Abnormal Returns were calculated as actual return minus expected return:

$$AR_{i,t} \equiv R_{it} - ER_{i,t} \quad (04)$$

ARITHMETIC MEAN OF THE ABNORMAL RETURN (AAR)

In order to avoid the effect of noise surrounding share price movement, the daily arithmetic mean of the abnormal (unexpected) return for the sample will be calculated using the following equation.

$$AAR_{it} = \frac{\sum AR_{it}}{n} \quad (05)$$

Where:

- AAR_{it} - Average Abnormal Return of Stock i on day t
 n - Number of events

THE CUMULATIVE AVERAGE ABNORMAL RETURN (CAAR)

The cumulative average abnormal return for stock i over a period from day t_1 to day t_n is calculated as the time series aggregation of average abnormal returns from day t_1 to day t_n as shown in following formula.

$$CAAR_{i,t_1,t_n} \equiv \sum AAR_{it} \quad (06)$$

Where:

- $CAAR(t_1,t_n)$ - Cumulative Average Abnormal Returns from day t_1 to day t_n
 AAR_{it} - Average Abnormal Return of Stock i on day t

Inferential analysis is used to test the significance of the t statistic of AAR and CAAR. Significance of the AAR is the ratio of the AAR to its estimated standard deviation.

The test statistic for AAR for any day t ;

$$t = \frac{AAR_t}{\sigma(AAR_t)} \quad (07)$$

Where;

$\sigma(AAR_t)$ is the square root of the variance of AAR

As per Kothari and Warners (2007), the test statistic for any given period is determined by;

$$t = \frac{CAAR_{(t_1,t_n)}}{[\sigma^2(t_1,t_n)]^{1/2}} \quad (08)$$

Where,

$$\sigma^2(t_1,t_n) = L\sigma^2(AAR_t)$$

$$L = t_n - t_1 + 1 \text{ (Horizon length)}$$

DISCUSSION OF THE RESULTS

Table 4 presents the results of a t-test of the average abnormal returns (AAR) during the event window and Table 5 presents the results of the cumulative average abnormal returns (CAAR) during both event and investigation window. It appears from the Table 4 that for UMO, UEM and QAR, there is a random pattern of AARs before the announcement date. However, all AARs after the event date are positive for UMO and negative for UEM and QAR. Considering the impact on CAARs, as per Table 5, every event window before and after the event date have been resulted positive figures for UMO and negative figures for UEM and QAR. However, those values are not statistically significant at 5% level.

When analysing the pattern on ADAR and DAR, AAR before, at the, and after the event date are remarkably positive. According to Table 5, CAARs during event window and investigation window of DAR shows higher positive figures and are significant at 5% level. It seems that stock returns more actively react around 20 days after the announcement of AR. Further it is noted that AARs and CAARs of DAR have gradually increased during the post event windows which could be seen as a novel finding where in the literature it is only found that no significant impact and negative significant impact from the modified AR.

This may be due to the nature of the capital market in Sri Lanka. Sri Lanka being a developing country and still not having an efficient capital market, share prices will not immediately react to the new information releases to the market. It will take a substantial period of time to react in the market. That may be the reason that stock returns are more active during T -20 to T +20 and T0 to T -20.

Table 4 : AARs for each category of Audit Reports

Days	AARs				
	UMO	UEM	QAR	ADAR	DAR
T -4	-0.0006 (0.02)	-0.0025 (-0.10)	-0.0037 (-0.12)	0.1142 (0.72)	0.0446 (0.55)
T -3	0.0004 (0.02)	0.0018 (0.05)	0.0012 (0.03)	0.0044* (9.74)	(0.0076) (-0.29)
T -2	-0.0006 (0.05)	-0.0018 (-0.06)	0.0067 (0.17)	0.0051 (1.03)	0.0171 (0.60)
T -1	0.0019 (0.05)	0.0007 (0.02)	-0.0092 (-0.13)	0.0021 (0.42)	(0.0019) (-0.08)
T 0	0.0020 (0.03)	-0.0025 (-0.04)	-0.0018 (-0.04)	0.0010 (1.19)	0.0159 (0.34)
T +1	0.0010 (0.03)	-0.0027 (-0.06)	-0.0031 (-0.08)	0.0011 (1.09)	0.0168* (2.07)
T +2	0.0008 (0.02)	-0.0035 (-0.13)	-0.0007 (-0.03)	0.0014 (2.50)	0.0177* (8.71)
T +3	0.0010 (0.02)	-0.0042 (-0.08)	-0.0077 (-0.19)	0.0027* (11.02)	0.0295* (2.44)
T +4	0.0027 (0.02)	-0.0044 (-0.08)	-0.0101 (-0.06)	0.011* (7.03)	0.0331* (2.13)

Notes: Table 4 presents AARs for each category of AR The t-statistics of AARs are shown in parentheses. * indicates statistical significance of test statistics at 5% significance level.

Table 5: CAARs for different windows for Each Category of Audit Reports

Window	Length (L)	CAARs				
		UMO	UEM	QAR	ADAR	DAR
T -4 to T 0	5	0.0030 (0.04)	-0.0042 (-0.06)	-0.0068 (-0.07)	0.1268 (1.68)	0.0681 (0.74)
T -1 to T +1	3	0.0049 (0.08)	-0.0044 (-0.07)	-0.0141 (-0.16)	0.0043 (1.06)	0.0308 (0.69)
T 0 to T +4	5	0.0075 (0.13)	-0.0172 (-0.24)	-0.0233 (-0.25)	0.0174* (9.06)	0.1130* (2.99)
T -4 to T +4	9	0.0084 (0.09)	-0.0190 (-0.20)	-0.0284 (-0.22)	0.1431 (2.49)	0.1652* (2.04)
T 0 to T + 20	21	0.0140 (0.10)	-0.0455 (-0.33)	-0.0297 (-0.10)	0.0334 (1.09)	0.3020* (3.38)
T -20 to T + 20	41	0.0204 (0.10)	-0.0558 (-0.30)	-0.0868 (-0.27)	0.2085 (3.52)	0.3530* (2.35)

Notes: * indicates statistical significance of test statistics at 5% significance level.

SUMMARY AND CONCLUSIONS

The study investigates the impact of each type of AR on stock returns in listed companies in CSE during the period of 2012 to 2018 by following the event study methodology. Hence, it tries to achieve the research objectives emphasising that UMO have a positive significant impact on share returns and other modified opinions have a significant negative impact on share returns of listed entities in Sri Lanka. As per the theoretical background also it is expected to have negative returns in connection with the modified opinions as those provide negative signals to the market. However, a novel result has been founded in respect of ADAR and DAR. It has been found that only ADAR and DAR have a significant positive impact on the stock returns which is in contrast to the most of the findings in the literature this direction is similar to the results of Samudera (2017) even though the results found by Samudera (2017) were not significant. However, there were no significant effects were found from other opinions (UMO, UEM, and QAR). As per the pilot study conducted by the researchers, in Sri Lanka, most of the investors who have financial background are referring the audit report before making an investment in listed companies. In contrast to that, the investors who do not have any financial background stated that they do not have any understanding regarding AR. Their investments are basically based on their gut feeling or recommendation by the stock brokers. Hence, no hypotheses were supported by the findings of the study concluding that audit report has a less informative value to the investors in Sri Lankan context.

Further it is noted that, ADAR and DAR were given to the companies with material and pervasive concerns such as continuous losses, going concern issues, regulatory issues, accounting application issues. Those companies can be treated as high risky companies to invest with potential of higher returns. That means those companies have higher actual stock returns than expected returns. Hence, such companies may yield high abnormal returns. Additionally, when analysing the behavior of the share prices and the trading volumes of the companies with ADAR and DAR during 2012 to 2018, it was noticed that even though they seem to be riskier companies to invest, those have a comparatively volatile share volume and comparatively higher share prices. Hence, the firms with the most severe opinion which is “Disclaimer Opinion” will have positive direction of stock returns. Similarly, as another reason it could be found that few leading investors in CSE may early response and manipulate the normal behavior of the market and general investors follow the dominant investors. This may be due to insider trading in the stock market which leads to leakage the information to inside investors through other sources since there is a considerable time gap between event date and AR announcement date. Therefore, other relevant information in the audited financial information may provide more information value than AR.

The current study theoretically contributes to the extant body of knowledge by investigating the impact of each type of AR which has not been tested in the literature so far even though the studies have been conducted relating to overall audit modification and stock returns. This exercise has also marginally contributed to the methodological knowledge as well by conducting the event study under RAR model. Further, it has improved the accuracy of impact on stock returns on event date by eliminating the multiple announcements (dividend, stock split, and right issue and bonus issue announcements) during the investigation window and estimation window when conducting the event study.

It is advisable for investors to look at the AR before making an investment decision. There is no information content in AR except for ADAR and DAR. Therefore, the audit professionals and professional bodies such as CA Sri Lanka may have to reconsider the reporting language, content of AR. Further they need to ensure that audited financial statements provide adequate information to

the readers, adaptation of Auditing Standards as suited to the local context and how to enhance the awareness of the readers including investors.

Based on the conclusions of the study, it is recommended to extend this study to investigate the impact of each type of AR on stock returns and EP during other time periods and using different test periods. Similarly, the researchers have used RAR model to assess the expected return. There is an opportunity to cover this study under other two methods Mean Adjusted Return model and Marker model. Further most of the previous studies have done for the developed markets. Therefore, the researcher recommends testing the stock price reactions and EP to each type of ARs in other untested frontier markets.

ANNEXURE 1

SUMMARY OF THE EMPIRICAL EVIDENCES ON THE RELATIONSHIP BETWEEN AR AND STOCK RETURNS

Author(s)	Context	Scope	Findings
Positive Relationship between AR and Stock returns			
Firth (1978)	United Kingdom (UK)	Going Concern and subject to opinion	Significant and negative returns after the event day were found.
Elliott (1982)	United States of America(USA)	'Subject to' qualifications	Significant negative abnormal returns are observed in the 45-week period before the Subject to opinion is released.
Chow and Rice (1982)	USA	Qualified AR	QAR has a negative impact on stock prices.
Dopuch et al. (1986)	USA	Subject to' qualifications	Media disclosures of 'subject to' qualified opinions are rare, but, when they occur, they are associated with significant negative stock price effects.
Loudder et al. (1992)	USA	First time 'Subject to' qualifications	Significant negative stock price effect can be seen with the first time 'Subject to' qualifications
Soltani (2000)	France	Qualified Opinions	Significant negative abnormal returns around the announcement dates of audit opinions were found.
O'Reilly (2010)	USA	Going Concern AR	Going-concern opinion is viewed as providing information content that is relevant for valuing stocks.
No Relationship between AR and Stock returns			
Baskin (1972)	USA	Consistency Modifications	There was little effect, and that the consistency exception type audit report possessed no information content.
Dodd et al. (1984)	USA	First time 'Subject to' audit opinions and disclaimers of opinions	Negative stock return prior to the release of qualified opinions while the public announcements of both 'except for' audit opinions and disclaimer of opinions had little impact on stock prices
Martinez et al. (2004)	Spanish Market	Qualified opinions, first time and recurrent qualifications.	Qualified audit reports do not have information value for investors as there was no significant relationship.
Anulasiri et al. (2015)	Sri Lanka	First time qualifications	No significant effect for qualified audit report on share prices and returns.
Wickramasingha and Nanayakkara (2015)	Sri Lanka	UMO,UEM and modified reports In Manufacturing sector	No significant relationship between audit report and share returns

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