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The Effect of Modified Auditors' Report on Share Prices: Evidence from Listed Companies of Sri Lanka

by

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The work described in this research was carried out by me under the supervision of Dr. Roshan Ajward and a report on this had not been submitted in whole or in part to any university or any other institution for another Degree/Diploma

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I certify that the above statement made by the candidate is true and that this research is suitable for submission to the University for the purpose of evaluation

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Dedication

To my beloved wife, son, the baby expectant and the parents

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ABSTRACT

The research study focuses on achieving three objectives. First is to understand the effect of the modified audit reports on shares prices and returns through a comprehensive analysis of extant literature. The second is to evaluate this effect by examining the Colombo Stock Exchange (CSE) as a developing and untested market. The third objective is to test whether the Sri Lankan capital market is of semi-strong efficiency based on the Efficient Market Hypothesis (EMH). Contradictory and Inconclusive evidence is noted in the comprehensive survey of literature. The audit reports that have been issued and published of listed companies in the CSE during 2010-2014 were examined. Only the first time modification to the audit reports was taken as the sample in order to reflect new information. Out of 172 modified audit reports issued within the above period 53 reports were selected as the final sample, where report with continued modifications, lack of clarity of the publication date and with contaminated events were removed. This sample was divided into three categories as total modified audit report (53), qualified audit report (27) and audit reports with emphasis of matters (26). For the purpose of analysis, the short window market model was used. The Average Abnormal Returns (AARs) and the Cumulative Average Abnormal Returns (CAARs) were analyzed graphically and t-test analyses were used to test the significance, for the three different categories of samples. The results in the study point out a lack of statically significant impact on the stock prices and returns by modified audit reports indicating that there is no information content in them. Nevertheless, the result indicated a slight negative impact by the reports with emphasis of matter. It was further concluded that the effect of modified audit reports do not fully, instantaneously and in an unbiased manner be reflected in the share prices or returns of respective listed companies, and therefore, it is unable to conclude that the Sri Lankan capital market is efficient in the semi-strong form of the EMH. The absence of information contents related to modified reports found in this study is expected to have significant pragmatic policy implications in the Sri Lankan regulatory context.

Chapter I : Introduction

1.1 Background of the Study

Financial statements enable an entity's management to provide useful information about its financial position at a particular time and the results of its operations and changes with respect to the financial position for a particular period of time. External financial reporting for these entities is directed toward the various users of common interest for example creditors, banks, regulators and other general users and provides owners (shareholders) with information about the stewardship of management. Next, they provide a basis to investors' to take their decisions whether they are to buy or sell securities; credit rating services' decisions about the credit worthiness of entities; bankers' decisions about money lending and for decisions of other creditors, regulators and others outside of the entity, so on.

The reason for this is that, those who own the companies, the shareholders, are not ones that manage it and other stakeholders also do not directly involved in the management. Owners and other stakeholders of these companies need to take in to consideration whether the financial statement provides the real picture about the company's financial position and performance. As a result, the independent audit of an entity's financial statements has undoubtly been a vital service to investors, creditors, and other participants in economic exchanges in the process of decision making.

As mentioned by Arens *et al.* (2006) the demand for audit services is triggered by many factors including the remoteness gap between the preparers and the users of the financial statements, the conflict of interest between the users of the financial statements, the complexity of the economic transactions, and the expected effect on the financial statements for decision making. However, since the audit report is the medium of communication between the auditor and the users of the audit report, this report should be objective, understandable and accepted by the users as a relevant source of information.

Auditing is the process of reviewing the financial information prepared by the management of a company (the financial statements and the footnotes) to determine that it conforms to a particular financial reporting framework. The audit is conducted in accordance with the set of auditing standards (In Sri Lanka, Sri Lanka Auditing Standards) and collects evidence to obtain reasonable assurance where the amounts and disclosures in the financial statements are free from material misstatements. Accordingly, the responsibility of auditor is to express an opinion whether the management of a particular company has fairly presented the information in the financial statements being within the particular financial reporting framework.

Dependent on the Auditing Standards, the auditor also evaluates whether the audit evidence raises doubt about the ability of the client to continue as a going concern in the foreseeable future. Therefore, through the audit process, the auditor adds credibility to management's financial statements, which allows owners, investors, bankers, and other creditors to use theme with greater confidence.

However, on a test basis evaluation of the characteristics of evidence, it is observed that accounting estimates are inherently imprecise, and those are difficulties associated with detecting misstatements hidden by collusion and careful forgery, which prevent the auditor from finding every error or irregularity that may effect on the decision of its user.

The auditor expresses his assurance on the financial statements in an auditor's report. The report, which contains standard technical words and phrases with a specific meaning, conveys the auditor's opinion related to whether the financial statements fairly present the entity's financial position and results of operations in accordance with reporting standard.

Based on the Auditor's Opinion, Audit reports for financial statements are of four main categories, they are unqualified reports, qualified reports, disclaimer of opinion reports, and adverse opinion reports. Under certain circumstances, an auditor's report is modified by adding an emphasis on the matter paragraph to bringing matter in to light affecting the financial statements in a note to the financial statements which discuss matter in a more extensive manner.

As mentioned by Al-Thuneibat *et al.* (2008) Audit report is the medium of communication between the auditor and the users of the audit report, this report must be understandable, objective and accepted by the users as a relevant source of information.

The relevance of the auditors' report means that it should make a difference in decision making; if not, the users of the financial statements will not read the report and will not consider it in the decision-making process. The effect on decision-making means that the report should have information content, that is, it must effect on decision making: investment decisions, credit decisions and share prices.

In this backdrop, this research paper focuses the impact of audit reports issued and published for Listed Companies on the share price and return in the Colombo Stock