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

by

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A research submitted to the University of Sri Jayewardenepura in partial fulfilment of the requirements for the Degree of Master of Business Administration (Finance) on 2012
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.

D.G.A.S. Anulasiri
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
# Table of Content

Chapter I : Introduction ........................................................................................................ 1
  1.1 Background of the Study ....................................................................................... 1
  1.2 Problem Statement ............................................................................................... 4
  1.3 Problem Justification ......................................................................................... 4
  1.4 Research Objectives ........................................................................................... 6
  1.5 Significance of the Study ................................................................................... 6
  1.6 Scope of the Study ............................................................................................. 8
  1.7 Limitation of the Study ...................................................................................... 9
  1.8 Summary ............................................................................................................ 9

Chapter II: Review of Literature ................................................................................... 11
  2.1 Introduction ...................................................................................................... 11
  2.2 A hypothesis on the impact of information on share prices: ......................... 11
    2.2.1 The Efficient Markets Hypothesis (EMH) ................................................... 11
    2.2.1.1 The Three Forms of Market Efficiency ................................................. 12
    2.2.2 The Forms of Market Efficiency in Sri Lankan Market ......................... 13
  2.3 The Colombo Stock Exchange (CSE) ................................................................ 15
    2.3.1 Background of the CSE ............................................................................. 15
    2.3.2 The origin of the Story of the CSE ............................................................... 16
  2.4 The Modified Audit Reports ............................................................................. 17
  2.5 Extant Literature – Modified Audit Report and Share Prices and Return ..... 19
    2.5.1 Background .................................................................................................. 19
    2.5.2 Extant Literature – In Support .................................................................... 23
    2.5.3 Extant Literature – that Do Not Support ...................................................... 31
  2.6 Summary .......................................................................................................... 41

Chapter III : Research Methodology .............................................................................. 43
  3.1 Introduction ...................................................................................................... 43
  3.2 Research approach used ................................................................................... 43
  3.3 Selection of Event Date ................................................................................... 45
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.4 Discussion of the Methodology Applied and Its Implication of the Study</td>
<td>74</td>
</tr>
<tr>
<td>5.5 Discussion on the Selected Event Date</td>
<td>76</td>
</tr>
<tr>
<td>5.6 Selection of Sample</td>
<td>76</td>
</tr>
<tr>
<td>5.7 The Possible Reasons for Inconclusive and Inconsistent Conclusions</td>
<td>77</td>
</tr>
<tr>
<td>5.8 Managerial Implications</td>
<td>79</td>
</tr>
<tr>
<td>5.9 Summary</td>
<td>80</td>
</tr>
<tr>
<td><strong>Chapter VI: Summery &amp; Conclusion</strong></td>
<td></td>
</tr>
<tr>
<td>6.1 Introduction</td>
<td>81</td>
</tr>
<tr>
<td>6.2 Summary of the study</td>
<td>81</td>
</tr>
<tr>
<td>6.3 Conclusion of the study</td>
<td>86</td>
</tr>
<tr>
<td>6.4 Limitation of the study</td>
<td>87</td>
</tr>
<tr>
<td>6.5 Direction for Future Research</td>
<td>88</td>
</tr>
</tbody>
</table>
References ................................................................. 89

Appendices

Appendix I: ............................................................... 94
Appendix II: .............................................................. 96
List of Tables

Table III-i: Distribution of Audit Opinion Issued 2010-2014 on the CSE.....................49
Table III-2: Selection of Sample ....................................................................................50
Table IV-1: Abnormal Return for Each Category of Modified Reports ......................63
Table IV-2: T-test results of the CAAR for All Shares (Companies) for the total event period..............................................................................................................................64
IV-3: t-test result for the CAAR for each two opposite days around the Event Day.....69

List of Figures

Figure III-1: Alternative Event Dates.............................................................................47
Figure III-1: Estimation and Test Period.......................................................................56
Figure IV-1: ARR during the test period........................................................................60
Figure IV-2: CAAR Return during the test period..........................................................61
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 undoubtedly 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
Exchange (CSE) during the periods of 2010-2014.

1.2 Problem Statement

Owing to the wide criticism of the audit profession within the context of business and audit failures, the value of the audit report continues to be scrutinized and criticized. As Thuneibat et al. (2008) has examined the informational value of audit reports and their contribution to investors' decisions. It reveals that investors probably do not understand the content of audit reports and cannot acknowledge its value. They further propose that some kind of educational procedure should take place to make investors aware of the audit reports. Gwilliam (1987) also highlights that the general investors pay a little attention to the audit report.

Therefore, the uncertainty of the auditing process and the value of the audit report is the subject of this study. As stated by Moradi et al. 2011, nowadays, there is a wide criticism on the audit profession within the context of business and audit failures and the value of the audit report continues to be scrutinized as the auditing is mandatory in all over the countries and as a result, there is a debate over its important and necessity.

As, this study intends to answer the question whether “Are there any impacts of modified audit reports on share prices of the Listed Companies of the CSE? Or is there any information content in the modified audit report in the Listed Companies of the CSE?”

1.3 Problem Justification

There is a significant importance in the audit report and much weight has been placed on it due to its information content. The audit report is a mandatory requirement in
many countries in the world. According to the Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995, specific business enterprises are required to comply with Sri Lanka Accounting Standards and Auditors with Sri Lanka Auditing Standards in auditing the specific business enterprises. Even in the Section 7.5.a of Listing Rule of the CSE (2014), a Listed Entity ensures that the audited annual report is issued to the Entity’s shareholders and given to the Exchange within a period not exceeding five (05) months from the close of the financial year of the listed entity and, the audited annual report shall then be published in accordance with the Sri Lanka Accounting Standards. As per the Companies Act, No. 07 of 2007 of Sri Lanka, audited annual financial statements should be presented to the shareholder of the company each year. Therefore, Sri Lanka also has given much prominence to the audit report in the financial sector.


This means that as many researchers have concluded it is very important to study the information content of the audit report by applying it to different markets and environments. Therefore, this intends to conclude the impact of audit modification on
the share prices of Listed Companies in the CSE, untested market and environment to
test whether any information content of the modified audit reports exists.

1.4 Research Objectives

There are three objectives to achieve in this study. They are,

i. To understand the effect of the modified audit reports on shares prices and returns
   or information content of the modified audit reports via a comprehensive analysis
   of past literature;

ii. To evaluate this effect through the investigation of the effect of the modified audit
    reports on share prices and return in Listed Companies (LC) in the CSE as a
    developing and untested market;

iii. To test whether the Sri Lankan market is efficient in the semi-strong form of the
     Efficient Market Hypothesis (EMH).

1.5 Significance of the Study

The purpose of an external audit is to ensure that a company’s internal controls,
operating guidelines and policies are adequate, effective and are in compliance with
governmental requirements, accounting standards and company policies. The audit
process ensures that reporting mechanisms prevent errors and fraud in financial
statement and also provides reasonable assurance to investor and financial market
participants of the truth and fairness of a company’s accounting records. Therefore, the
auditor plays an important role in improving confidence in the integrity of the process
of and organizational and its procedure relating to internal control and financial
reporting to users in the stock exchange.
Salahi, 2008, in his study about the same topic, stats that,

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.

Therefore the result of the study will be beneficial to the users of the financial statements in Sri Lanka. This study will also make it possible to identify the investors’ reaction to the modified audit report, especially, in the process of deciding the company share prices. It would also be possible to evaluate the speed of response to new information arising from the audit process.

General view on audit modification is that it would have negative effect on the share price of the company. As far as the researchers are in concern observed, even most of the countries in the world have studied the impact of the audit opinion modification to share prices, yet, there is no studies identified in Sri Lankan Context in this regards. Therefore, this study expects to reveal the actual reaction of the Listed Companies in the CSE on modified audit reports. Through, this process, it also would be possible to evaluate whether Sri Lankan Capital Market is efficient in Semi-strong Form under EMH.

Auditing being a comprehensive task, all activities are accompanied in accordance with internationally recognized Auditing Standards. There are lots of professional institutions and experts engaged in the continuous reviewing of the activities of the auditors and updating the processes and Auditing Standards concurrently. The institute of Chartered Accountant of Sri Lanka is the leading professional in Sri Lanka
institution in this regard. The result of this study will provide information about the investors’ reaction on the audit outcome and help them to strengthen their policy decisions on the auditing process. On the other hand, if there are no proper adjustments to the share prices in the market due to audit modification, it will signal the professionals in the field to rethink their process and the ways improve the validity of the audit outcomes to the stakeholders including investors. Otherwise auditing function will be a worthless process and outcome of the audit process could be questionable.

When any regulations are enforced for the stock market such as, Securities Exchange Commission, Central Bank of Sri Lanka, Ministry of Finance, etc. by the various parties, those regulations are based the audited financial statements of the companies. They request to present the audited financial statement. In the belief this mean that auditing is a reasonable basis for the correctness of the accounting and the internal control process of the organization. The result of this study is expected to conform the correctness of the decision making on audit outcomes, and if not, they may have to rethink the regulatory process based on the audit outcome in the content which the study outcome is not favorable for the existing system.

Most of the time, brokers in the share market advice their clients (investors) on the behavior of the share prices. The audit report is one of basic information source for brokers and investors to base their prediction about the market. The result of this study will help the brokers and investors to ensure the correctness of their prediction bases or to rethink about their prediction base on audit reports.

1.6 Scope of the Study

The aim of this research is to examine the impact of modified audit reports on share
prices of the Listed Companies in the CSE during the period of 2010-2014. The companies covered by the study include all shareholding companies in all the sectors with modified audit reports that were disclosed with the CSE on this period.

By using the market model and calculating returns, the effect of the modified audit report on a company's stock price is examined. In order to evaluate the informational content of audit reports, the various types of modified audit reports including audit reports with matters for emphasis have been examined.

1.7 Limitation of the Study

In this study, it is assumed that factors other than modification to the audit report are not impacting to decide the share prices in the markets. However, many other factors could make an impact on the price of shares simultaneously in the markets since audit Reports of the company are filed in the stock exchange together with Financial Statements which may include more price sensitive information other than audit modification, such as dividend notice, other earning announcement, etc. In addition, other events that happen during the event period have been disregarded in this analysis. This may lead to the disappearance of the effect of audit modification on the share price and return during the event period.

1.8 Summary

This study is to answer the question whether any impacts of modified audit reports on share prices of the Listed Companies of the CSE or is there any information content in the modified audit report in the Listed Companies of the CSE. Therefore, there are three objectives to achieve in this study. First is to understand the effect of the modified audit reports on shares prices and returns or information content of the
modified audit reports via a comprehensive analysis of past literature. Second is to evaluate this effect through the investigation of the effect of the modified audit reports on share prices and return in Listed Companies (LC) in the CSE as a developing and untested market and finally, is to test whether the Sri Lankan market is efficient in the semi-strong form of the Efficient Market Hypothesis (EMH). The result of the study will be beneficial to the users of the audited financial statements such as professional institutions and experts, regulators, investors, share brokers and analysts, etc... The research examines the impact of modified audit reports on share prices of the Listed Companies in the CSE during the period of 2010-2014.

The rest of the research report proceeds as follows. Chapter II - Literature Review, covers the theoretical and empirical findings in relation to the issues concerned. Chapter III - Methodology covers the research approach, selection of event date and basic formulas such as Actual Return, Return on Market Portfolio, Regression Line Parameters, Expected Return, Abnormal Return, Arithmetic mean of Abnormal Return, the Cumulative Average Abnormal Return; Selection of Test period and data collections. Chapter IV – Analysis covers basic analysis relevant to the study, which is consisted, graphical analysis, main analysis and other analysis, for three different set of audit modifications separately. Chapter V – Discussion discusses the findings with available literature, both globally and locally, and also the possible managerial implications and solutions relevant and related to the research problem. Chapter VI - Summary and conclusion give a brief introduction of the problem, objectives, findings and conclusions drawn with other managerial implications.
Chapter II: Review of Literature

2.1 Introduction

This chapter discusses the theoretical and empirical findings in relation to the effect of Modified Auditors' Reports on Share Prices. Accordingly the chapter initially discusses the Efficient Markets Hypothesis (EMH) and form of efficiency of the Sri Lankan Market. Secondly, it briefly discusses about the CSE. Next, it discusses the basic type of modified audit reports and the way it is arisen. Thereafter, this becomes a discussion over the contradictory and inconsistent conclusions provided by the previous studies in the area of modified audit reports and behavior of the share prices.

2.2 A hypothesis on the impact of information on share prices:

2.2.1 The Efficient Markets Hypothesis (EMH)

One of objective of this study is to test whether the Sri Lankan market is efficient in the semi-strong form of the Efficient Market Hypothesis (EMH). As discussed by Fama (1965) the Efficient Markets Hypothesis (EMH) explains that current stock prices are fully reflected the available information about the value of the firm, and it is not possible to earn excess profits, which is more than the market overall by using this information.

It further discusses about one of most vital and exciting issues in finance. It is explains why prices are fluctuating in stock markets and how those changes take place. This is a very important implication for potential investors as well as for anyone who deal with the Stock Market. Fama (1965) stats for the first time about the concept of “efficient market” in a paper and conclude emphasizing that in an efficient market, on the
average competition will cause the full effects of new information on intrinsic values to be reflected "instantaneously" in actual prices. According to the EMH, stocks prices in the stock exchange trades its fair value and it is impossible for investors to either buy undervalued stocks or sell stocks for overvalued prices. Accordingly, Fama (1965) concludes that it should be impossible to outperform the whole market through expert security selection or best market timing, and the only possible way to obtain higher returns is through purchasing riskier investments.

2.2.1.1 The Three Forms of Market Efficiency

Fama (1970) in his classic paper has defined three types of efficiency in a capital market which is based on a different type of information relevant in the phrase: “a market in which prices ‘fully reflect’ all available information is called ‘efficient’”.

**Weak-form efficiency:** This implies that all historical information is fully reflected in the actual price of the security. It means that investor is not possible to earn excess returns by developing trading rules based on historical price or return information. In other words, technical analysis or chart reading is not useful to ‘beat’ the market. It also implies that security prices follow random walks. To be more precise there is no correlation between subsequent price changes of the security.

As Kortian (1995) argues that there are several aspects of modern asset markets trading, which are clearly contrary to the sort of behavior implied by the weak-form efficiency. For instance, the frequent employment of stop-loss orders (selling orders which are activated once the asset price has fallen by a particular pre-determined amount), and the development of dynamic hedging strategies, such as portfolio
insurance, according to which, investors buy in a rising market and sell into a falling one. Such strategies base investment decisions on past asset price movements. Their presence is also consistent with the view that investors can often behave in a destabilizing manner, moving the asset price away from its intrinsic (fundamental) value rather than towards it.

*Semi-strong-form Efficiency:* This form implies that all publicly available information is fully reflected in the actual security price. It means that investor is not possible to earn excess returns from trading rules based on any publicly available information such as annual reports and financial statements of companies, reports in the financial media or press, and other historical data. Fama (1970) further states that with semi-strong efficiency the market’s reaction to new relevant information should be instantaneous and unbiased, without any systematic pattern of under or overreaction.

*Strong-form Efficiency:* It means that investor is not possible to earn excess returns using any information, through public or private information. This form implies that all information is fully reflected in the actual asset price. The strong-form efficiency is very strong indeed and corporate insiders cannot profit using private information: an important technological discovery for example

2.2.2 The Forms of Market Efficiency in Sri Lankan Market

It has been given mixed conclusion by previous empirical that Sri Lankan capital market is efficient in the semi-strong form.

Abeyrathna and Power (1995) have studied whether, the CSE is Weak Form Efficient and stated that it is not categorically concluded that the CSE as Weak Form Efficient.
However, they have further highlighted that they have analyzed a very shorter period and emphasized the need to analyze for longer period which employ variety of advance methodologies.

Dharmasena *et al.* (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. The result suggests the non-Indian markets including Sri Lanka are both weak-form and semi-strong form efficient.

Disabandara *et al.* (2010) have examined the semi-strong form of EMH which asserts that current stock prices reflect not only historical price information but also all publicly available information. The results suggest that on average; the share prices instantaneously and unbiasedly reflect the publicly available information. They further concluded that considerable anticipation before the event date and this would limit the information dissemination process of the market or insider abuse or any other misconduct of some of the market participants. This may lead some participants to predict the future prospects of the companies and earns ARs over the others. Therefore, it is concluded that the results do not support the semi-strong form of EMH.

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
the efficient capital market hypothesis; 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.

Therefore, the previous studies about the capital market efficiency of Sri Lankan capital market have given mixed conclusions.

2.3 The Colombo Stock Exchange (CSE)

2.3.1 Background of the CSE

The CSE is the only share market in operation in Sri Lanka. It is responsible for providing a transparent and regulated environment where companies and investors can come together. The CSE is a company that is limited by guarantee established under the companies’ act of Sri Lanka. The CSE is licensed by the Securities and Exchange Commission of Sri Lanka (SEC) and is a mutual exchange consisting of 15 Members and 14 Trading Members. All Members and Trading Members are licensed by the SEC to operate as Stockbrokers. At present the CSE functions as a market operator and through the fully owned subsidiary the Central Depository Systems (Pvt.) Limited (CDS), acts as a clearing and settlement system facilitator. The CSE also oversees compliance through a set of rules, promotes standards of corporate governance among listed companies and is actively involved in educating investors. In the course of its operations, the CSE interacts with many customers and stakeholders which include issuers (such as companies, corporations and unit trusts), commercial banks, investment banks, fund managers, stockbrokers, financial advisors, market data vendors and investors.
2.3.2 The origin of the Story of the CSE

The CSE's origin story dates back to the 19th century. The trading of shares in limited liability companies began with the inception of the Colombo Share Brokers Association (CSBA) in 1896. In 1904 the CSBA changed its name to the Colombo Brokers Association (CBA). The share market was opened to the public in July 1984 as the CBA recognized the importance of mobilizing local savings to meet the capital requirements of the growing private sector of the country. A public trading floor was established with an ‘Open Outcry’ system of trading, instead of the ‘Closed Door’ system of trading utilized previously. In 1985, a formal stock exchange was established in Sri Lanka. It was then called the Colombo Securities Exchange Limited and in 1990 came to be known as the Colombo Stock Exchange. The CSE was one of the first Exchanges in the region to have in place a depository for listed securities with the implementation of its clearing and settlement house and in 1991 successfully installed an automated electronic clearing and settlement system-Central Depository System (CDS).

The CSE introduced its Automated Trading System (ATS) in 1997. This has enhanced the transparency and efficiency of the securities market in Sri Lanka. In recognition of the technology, systems and regulation, the CSE was admitted to the World Federation of Exchanges (WFE) in 1998, becoming its first South Asian member. It is also a founding member of the South Asian Federation of Exchanges (SAFE) established in 2000. In 1999, the CSE commenced the broad-basing of the stock market by establishing a regional office in Matara in the Southern Province of Sri Lanka. In
addition the CSE currently operates branches in Kandy, Kurunegala, Negombo, Jafna Anuadhapura and Ratnapura providing access to regional investors. In February 2012 the CSE migrated to the Automated Trading System 7.10 (ATS 7.10), a new trading platform which permits a broad range of trading functionality and efficiency. It is also a multi-asset platform that facilitates trading of several types of assets including equities, derivatives and fixed income. The CSE also partnered with S&P Indices to jointly develop the S&P Sri Lanka 20 Index (S&P SL 20) launched in June 2012. The new index is comprised of the 20 largest and most liquid stocks of the Sri Lankan equity market. The index is based on S&P Indices’ global index methodology, which provides consistency and transparency. It is anticipated to provide the foundation for the introduction of tradable instruments such as Exchange Traded Funds (ETFs) (Based on Colombo Stock Exchange-Investing in Shares - A Basic Guide, 2014).

2.4 The Modified Audit Reports

The audit report is a legally established obligation of a company in most countries around the world. Sri Lanka also has a legally established obligation for independence audit especially for specific business enterprises. However, the methodology is being used to derive the audit opinion is almost similar to auditor to auditor. And also the audit report and its information content have been an area of interest of many researchers. Two type of audit reports could be seen, namely, unmodified (or unqualified) audit reports and modified audit reports.

According to the section 27 of Sri Lanka Auditing Standards 700 (SLAuS 700), an unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view (or are presented fairly, in all material respects) in
accordance with the identified financial reporting framework. An unqualified opinion also indicates implicitly that any changes in accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements”.

According to the Sri Lanka Auditing Standards (SLAuS), there are four main type of modifications to the audit report such as qualified audit opinion reports, adverse audit opinion reports, disclaimer of audit opinion reports or unqualified audit opinion with Emphasis Matters [Explanatory notes]). Each modification gets negative information about the entity.

According to SLAuS 700, A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed, but that the effect of any disagreement with management, or the limitation of the scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being ‘except for’ the effects of the matter to which the qualification relates (Sec 37). A disclaimer of opinion should be expressed when the possible effect of a limitation on the scope is so material and pervasive that the auditor has not been able to obtain sufficient, appropriate audit evidence and accordingly is unable to express an opinion on the financial statements (Sec 38). An adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements (Sec 39).

Section 30-32 of SLAuS 700 states that, “In certain circumstances, an auditor’s report
may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition such an emphasis of matter paragraph does not affect the auditor’s opinion. The paragraph would preferably be included after the opinion paragraph and would ordinarily refer to the fact that the auditor’s opinion is not qualified in this respect” (section 30).

2.5 Extant Literature – Modified Audit Report and Share Prices and Return

2.5.1 Background

According to the previous studies to test ‘whether investor decisions are affected by the content of published audit reports’ has now reached contradicting results. And no clear answers have been provided as to whether investor decisions are affected by the content of published audit reports or not. Some researchers stated that the type of the audit report affects the company's stock market price, while others are with the opinion that there is no relationship between the two.

According to Ittonen (2012), in his study under the topic “review of archival literature on market reactions to qualified audit reports and to identify the different approaches used in these studies” has identified three different approaches used to examine the existence of abnormal stock returns to qualified audit report disclosures. First, traditional short-window event studies analyze the instant market reaction after the audit report disclosure. An instant reaction is expected based on the efficient market hypothesis, which implies stock prices reflect all past public information and adjust instantaneously to new information. This is the most commonly used approach and in theory it should be a very powerful test if the event date can be identified, the
predictability of the report be estimated, and the concurrent disclosures be controlled for. Second, the long event window approach has been applied to investigate the market under-reaction to announcements of audit reports over a 12-month period. Third, indirect approaches have been used to study the relevance of audit reports by examining market reactions to related disclosures while controlling for the content of the audit report.

Iltonen (2012) has further concluded that

The empirical findings in the literature are mixed. A more detailed analysis of the approaches and event dates used in the papers reveals that only the indirect approach has consistently found support for the hypothesis that qualified audit reports are relevant to investors. Researchers conducting and analyzing research in this field should acknowledge that certain environmental and institutional factors, such as clarity of the event date, concurrent disclosures, predictability of the report, trading volume and availability of daily quotes of the underlying stocks, frequency, recurrence and type of qualified audit reports, and availability of related disclosures, significantly affect the measurement of stock market reactions and interpretation of the empirical finding.

Craswell (1985) states that, the audit report have been an area of interest for many researchers and, however the conclusions provided by the studies in the area of audit reporting have been contradictory and inconsistent.

David et al. (2013) have analyzed the role of the audit report in enhancing the credibility of financial information in the stock market. Since most of the previous studies have examined the association between information asymmetry and the financial reporting process through disclosure, earnings quality and different proxies of audit quality, a gap exists in the literature on the association between audit qualifications and information asymmetry. They use several microstructure measures
of information asymmetry such as the relative spread, intraday price impact measures, PIN and VPIN, and find that firms with audit qualifications show higher information asymmetry than those with unqualified opinions. They provide evidence on this for a sample of Spanish listed firms during the period 2001-2008 and concluded that; The investigation for investigating the first relation between the type of audit qualification and information asymmetry and find that firms with non-quantified qualifications show higher information asymmetry than firms with unqualified opinions, whereas there is no significant difference between quantified qualifications and unqualified opinions. Therefore, higher information asymmetry in qualified opinions is generated by those qualifications that include unquantifiable uncertainties and going concern qualifications; Both uncertainties and scope limitations, on the one hand, and going-concern qualifications, on the other, present higher information asymmetry than unqualified opinions, although it was reported a stronger effect on informational asymmetry level in the case of going concern qualifications; Finally and consistent with previous research, find that Big 4 auditors are associated to lower information asymmetry.

David et al. (2013) finds further suggest that since audit qualifications are a signal of low accounting quality, they reduce the credibility of the firm’s financial reporting. However, earnings of number of firms whose qualifications are quantified can be adjusted by market participants and associated with information asymmetry, the earnings of number of firms whose qualifications are non-quantified are noisier and more difficult to interpret by market participants and, consequently, are associated with higher information asymmetry.
Mutchler (1984) has stated that, there are two primary reasons why an audit report might affect stock prices. First, the audit report may contain information that affects either the estimation of the magnitude of future cash flows and/or the riskiness of future cash flows. Any information that affects these components is relevant to the investors. Second, the audit report can contain substantial information about the viability of the firm, in the form of the going concern audit report. The audit report should at all times reflect the auditors’ access to inside information such as forecast data and management plans, and, taking this into account, the auditor’s reporting decision also reveals some private information.

However, an alternative view stated by Mutchler (1984) and Dopuch et al. (1987) and Suggest that the going concern audit report is a function of publicly available information, and therefore its contents is predictable. Predictable financial information would likely to be of low or insignificant value to financial statement users. Additionally, Melumad and Ziv (1997) have proposed in their theoretical model of market reactions to qualified audit report that the reactions to avoidable and unavoidable qualified audit reports are different. An avoidable audit report, which the management could have avoided by making a change in reporting, could result in either a positive or a negative reaction whereas an unavoidable qualified audit report, which the management could not have avoided, is expected to result in a negative reaction.

From the next section, the contradictory and inconsistent conclusions provided by the previous studies undertaken in the area of audit reporting and behavior of the share prices and returns are deeply discussed.
2.5.2 Extant Literature – In Support

Charles et al, (2014) studies the effect of auditing with evidence from variability of stock returns and trading volume using a sample of Chinese firms. They provide evidence that auditing decreases information divergence across investors measured by reduced stock return variability and trading volume. They find that the reduction in stock return variability and trading volume are both statistically significant and economically material. Results are robust after controlling for self-selection bias and several other factors. They further states that findings are consistent with the argument that investors place more weight on audited financial statements than on non-audited ones in pricing stocks and show that auditing has the beneficial effect of decreasing inter-investor divergence even in an emerging economy such as China. And also their findings are consistent with the argument that the benefits of auditing in improving the confidence of ordinary investors who rely on public information do not require a highly developed market and legal infrastructure. However, researchers have stated that although this study is based on the Chinese context, they believe that investors in China are motivated by similar economic incentives as in other parts of the world and to that extent the findings can be generalized to other emerging economies. However, institutional differences between countries should be considered when the results are generalized.

Chan and Walter (1996) investigated the information content of the auditor’s qualification in the financial characteristics of the population of listed Singaporean companies receiving first-time qualified audit reports within a costly contracting framework. It develops and tests hypotheses which take into account the costly
contractual implications of a qualification for both the auditor and client. A matched pair design is used as a control. Results indicate that firms receiving qualified reports are significantly less profitable and liquid and have significantly more debt than the control in the year of qualification. Profitability and liquidity are shown to have declined in the four-year period up to the qualification, while debt levels have increased. These results may partially explain why the general "no effect" result from share market announcement date studies exists; the qualification per se is a dated signal of financial deterioration which has existed for at least the previous four years. They further states that qualification is also significantly associated with the dollar effect of a recent change in accounting method and an asset revaluation. Ownership of the firm also differs for the two groups. It is more likely that a qualified report will be issued to a firm that has a higher proportion of the equity owned by the management and/or that has recently changed its accounting methods to increase income or assets (via revaluation).

According to further explanation of Chan and Walter (1996), the strength of the results is also shown to depend on the nature of the qualification. Companies which receive "severe" qualifications (ie. going concern, not true and fair, unable to form an opinion) have more significant differences than their pairs compared to firms receiving "moderate" or "other" qualifications. They have also analysed an agency-related variable, i.e. managerial ownership of the firm, and concluded that a qualified audit report is an independent opinion to shareholders that the accounts are in some respect not true and fair and some aspect of stewardship is brought into question.

Firth (1978) stated that, with the occasion of the sudden increase in the number of
qualified reports issued in the United Kingdom in the mid-70s, carried out a study with the purpose to examine the effect of these certificates on investment decisions. The results of the study have showed that certain types of qualified reports contain important information that affect investment decisions, while they affect stock prices of the companies involved in a negative manner, immediately after their announcement. Therefore, firth has concluded that there is information content in the qualified audit reports.

Chow and Rice (1982) have studied the power in the US market of the notion that issuing a qualified audit report reveals unfavorable information, which managers intend to hide. The researchers have concluded that issuing a qualified audit report has a negative impact on a company's stock price. This relationship, which indicates solely the existence of correlation among variables and not a causal link, seems to vary depending on the reservations expressed.

Soltani's (2000) in the empirical studying examines the case of France, and attempts to examine the relationship between the opinions expressed by a company's auditors and its stock prices. The general conclusion of the study is 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 certificates have an informational value to investors.

Syou-Ching et al. (2009) has studied to ascertain whether or not the modified unqualified audit opinion has impact on stock price or whether the modified unqualified audit opinion has information contents. They have studied the case of Taiwan with the understanding that the modus operandi of its stock exchange is no
different from those of the market-based economies around the world. This study has found that a significant negative association exists between stock price and the modified unqualified audit opinion issued under any one of the following five scenarios or circumstances: (1) the going concern consideration, (2) the change in the application of accounting principles for financial reporting as required under the law, (3) the change in the application of accounting principles for financial reporting on a voluntary basis, (4) the uncertainty of events that may have significant impact on the future financial condition of the firm, and, (5) the adoption of the other auditor’s audit report for the current year audit. Of the five circumstances mentioned above, the one based on the going concern consideration had the highest significant impact on stock prices and the application of different accounting principles between two reporting periods and the uncertainty of events that may affect the future financial condition of the firm is the next. They have further concluded that, the modified unqualified audit opinion rendered by an auditor who was concerned about the client’s ability to survive as a going concern had the largest impact on stock prices in comparison with the same opinion issued under other circumstances and the modified unqualified audit opinion, if based on the adoption of another auditor's opinion, was found to possess the least amount of information contents.

Elliott (1982) has studied the relationship between qualified reports and the excess performance of company stocks and reached to conclusion that for certain types of reservations expressed, there is an important fall of company stock prices for 45 weeks prior to the announcement of profits.

Elliott et al (2011) have attempted to look at the audit opinion announcements and the
contagion or competitive effect on Rival Firms in Home Health Care Services. A total of 2 announcing firms and 35 rival firms are included in the sample. To determine the announcement effects of going concern opinions on rival firms, abnormal returns are calculated for each firm. Abnormal returns are the difference between the stock's return and its expected return as estimated by the single index model. The findings suggest that going-concern audit opinions of one firm influence stock prices of other firms in the industry. Average abnormal returns to rival firms are positive and significant at the .01 and .05 level for the SIC 8080 and SIC 8090 firms, respectively.

Chen and Church (1996) in Panayiotis et al (2010) have attempted to study the correlation between audit reports for a company's Going Concern Qualifications with the market response in the case of bankruptcy. The results of the analysis show that companies that receive a Going Concern certificate present less negative abnormal returns on their stock prices following the announcement of bankruptcy, in comparison with companies that receive a "clean" certificate. This sanctions the notion that Going Concern certificates have informational value to investors. They have further stated that bankruptcy is not the sole form of financial difficulties encountered or the only reason to issue a GC certificate.

Guiral et al. (2014) have made an investigation under the topic “the Audit report information content and the provision of non-audit services: Evidence from Spanish lending decisions”. It was examined whether auditor economic independence affects the information content of going concern audit reports in the European setting. They conduct an experiment where 80 experienced Spanish loan officers from the second largest European commercial bank review a loan request under two
lending scenarios: (1) a potential borrower receiving an unqualified, but modified going concern opinion, and (2) a potential borrower receiving a qualified going concern opinion. Findings suggest that loan officers view a qualified audit report as a mechanism/filter that acts as an early warning system. Indeed, this warning signal has such a high intensity that first-order its impact on loan officer decisions is not affected by the degree of auditor economic independence. The results also suggest that auditor economic independence is viewed as a second-order mechanism that only activates loan officer skepticism when the auditor has issued a modified but unqualified going concern audit report.

Tahinakis et al (2013) have studied “the Eurozone Crisis and Audit Opinion Credibility Perception”. They have examined the impact of recession and the effect of certain audit opinion determinants on market perception of audit opinion. It has employed a market valuation model has been employed here for a dataset consisted of all the EMU countries for the 2005-2012 periods. The models relate stock returns with earning’s and incorporates auditor’s variables, recession, audit opinion determinants and their interactions with audit opinion. Growth and leverage have been introduced as proxies to ensure robustness. The results, illustrate a rather significant market perception of specific types of audit opinions, namely the unqualified opinion with explanatory paragraph and disclaimer of opinion. Both of these types of opinions seem to impact on investors when issued for a firm during a recession. The estimated relation is negative in both cases, implying the lower market returns and a negative informational content. Therefore, the findings support the argument that both unqualified and qualified opinions have a significant market effect. The Recession and the analyzed audit opinion determinants differentially impact on the market perception of audit opinion.
Gul (1990) in Al-Thuneibat et al (2008) has used the experimental approach to investigate the influence of both the unqualified audit report and the "except for" qualified audit report on the estimated price of shares. He has sent the respondents (bank officers) 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 state the appropriate price of the hypothetical company's shares. He has used statistical techniques to analyse the data, such as One-Way NOVA. The results have shown that the "except for" qualified audit report has negatively influenced on the share price.

Guillamon (2003) in Al-Thuneibat et al. (2008) has used experimental methodology to investigate the importance of the audit report in investment decisions made by dealers and brokering companies and lending decisions made by credit institutions. In other words the aim of the research was to investigate the influence of the auditor's opinion (clean, qualified, adverse and disclaimer) on investing and financing decisions. The researcher has used the survey method, that is, the researcher has used a questionnaire through which the respondents were asked about the source they consider relevant when making decisions. The findings of the study indicated that the auditor's opinion represents a useful source of information when making investment and financing decisions.

Baskin (1972) has 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 has concluded that there was little effect, and that the consistency exception type (qualified) audit report has possessed no information content.
Dodd et al (1984) investigates whether announcements of "subject to" audit opinions and disclaimers of opinions affected stock prices. Their results indicated that many firms experienced negative abnormal performances prior to the release of qualified opinions, and that the magnitude of prior abnormal performance differs across types of qualifications. The results also indicate that there was little evidence of a stock price effect when qualifications were disclosed publicly. In other words, the announcements of both "subject to" audit opinions and disclaimers of opinions have little impact on stock prices. However, they have further stated that these results do not mean that qualifications are unimportant, or that the audit opinion should be eliminated.

Ameen et al (1994) investigate the information content of the qualified audit opinions for the "over-the-counter" firms in the USA. The researchers have used an event study to investigate whether the qualified audit opinions of the small-sized companies affect share prices. The investigation has covered 177 qualified audit reports issued during the period 1974-1988. The researchers have used the market model to calculate the normal and abnormal returns and then the average and the cumulative abnormal returns were calculated. The results of the study showed a negative reaction of the market during the period preceding the date of the announcement of the qualified opinions, but there was no market reaction during the event period.

Chen et al. (2012) empirically investigate the effect of qualified audit opinions on private debt contracts using a comprehensive sample of qualified audit opinion from 1992 to 2009. Consistent with the monitoring role of audit opinions on accounting quality, they find that a qualified audit opinion is associated with an average increase of 18 basis points in the interest rate of loan facilities issued within the same year.
They find that this effect persists for at least three years following a restored clean opinion with an average increase of 8 basis points in the interest rate for these loans. Furthermore, they find evidence that lenders replace financial covenants with non-financial covenants following a qualified audit opinion on the borrower's financial statements. They also find a qualified audit opinion associated with a decrease in loan size and an increase in the likelihood of requirement of collateral from a borrower, but find no evidence that a qualified audit opinion is associated with a change in the length of loan maturity. Finally, they have concluded that a qualified audit opinion is associated with a decreased use of performance pricing provisions in debt contracts that are based on financial ratios. A variety of additional tests demonstrates that the effects of a qualified audit opinion on contractual terms are robust to controlling for other indicators of accounting quality such as abnormal accruals, volatility of accounting accruals and disclosure of an internal control weakness. In contrast to the mixed evidence of stock market reactions to audit opinions, they find a strong and economically significant response of debt contracting to qualified audit opinions. These results are not obvious given that private lenders have access to private information unavailable to most market participants and suggest that auditors play a unique role in debt contracting through monitoring borrowers accounting quality.

2.5.3 Extant Literature – that Do Not Support

Moradi et al. (2011) investigates the effect of qualified Audit Report on Share Prices and Returns in Iran. In order to determine the effect of the qualified audit reports on share prices and returns, the researchers have used a market-based study for five years (2005-2009). The changes in share prices and returns during the test period
which represents one week before and another after the announcement's date have been 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 show 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 suggests that the audit reports' users do not perceive their information or appreciate its value.

Anvarkhatibi et al. (2012) also investigate the effect of auditor's opinions on shares prices and returns in Tehran Stock Exchange (TSE) during the period 2002-2008. To do the investigation, opinion presented by the auditor is divided into two groups the unqualified opinion and the unacceptable opinion and also based on the researched theories in the group of differences in prices and returns of examined shares to testify the effect of the kind of opinion on price and return differences. Specially, the return of shares in a period of time includes all the benefits that belong to the owner of that share. These benefits include the changes of price, cash dividend, and other benefits such as increase in investment and stock dividends. They have selected the Annual General Meeting (AGM) date as the event date and before and after the general meeting have been divided into short term and long term periods for further analysis. Two statistic techniques were used and results shows that, in confidence interval 95% there is no significant relationship between auditor's opinion and share prices while in
confident interval 95%, there is no significant relationship between auditor's opinion and share returns too. Therefore, they have concluded that there is no significant effect of the auditor's opinion on share prices and returns in Tehran Stock Exchange around the annual general meeting date. Originally, that is, there is no information content of the audit opinion in decision making.

Lin et al. (2003) examines under the topic “An experimental study of users’ responses to qualified audit reports in China” and aims to study the users’ responses to the qualification of audit reports in China. By employing the type of audit report (e.g., unqualified vs. qualified auditor opinion) as a manipulated variable in the experiment, the researcher found mixed responses from the participants towards the perceived impact of a qualified audit report on users’ understanding and the use of the financial statements. In general, Chinese users, credit and loan officers in particular bare a perceived a qualified auditor opinion which has somewhat negative impact on the credibility of financial statements. However, no significant difference was found in users’ investment or credit decisions with respect to their exposure to the financial statements accompanied by an unqualified or a qualified auditor opinion. The study findings further suggest that the US style qualified audit reports have fairly limited “information content” to users in the present Chinese auditing environment and, that there is a need to further improve Chinese auditing standards and practices.

Novoselova and Soklim (2011) have examined the short-term financial market reaction to the going concern audit opinion on public announcements within the time period of 2007-2009 in the Australian context. The primary purpose of the study was to examine the ASX market response to the Going Concern opinion whereas the sub-purposes of
the paper attributed to the explanation of the detected reaction to the going concern audit modifications, testing the difference in reactions to the final and preliminary going concern announcements and, finally, investigation of the value of an audit opinion are perceived by the stock market participants. Based on the event study method abnormal returns around the Going Concern Opinion announcement events were tested by applying the parametric and non-parametric tests in order to define the significance. They have concluded that there is no adverse financial market reaction to the initial going concern audit opinion on public announcements in a short term period captured in the ASX. However they provide a weak evidence of the statistically significant decrease of the abnormal returns on the 6 day after the final Going Concern Opinion announcement, which indicates the deferred market response to the event.

Novoselova and Soklim (2011) have further speculated that, information content of the audit opinions with going concern notes is of a great concern since investors do not perceive it as a newsworthy signal of impending bankruptcy. That is, due to the investors who mainly rely on the financial figures and director’s declarations of the preliminary reports, while the final Going Concern Opinion is unable to deliver any new information content and expected by the market participants; the country-specific Australian Stock Market continuous price-sensitive information disclosure regime, which provides the investors with sufficient announcement information and predetermines the expectations of the going concern in a timely manner; the financial markets are not absolutely efficient, it takes longer time to detect the stock market reaction since the prices are unable to incorporate the new information immediately in a short-term period.
Tahinakis et al. (2010) investigate the information content of the Qualified Audit Opinion by examining the shares prices' fluctuations at the Athens Stock Exchange, during the announcement date of the report contents, as well as, around this date under the topic “An Appraisal of the Impact of Audit Qualifications on Firms' Stock Exchange Price Fluctuations”. In order to study the informational content of audit reports, qualified opinion reports and disclaimer of opinion reports during 2005-2007 were used for companies with shares in the Athens Stock Exchange (ASE). The final sample consisted of 51 audit reports, corresponding to 39 companies from a total of 388 companies with shares in the Athens Stock Exchange during these three years. By using the market model and calculating bonuses, the effect of the audit report on a company's stock price is examined. The results of this study indicate that audit reports have limited informational content for investors and do not involve as a part of their decision making process. They have further highlighted that this may be due to the lack of understanding for the contents, importance and value of such reports.

Ahmadi et al. (2014) have made an investigation to answer to what kind of consequences could be for qualified audit opinions? On the other side, shareholders, capital investors and creditors show what kind of reaction should be with regard to qualified audit opinions when taking into consideration that, audit opinions increase reliability of information that are accessible for investors and creditors, and at the same time, represent the qualified audit opinions that can increase the risk of information as well. This research examines the impact of qualified audit opinions on the expected return on common shareholders' and gives credibility by creditors. Statistic samples in this study are collected from 120 companies listed on the Tehran Stock Exchange for the time period of 2004 to 2011, and in order to examine hypothesis of this study the
panel data method of research was applied. Based on the findings of this study, they have concluded that there is a Positive relationship between qualified audit opinions and the expected return on common shareholders and, on the contrary, there is no relationship between qualified audit opinions and the granting of credit by the creditor.

Shelvin and Whittred (1984) in Panayiotis et al (2010), applying an experimental model attempts to obtain further information on how the issuing of a qualified opinion report affects a company’s stock price. From the results of this study, no such effect has been documented. Yet, it has emerged that stock prices fall during the period prior to the announcement, and that the extent of this fall depends on the type of reservations presented in the certificate.

Dodd et al (1984) examines the impact on stock prices of the issuing of a qualified opinion report, while other examinations take place in order to determine the effect of disclaimer of opinion reports. From the results of the research process, it has been concluded that the publishing of a report with reservations for enterprises is a rare case. Yet, when it actually happens, it causes negative abnormal returns on company stocks.

Chen et al (2000) investigate the valuation effect of modified audit opinions (MAOs) on the emerging Chinese stock market over a three-year period (1995-97). Here, the term MAO refers to both qualified opinions and unqualified opinions with explanatory notes. The latter can be considered an alternative form of a qualified opinion in China. The institutional setting in China enables to find compelling evidence in support of the monitoring role of independent auditing as an institution. First, they find a significantly negative association between MAOs and cumulative abnormal returns after controlling for effects of other concurrent announcements. Further, results from a by-year analysis
suggest that investors did not reach negative consensus about MAOs' valuation effect until the second year, exhibiting the learning process of a market without prior exposure to MAOs. Second, they do not observe significant differences between market reactions to non-GAAP and GAAP-violation-related MAOs. Third, no significant difference is found between market reaction to qualified opinions and market reaction to unqualified opinions with explanatory notes.

The study of Lin et al. (2003) is one of attempts made within Chinese borders to examine the effect of audit reports on investment and financing decisions. The results of the questionnaire analysis indicate that the qualified opinion reports have a negative impact on the estimation of a financial statement's reliability with regard to the beliefs of banking and financial institution employees. The reservations expressed in a report have slight impact on the beliefs of managers and financial auditors. Yet, these reservations do not seem to be affecting on the investment and financial decisions of these two groups at all.

Houghton (1983) in Al-Thuneibat et al. (2008) conduct an experimental study in order to investigate the impact of the audit opinion on the decision-making process and the decision outcome of the lending process of Australian banks. The concern was to discover if there was a difference in the information content between different types of audit reports, i.e. qualified and unqualified whether there was any difference between the presence and the absence of the report in general. He has designed a set of hypothetical information consisting of a balance sheet and income statement; statutory declarations; funds flow statement; notes to the accounts; and bank loan application. Similar sets of this information were given to three groups, the first accompanied by a "subject to"
qualified audit report; the second accompanied by an unqualified audit report; and the third without a report. The results indicate that there was no significant influence in each of the three cases on the decision outcome, i.e. the qualified report, the clean report, and the absence of the report had no significant influence on the agreement with, or the amount of, the loan. However, he has stated that the results indicated 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 has 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.

The study of Hamill et al.(2004) in Panayiotis et al (2010) aims at examining the consequences of audit report explanatory paragraphs on enterprises with shares in the stock exchange, and whether investors can understand the difference between special treatment reports and modified reports. Following the analysis of results, Hamill et al. were not in position to support that the existence of explanatory paragraphs in audit reports have informational value to investors. What they seem to overlook is the existence of a special treatment report. It has been observed that the performance of companies that had received a special treatment report was notably lower than the respective performance of auditing companies for the period both prior to and following the announcement.

Al-Thuneibat (2008) has investigated whether the audit report in Jordan represents an
important source of information in the process of decision making, that is, to investigate whether the audit report has information content. This study concentrates on the effect of the qualified audit reports on share prices and returns in Jordan. In order to determine the effect of the qualified audit reports on share prices and returns, the researchers have used a market-based study, covering five years (2000-2005). The changing prices and returns on stocks on the date of delivering the audit report to the ASE and during the test period which represents one week before and another after the announcement date was measured. It appears no clear pattern of stock reactions to the qualified auditor's opinion report and the conclusion is 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 further suggested that the readers of the audit report do not understand its meaning or appreciate its value.

Robertson (1988) in Al-Thuneibat et al. (2008) was concerned with investigating whether the terminology of report qualifications influences the reactions of financial analysts to the audit report. He has sent an identical set of financial statements from a hypothetical company to the respondents and each set has been accompanied by one type of qualified audit report. The respondents were asked to determine whether they felt that the audit report added credibility to the financial statements; whether they relied on this information when making financial investment decisions; and whether they felt that this information satisfied their needs when doing the analysis. The results indicated that the financial analysts did not make any significant distinctions among different types of audit report qualifications.

Bessell et al (2003) in Al-Thuneibat et al. (2008) has used an experimental study to
investigate the information content of going concern "modified audit reports" in Australia. They surveyed the opinions of the members of the Australian Institute of Banking and Finance. They have distributed various types of audit reports (unqualified, qualified and unqualified with explanatory paragraph) accompanied with questionnaires to a sample of 500 of the members of the institute. The researchers have found that an "Emphasis of matter" and an "Except for report" has information content if a company has no financial distress. However, the results showed that if the company was in a state of financial distress, the modification does not appear to significantly enhance perceptions of risk or decision making.

Mong and Roebuck (2005) in Al-Thuneibat et al. (2008) investigate the effect of audit report disclosure on auditor litigation. They have used a survey study to examine whether the issuance of an audit opinion with a going concern related "emphasis of matter" paragraph or work practices disclosure has any effect on potential litigants' likelihood of pursuing litigation against the auditor. The results of the study indicated that a modified (but not qualified) audit report effectively acts as a "red flag" and reduces litigants' propensity to initiate litigation. The results also indicated that, although work practices disclosure was an important factor, it did not significantly alter potential litigants' inclination to recommend litigation.

Martinez et al. (2004) have investigated the reaction of the Spanish capital market to qualified audit reports, that is, they have used an event study methodology to investigate the relationship between the audit report qualifications and the stock prices during the period 1992-1995. The results of the study showed that there was no relationship between stocks prices and qualified audit opinions no information content of the
qualified audit opinions.

2.6 Summary

This chapter discusses the theoretical and empirical findings in relation to The Effect of Modified Auditors' Report on Share Prices. First it discusses the Efficient Markets Hypothesis (EMH, which concludes that the current stock prices fully reflect available information about the value of the firm, and there is no way to earn excess profits. Based on the empirical findings, the researcher concludes that Sri Lankan capital market is semi-strong form efficient. Secondly it briefly discussed about the CSE and its history. Thereafter, it deeply discusses the contradictory and inconsistent conclusions provided by the previous studies undertaken in the area of audit reporting and behavior of the share prices.

As identified by K. Ittonen (2012), three different approaches are used here to examine the existence of abnormal stock returns to qualified audit report disclosures. These are traditional short-window event studies, the long event window approach and indirect approach. The traditional short-window event studies are the most commonly used and very powerful test when the event date is correctly identified. Different event dates have been used by the researchers (such as Audit Report Date (signed date by the auditors), announcement date at the stock exchange, AGM date likewise). The audit modification also has been identified in different categories such as unqualified opinion reports; qualified opinion reports; disclaimer of opinion reports; and adverse opinion reports and unqualified opinion reports with emphasis of matters.

It has found that indirect approach has consistently supported for the hypothesis that the qualified audit reports are relevant to investors while other two approaches have
mixed conclusion.


Therefore, based on the overall literature review, the researcher concludes that previous studies have provided contradictory and inconsistent conclusions about the information content of the modified audit reports in the stock exchange in the area of audit reporting and behavior of the share.
Chapter III : Research Methodology

3.1 Introduction

This intends to achieve research objectives while addressing the research problem. Accordingly, this chapter provides information on testing whether modified audit report has a significant impact on the stock prices and returns of the corresponding companies. Therefore, the description of the research approach, selection of Event Dates, Sample Selection would be discussed under this chapter. The steps and equations are used to analyze the data of the study such as Actual Return, Return on the Market Portfolio, Regression Line Parameters ($\alpha$ and $\beta$), Expected Return, Abnormal Return, Arithmetic Mean of the Abnormal Return (ARR), The Cumulative Average Abnormal Return (CAAR). Finally discuss the estimation of Estimation Period and Test Periods and methods of Data Collection.

3.2 Research approach used

This study uses the positivist research paradigm and a quantitative research strategy. Positivism in general refers to philosophical positions that emphasize empirical data and scientific methods. This tradition holds that the world consists of regularities, that these regularities are detectable, and, thus, that the researcher can infer knowledge about the real world by observing it. The researcher should be more concerned with general rules than with explaining the particular.

Ittonen (2012) in his archival study has identified three different approaches used to examine the existence of abnormal stock returns to qualified audit report disclosures. They are traditional short-window event studies methods; the long event window approach methods and indirect approaches. Al-Thuneibat et al.
(2008) has also mentioned that many methodologies have been used to investigate the information content of the audit report, including market-based studies, experimental studies and interpretational studies.

This study investigates the effect of the qualified audit reports of the listed companies in the CSE on share prices and concentrates on share prices and returns in the real world, and therefore the methodology that is applied here is market-based. This is more similar to the traditional short-window event study methods described by Ittonen (2012). According to Kothari and Warner (2006), the short event window approach is a powerful method for examining the relevance of audit reports and it is perceived to be a reliable measure of the abnormal performance of a stock at the time of an unanticipated event.

As Brown and Warner (1984) have concluded the research methodology based on the market model is both well specified and relatively powerful under a wide variety of conditions. However, the applicability of these conclusions for event studies, with daily data is an open question.

Bartholdy et al. (2007) have concluded that event studies using daily data can be meaningfully performed on a small exchange provided that certain adjustments are made to account for the problems caused by very thin trading. Among others, a minimum of 25 events appears necessary to obtain the acceptable size and the power in statistical tests. If possible, 50 or more events provide even better size and power in the test statistics.

Ittonen (2012) too states that event study approach presents two significant
challenges because a market reaction is expected only if the disclosed information is relevant and new. The information in these two report types is considered relevant to investors. While studying the market reaction to the disclosure of these audit report types, researchers have occupied with controlling for the surprise and novelty of the information disclosed in the audit report. To control for novelty and surprise two issues should be considered. They are the point at which the audit report is publicly disclosed which involves defining the event date and subject to controlling for being surprising over the information in the audit report.

As far as researcher concerned, there are no empirical in the field of audit report and share prices in Sri Lanka. However there are a number of empirical where event study method is applied as evident from Dissabandara (2001), Dissabandara et al. (2002), Gunarathna Banda (2002), Dissabandara et al. (2010), Dissabandara et al. (2012), etc... Therefore, applicable parameters of these local empirical were adapted when required to match the event study methods to local context.

3.3 Selection of Event Date

To investigate the reactions of share prices and returns for the issue of qualified audit opinions, it is needed to measure the change in share prices and returns as a result of the modified opinions effect. Therefore, it is needed to determine the appropriate date that can be considered the date of the auditor's opinion will affect the prices (Al-Thuneibat et al., 2008). In Market base study or short-window event study, the identification of the event date is one of the most fundamental issues. Since, assuming semi strong efficient markets, the stock market will quickly digest any new and relevant publicly available information and the stock price will be
instantly re-estimated. As a theory, the correct event date is the date when the audit report information reaches investors.

As appear in the Figure III-I, Ittonen, 2012 in his Literature Review have summarized the alternative event dates used by the several studies from 1972-2010.
**Figure III-1: Alternative Event Dates**

<table>
<thead>
<tr>
<th>Earliest of conceivable disclosure dates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Louder et al. (1992, AJPT)*</td>
</tr>
<tr>
<td>Ameen et al. (1994, JBFA)</td>
</tr>
<tr>
<td>Fleak et al. (1994, JAAF)*</td>
</tr>
<tr>
<td>Jones (1996, JAPP)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Earnings announcement date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Davis (1982, AJPT)</td>
</tr>
<tr>
<td>Elliot (1982, JAR)*</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>SEC filing date of annual report/10-K report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baskin (1972, TAR)</td>
</tr>
<tr>
<td>Firth (1978, TAR)</td>
</tr>
<tr>
<td>Chow et al. (1982, AJPT)*</td>
</tr>
<tr>
<td>Banks et al. (1982, JAR)*</td>
</tr>
<tr>
<td>Davis (1982, AJPT)</td>
</tr>
<tr>
<td>Dodd et al. (1984, JAE)</td>
</tr>
<tr>
<td>Mittelstaedt et al. (1992, AJPT)</td>
</tr>
<tr>
<td>Frost (1994, AJPT)*</td>
</tr>
<tr>
<td>Carlson et al. (1998, QJBE)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Media coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chen et al. (2000, CAR)*</td>
</tr>
<tr>
<td>Pucheta et al. (2004, EAR)</td>
</tr>
<tr>
<td>Taffler et al. (2004, JAE)*</td>
</tr>
<tr>
<td>Ogneva et al. (2007, JAE)</td>
</tr>
<tr>
<td>Herbohn et al. (2007, AF)*</td>
</tr>
<tr>
<td>Beneish et al. (2008, TAR)</td>
</tr>
<tr>
<td>Hammersley et al. (2008, RAST)*</td>
</tr>
<tr>
<td>Ashbaugh-Skaife et al. (2009, JAR)*</td>
</tr>
<tr>
<td>Kausar et al. (2009, JAR)</td>
</tr>
<tr>
<td>Czernkowski et al. (2010, MAJ)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Annual general meeting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Soltani (2000, IJA)*</td>
</tr>
<tr>
<td>Pucheta et al. (2004, EAR)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Filing of related event</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fields et al. (1991, AJPT)*</td>
</tr>
<tr>
<td>Chen et al. (1996, TAR)*</td>
</tr>
<tr>
<td>Fargher et al. (1998, JBFA)*</td>
</tr>
<tr>
<td>Holder-Webb et al. (2000, JAR)*</td>
</tr>
</tbody>
</table>

The date of the balance sheet, which is on 31 March and 31 December in general in Sri Lanka (Specially in Banking Sector), is not an appropriate date because the auditor continues doing his field work after this date and thus, the auditor's opinion will not be known or issued at this date.

The date of the end of the field work, which represents the date of the auditor's report, is not necessarily the same date of writing the report that is the auditor may prepare his report few days after the end of the field work. Thus, this date will not represent a date that can reflect the effect of the auditor's opinion.

The date of writing the report and submitting it to the client is still private information because general investor does not know such information. Earning Announcement date also does not disclose the audit opinion except this is not announced together with audited Financial Statements. The date, of which a specific audited annual report announcement appears in the official publication of the CSE after delivering the audited annual report to the CSE, the report will be declared to the public and therefore this date will represent the best date for investigating the effect of the qualified opinions on shares prices.

According to Moradi, 2011, 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. Ittonen, 2012 in his literature review also has stated that the most frequently used event date is the date of filing of the annual report in the Stock Exchange. The date of Annual General Meeting (AGM) has also been selected by several researchers as the event date. However, The Modified Audit Report is not new information when AGM is held and therefore such impact may have been already reflected in the share price. Therefore, the researcher has selected the date, of which a
specific audited annual report announcement appears in the official publication of the CSE as the event date which is the next working day to the submission of annual reports which contains the audit report.

3.4 Sample Selection

Annual report releases are collected from the CSE website (www.cse.gov.lk) for the companies listed on the CSE from 2010 to 2014. The original sample consists of 1,298 Audited Annual Reports, and after removing those companies with incomplete data the sample is reduced to 1,244 Audited Annual Reports. Summary of the audit opinions issued are shown in the Table III-1.

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2013</th>
<th>2012</th>
<th>2011</th>
<th>2010</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unqualified Opinions</td>
<td>193</td>
<td>242</td>
<td>240</td>
<td>213</td>
<td>184</td>
<td>1,072</td>
</tr>
<tr>
<td>Qualified Opinions</td>
<td>11</td>
<td>11</td>
<td>16</td>
<td>17</td>
<td>23</td>
<td>78</td>
</tr>
<tr>
<td>Disclaimer of Opinions</td>
<td>-</td>
<td>1</td>
<td>-</td>
<td>1</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Adverse Opinions</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Emphasis of Matters</td>
<td>17</td>
<td>20</td>
<td>15</td>
<td>18</td>
<td>19</td>
<td>89</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>221</td>
<td>274</td>
<td>271</td>
<td>249</td>
<td>229</td>
<td>1,244</td>
</tr>
</tbody>
</table>

There were 172 modified audit reports corresponding to 71 companies having 78 qualified opinion reports, 4 disclaimers of opinion reports, 1 adverse opinion report and 89 emphasis matters report during the test period. When there are more than one modification such as qualification to the opinion and emphasis of matters, it was considered as a qualification to the audit opinion. When there are any modifications consecutively for a company more than one year, it was taken only the first time modification for the sample as to test only the impact of newly information. When
there is more than one modified report in a specific company within the test period, they were considered as separate events, when there is no continuous modification to the report. However, 17 companies who had their reports modified were excluded from the sample in the study because the date of disclosing the reports with the CSE was not clear.

Table III-2: Selection of Sample

<table>
<thead>
<tr>
<th>Description</th>
<th>No. Reports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Modified Audit Reports (2010-2014)</td>
<td>172</td>
</tr>
<tr>
<td><strong>Less : Exclusion</strong></td>
<td></td>
</tr>
<tr>
<td>Due to Continues Modification</td>
<td>95</td>
</tr>
<tr>
<td>Due to publication date is not clear</td>
<td>17</td>
</tr>
<tr>
<td>To prevent contaminated events</td>
<td>7</td>
</tr>
<tr>
<td><strong>The Final Sample</strong></td>
<td>53</td>
</tr>
<tr>
<td>Qualified Opinions</td>
<td>26</td>
</tr>
<tr>
<td>Disclaimer of Opinions</td>
<td>1</td>
</tr>
<tr>
<td>Adverse Opinions</td>
<td>-</td>
</tr>
<tr>
<td>Emphasis of Matters</td>
<td>26</td>
</tr>
<tr>
<td><strong>The Final Sample</strong></td>
<td>53</td>
</tr>
</tbody>
</table>

60 modified audit reports corresponding to 54 companies were identified with full information for the analysis. However, 07 modified reports (corresponding to 06 companies) out of 60 were further excluded from the sample due to high volatility of the share prices during the estimation period as to exclude the effect of contaminated events. Therefore, the final number of 53 modified audit reports corresponding to 48 companies were entered into the analysis as the dates of disclosing their reports with the CSE were clear and the information about the prices of their stocks were available through the test and estimation periods.
In order to determine the effect of the qualified audit reports on share prices and returns, it was needed to measure the change in share prices of stocks on the date of delivering the audit report to the CSE. If there is an abnormal return on that date, it means that there is information content of the qualified audit report. If there is no abnormal return, then there is no information content of the qualified audit report.

3.5 Estimation of Returns

The researcher has used the following steps and equations to analyze the data of the study.

3.5.1 Actual Return

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

\[ R_{i,t} = \frac{P_{i,t} + D_{i,t} - P_{i,t-1}}{P_{i,t-1}} \]

where:

- \( R_{i,t} \) - Actual return of stock (i) on day (t);
- \( P_{i,t} \) - Closing price of stock on day (i);
- \( D_{i,t} \) - Dividends on stock (i) on day (i);
- \( P_{i,t-1} \) - Closing price of stock on time (t - 1).

Even the most suitable formula to calculate the return of the stock, dividends would be ignored because of the timing differences of dividends declarations and the unavailability of these dividends. Therefore, the following equation will be used in calculating actual stock returns:

\[ R_{i,t} = \frac{(P_{i,t} - P_{i,t-1})}{P_{i,t-1}} \]

Therefore, the stock prices were entered into an excel spreadsheet and the actual stock returns of the companies were calculated using the above formula 02.
3.5.2 Return on the Market Portfolio

The value of the market indices (All Share Price Index-ASPI) were entered into an excel spreadsheet and the returns on the market portfolio were calculated using the following equation:

Formula 03: \[ R_{m,t} = \frac{(MP_{t,t} - MP_{t,t-1})}{MP_{t,t-1}} \]

Where: \( R_{m,t} \) - Return on the market portfolio; \( MP_{t,t} \) - Market Price Index on Day \( t \), \( MP_{t,t-1} \) - Market Price Index on Day \( t - 1 \).

3.5.3 Regression Line Parameters (\( \alpha \) and \( \beta \))

The stocks prices and indices during the estimation period which is 60 days were entered into excel spreadsheet, and the simple regression was used to estimate the regression line parameters Alpha and Beta (\( \alpha \), and \( \beta \)) for each company. The Alpha (\( \alpha \)) is the intercept estimation from the regression analysis and the Beta (\( \beta \)) is the estimation of the slope for the ASPI Return variable. The slope measures how much the dependent variable (Company’s Return in this case) varies with one unit increase in the independent variable (ASPI Return). This regression is run for each company and hence 53 Alpha’s and Beta’s are estimated, which are then used in the calculation of abnormal returns as shown in Appendix I.

3.5.4 Expected Return

The parameters \( \alpha_i \) and \( \beta_i \) for each company and the returns on the market portfolio \( (Rm,t) \) were entered into excel spreadsheet and the expected returns ( \( ER_{i,t} \) ) were calculated using the following formula (the Market Model Formula)
Formula 04  \[ ER = \alpha_i + \beta_i (R_{m,t}) + e_i \]

Where: \( ER_{i,t} \) - Expected Return on Share \( i \) on day \( t \); \( \alpha_i \) - The intercept estimation from the regression analysis on Share \( i \), \( \beta_i \) - The estimation of the slope for the ASPI Return variable on Share \( i \), \( e_i \) - Error Term

3.5.5 Abnormal Return

Abnormal Returns (Unexpected Return) were calculated as actual return minus expected Return:

Formula 05  \[ AR_{i,t} = R_{i,t} - ER_{i,t} \]

3.5.6 Arithmetic Mean of the Abnormal Return

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

\[ AAR_{i,t} = \frac{\sum AR_{i,t}}{n} \]

Formula 06

Where: \( AAR_{i,t} \) - Average Abnormal Return of Stock \( i \) on day \( t \); \( n \) - number of firms.

3.5.7 The Cumulative Average Abnormal Return (CAAR)

According to Dissabandara et al. (2010), the leakage of information is commonly observed when information is released to a small group of market participants before official public announcement. ARs on the announcement date are then a poor indicator
of the total impact of the information release. Therefore, a better indicator would be
the CAARs which are the sum of all ARs over the event period. The CAARs captures
the total firm specific stock movement for an entire period when the market might be
responding to new information.

Therefore, CAAR is calculated in order to find the total effect of the qualified
auditor's opinion during the window (the period surrounding the issuance of the audit
report)

\[ CAAR = \sum AAR_t e \]

Formula 07:

3.6 The Analysis

Based on the above formula, this analysis is of three major components, they are the
Graphical Analysis, the Main Analysis and Other Analysis. The Main analysis consist of
t-test Analysis for the difference between Average Abnormal Return (AAR) and Zero;
for the difference between Two Day Cumulative Average Abnormal Return (CAAR)
and Zero; for the difference between Cumulative Average Abnormal Return (CAAR)
and Zero for different window periods.

3.7 Estimation Period and Test Period

The estimation period is the period used to estimate the parameters of the regression line
\((\alpha_t \text{ and } \beta_t)\) to estimate the expected returns. To estimate the parameters of the
regression line to calculate the expected returns, a period of 60 days before the starting
date of the test period have been used.

The estimation period selected in most of the prior studies in relation to studying the
impact of modified audit reports to share prices and returns is 100 days prior to test period and the event period or test period is 11 including 5 days before and after the date of disclosing the financial statements have been used such as Moradi 2011; Al-Thuneibat et al., 2008; Panayiotis et al and many others. However, most of those markets are developed and big markets.

The CSE is relatively developing and smaller stock market and the share prices and returns are highly volatile. This study attempted to minimize the impact volatility and contaminated events occurred during the test period. Hence, for the purposes of this study, a period of 60 Colombo Stock Market working days (T=-64) before the starting date of the test period was used to estimate the parameters ($\alpha$ and $\beta$) of the regression line to calculate the expected returns. The test period consisted of four stock market working days before (T=-4) and after (T=+4) the date of disclosing the financial statements by the CSE, that is, 9 Stock Market working days (including day 0). The shorter event period is preventing the impact of contaminated events. The following diagram shows the estimation periods and test periods.

---

1 The researcher also has tested the impact of modified audit reports to share prices and returns using different estimation period and test period. For this, the selected estimation period is 100 days prior to the test period. The event period or the test period is 15 days including 7 days before and after the date of disclosing the financial statements of the audit report available at the official website of CSE. However, it was identified that there was no difference between test result of this study and the previous. The parameters ($\alpha$ and $\beta$) of the regression line used to calculate the expected returns are attached in the appendix II.
3.8 Data Sources

The following sources of data and information were collected for the study:

i. All the Audited Annual Reports issued by the Companies listed in the CSE and disclosed (uploaded) in the official Websites of the CSE (www.cse.gov.lk) during the period 2010-2014.

ii. The dates of receiving the modified audit reports by the CSE.

iii. Daily prices of companies securities that have issued modified audit reports for the period surrounding the date of delivering the financial statements to the CSE for the period 2010-2014.

iv. Daily All Share Price Index (ASPI) of securities prices for the period surrounding the date of delivering the financial statements to the CSE for the period 2010-2014.

v. Daily prices of company’s securities that have issued modified audit reports for the period of 60 days preceding the starting date of the test period surrounding the date of delivering the financial statements to the CSE for the period 2010-2014.

vi. Daily All Share Price Index (ASPI) of securities prices for the period surrounding the date of delivering the financial statements to the CSE for a period of 60 days preceding the starting date of the test period.

vii. All the daily reports issued by the CSE from 01st January 2010 to 31st December 2014.
3.9 Summary

The conceptual model was derived from the literature survey and their evaluation. Based on the research problem, objectives and previous studies, on this study is hope to test whether Qualified Audit Opinion Reports, Adverse Audit Opinion Reports, Disclaimer of Audit Opinion Reports or Unqualified Audit Opinion with Emphasis’s Matters (Explanatory Notes) reports have significant impact on the stock prices and returns of the corresponding companies. The market-based methodology is applied. The date which a specific audited annual report announcement appears in the official publication of the CSE has been selected as the event date.

The sample was derived from Annual Report released in the CSE website (www.cse.gov.lk) for the companies listed on the CSE from 2010 to 2014. There were 172 modified audit report corresponding to 71 companies during the test period. Only the first time modification was taken to test only the impact of the new information and, when there is more than one modified report within the test period, it is considered as separate events, when there no continuous modification. 17 companies were excluded from the sample due to disclosing date in the CSE was not clear. 07 modified reports (corresponding to 06 companies) excluded from the sample d to mitigate the effect of contaminated events.

Few equations were derived to analyze the data such as Actual Return, Return on the Market Portfolio, Regression Line Parameters ($\alpha$ and $\beta$), Expected Return, Abnormal Return, Arithmetic Mean of the Abnormal Return (ARR), The Cumulative Average Abnormal Return (CAAR). The estimation period is to estimate the parameters of the regression line ($\alpha$ and $\beta$); a period of 60 days before the starting date of the test
period. The test period consisted of seven stock market working days before and after the date of disclosing the financial statements by the CSE.

The information thus collected to test was included; All the Audited Annual Reports issued by the Listed Companies in the CSE; the dates of receiving the modified audit reports by the CSE; Daily prices of Listed companies securities; and All the daily reports issued by the CSE, from 01st January 2010 to 31st December 2014.
Chapter IV : Analysis

4.1 Introduction

This chapter is intended to analyze the Effect of Modified Auditors' Report on Share Prices and evidence from Listed Companies of the CSE. It evaluates the efficiency of the CSE under EMH in addition.

As the methodology illustrated that, Arithmetic mean of the Average Abnormal Return (AAR) was used in order to investigate the effect of modified audit report on share prices and returns. Base on the Auditor’s Opinion, the whole data set (sample) has been divided into three categories for the purpose. Firstly, the whole data set was considered as one including all the modification such as, the qualified opinion reports; disclaimer of opinion reports; adverse opinion reports and unqualified audit opinion reports with emphasis matter (explanatory note). Secondly, all the qualified audit opinion report including the disclaimer of the opinion reports and adverse opinion reports were separately considered. However, only one disclaimer of opinion report and no adverse opinion reports come under the sample. Thirdly, all the unqualified opinion reports with explanatory notes or emphasis matter/s were also identified as separate category. The first category consisted with 53 modified reports and second and third categories are consisted with 27 and 26 in sequence.

4.2 Graphical Analysis

This section of the analysis graphically explains the behavior of the ARR and the CAAR during the test period. X axis shows the days in the test period while Y axis shows the Abnormal Return for the given date.
4.2.1 Graphical Analysis for ARR

Figure IV-1 presents the pattern of the Average Abnormal Return (AAR) of the all three set of data categories such as the whole data set as one including all the modification (Total AAR), the qualified audit report including one disclaimer of the opinion report separately (Q AAR) and all the unqualified opinion reports with the emphasis matter/s separately (ME AAR). X axis shows the days in the test period while Y axis indicates the AAR for the given date.

Figure IV-1: ARR during the test period

As evident from the figure IV-1 that the AAR before the event dates (T 0) is fluctuating without a specific pattern and the researcher notices that some observations of negative and positive signs except for the Q AAR. The Q AAR continuously shows a positive sign prior to the event date. However, after the event date, all AAR have a negative sign for all three set of data including the event date except for the Q AAR.
Therefore, it clearly shows that a pattern from the event date (T-0) that, AAR is negative. Therefore, it is true to say that, after the event date there is a negative effect on share prices and the return of the Modified Audit Reports. Yet, it seems that there is information content in the modified audit reports in the CSE. The ME AAR has a greater negative AAR compared to other two sets of sample.

4.2.2 Graphical Analysis for CAAR

Figure IV-2 presents the pattern of the Cumulative Average Abnormal Return (CAAR) of all the three set of data categories such as the whole data set as one including all the modification (Total AAR), the qualified audit report with one disclaimer of opinion report separately (Q AAR) and all the unqualified opinion reports with the emphasis matter/s separately (ME AAR). This shows the cumulative impact of the modified audit reports during the test period. The X axis shows the days in the test period while the Y axis represents the CAAR for the given date.

Figure IV-2: CAAR Return during the test period
According to the Figure IV-2, the CAAR of the all three set of data categories such as “Total CAAR”, “the Q CAAR” and “the ME CAAR” presents a positive trend up to the event date. However, it is clearly shows a negative trend or a pattern after the events date for all three set of data categories. Therefore, it graphically shows a negative trend or a negative impact on share prices and the return on modified audit report. This conclusion is common for all three set of data categories. In other words, it seems that, there is negative information content in the modified audit report.

4.3 The Main Analysis

The table IV-1 presents daily AAR, daily CAAR in different window periods surrounding the event date and the direction of ARs on modified audit report publication dates.

The Panel A of Table IV-1 analyses whether these are any AAR on announcement of modified audit reports in the CSE in the corresponding companies under three categories such as, for all Modified Audit Reports Companies together (Total), for only the Qualified Audit Reports (Qualified) and for only the Unqualified Audit Reports with Emphasis Matter companies (Matter Emphasis) separately during the test period. It also checks whether AAR is significant during the test period. One sample t-test model was used to calculate the Significant (Sig.). The test period covers four days before (T-4 to T-1) and four days after (T+1 to T+4) the date of disclosing the financial statements with the CSE. The Panel B of Table AA analyses the Cumulative impact of the AAR in different window periods such as T-4 to T0, T0 to T+4, T-2 to T+2, T-1 to T+1, T0 to T+1 and T-4 to T+4. The Panel C of Table IV-1 analyses the direction of ARs on modified audit report publication dates such as “Total”, “Qualified” and “Matter Emphasis”.

62
Table IV-1: Abnormal Return for Each Category of Modified Reports

Panel A
Average Abnormal Return (AAR)

<table>
<thead>
<tr>
<th>Days</th>
<th>Total (53)</th>
<th></th>
<th>Qualified (27)</th>
<th></th>
<th></th>
<th>Matter Emphasis (26)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ARR</td>
<td>Sig.</td>
<td>ARR</td>
<td>Sig.</td>
<td>ARR</td>
<td>Sig.</td>
<td></td>
</tr>
<tr>
<td>T-4</td>
<td>-0.0016</td>
<td>0.7839</td>
<td>-0.0023</td>
<td>0.8161</td>
<td>-0.0009</td>
<td>0.8902</td>
<td></td>
</tr>
<tr>
<td>T-3</td>
<td>0.0066</td>
<td>0.2011</td>
<td>0.0044</td>
<td>0.5296</td>
<td>0.0090</td>
<td>0.2572</td>
<td></td>
</tr>
<tr>
<td>T-2</td>
<td>-0.0023</td>
<td>0.6598</td>
<td>0.0040</td>
<td>0.6314</td>
<td>-0.0089</td>
<td>0.1681</td>
<td></td>
</tr>
<tr>
<td>T-1</td>
<td>0.0071</td>
<td>0.3333</td>
<td>0.0109</td>
<td>0.4179</td>
<td>0.0032</td>
<td>0.5932</td>
<td></td>
</tr>
<tr>
<td>T0</td>
<td>-0.0013</td>
<td>0.8216</td>
<td>0.0061</td>
<td>0.5003</td>
<td>-0.0089</td>
<td>0.2048</td>
<td></td>
</tr>
<tr>
<td>T+1</td>
<td>-0.0018</td>
<td>0.8019</td>
<td>-0.0013</td>
<td>0.9145</td>
<td>-0.0023</td>
<td>0.7688</td>
<td></td>
</tr>
<tr>
<td>T+2</td>
<td>-0.0042</td>
<td>0.3352</td>
<td>-0.0007</td>
<td>0.9084</td>
<td>-0.0079</td>
<td>0.1969</td>
<td></td>
</tr>
<tr>
<td>T+3</td>
<td>-0.0045</td>
<td>0.1748</td>
<td>-0.0062</td>
<td>0.2257</td>
<td>-0.0027</td>
<td>0.5269</td>
<td></td>
</tr>
<tr>
<td>T+4</td>
<td>-0.0102</td>
<td>0.0779</td>
<td>-0.0166</td>
<td>0.1177</td>
<td>-0.0036</td>
<td>0.4263</td>
<td></td>
</tr>
</tbody>
</table>

Panel B
Cumulative Average Abnormal Return (CAAR)

<table>
<thead>
<tr>
<th>Window</th>
<th>Total (53)</th>
<th>Qualified (27)</th>
<th>Matter Emphasis (26)</th>
</tr>
</thead>
<tbody>
<tr>
<td>T-4 to T0</td>
<td>0.0086</td>
<td>0.0232</td>
<td>-0.0065</td>
</tr>
<tr>
<td>T0 to T+4</td>
<td>-0.0221</td>
<td>-0.0188</td>
<td>-0.0255</td>
</tr>
<tr>
<td>T-2 to T+2</td>
<td>-0.0025</td>
<td>0.0190</td>
<td>-0.0248</td>
</tr>
<tr>
<td>T-1 to T+1</td>
<td>0.0041</td>
<td>0.0157</td>
<td>-0.0081</td>
</tr>
<tr>
<td>T0 to T+1</td>
<td>-0.0031</td>
<td>0.0048</td>
<td>-0.0113</td>
</tr>
<tr>
<td>T-4 to T+4</td>
<td>-0.0122</td>
<td>-0.0017</td>
<td>-0.0230</td>
</tr>
</tbody>
</table>

Panel C
Direction of Abnormal Returns (ARs) on Day 0

<table>
<thead>
<tr>
<th>Direction</th>
<th>Total (53)</th>
<th></th>
<th>Qualified (27)</th>
<th></th>
<th></th>
<th>Matter Emphasis (26)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>%</td>
<td>No.</td>
<td>%</td>
<td>No.</td>
<td>%</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>26</td>
<td>49%</td>
<td>12</td>
<td>44%</td>
<td>15</td>
<td>58%</td>
<td></td>
</tr>
<tr>
<td>Positive</td>
<td>27</td>
<td>51%</td>
<td>15</td>
<td>56%</td>
<td>11</td>
<td>42%</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>53</td>
<td>100%</td>
<td>27</td>
<td>100%</td>
<td>26</td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>

As discussed in the Methodology Chapter, to avoid the noise surrounding the announcement date, CAAR is calculated and tested by t-test. The results of the test for all three categories are given in the Table IV-2.
Table IV-2: T-test results of the CAAR for All Shares (Companies) for the total event period

<table>
<thead>
<tr>
<th>Category</th>
<th>N</th>
<th>CAAR</th>
<th>SD</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Modified Audit Reports Shares</td>
<td>53</td>
<td>(0.0122)</td>
<td>0.1093</td>
<td>.421</td>
</tr>
<tr>
<td>The Qualified Audit Reports Shares</td>
<td>27</td>
<td>(0.0017)</td>
<td>0.1238</td>
<td>.943</td>
</tr>
<tr>
<td>Audit Reports with Emphasis matters</td>
<td>26</td>
<td>(0.0230)</td>
<td>0.0930</td>
<td>.219</td>
</tr>
</tbody>
</table>

From next section, impact of the analysis are explained separately for three different set of samples

4.3.1 All Modified Audit Reports Companies ("Total")

According to Panel - A of Table IV-1 shows that the AAR for all Modified Audit Reports Companies together category (Total) at the event date is negative (-0.0013) and it brings a negative impact on the share prices and return. However, the p-values (Sig. values) (.8216) is greater than .05. Therefore, it could be concluded, as a whole, at the 95% confidence level, the effect of the modified audit reports on share prices and returns at the event date is not significant. Also it is in the Panel - A of the table AAA in which some of the AAR’s of the “Total” are positive and others are negative during the event period and all the p-values are greater than .05. It means that there is no clear pattern of stock reactions when considered to all the Modified Audit Reports shares together within the event period and, at the 95% confidence level, there is no significant effect on the share prices and the returns of the corresponding companies during all days of the event period.

The panel - B of the table IV-1 shows the CAAR for different windows during the test period. The CAAR of the “Total” for the window period of the (T0 to T+1) is -
0.0031 and the CAAR for the window period of the (T0 to T+4) is -0.022. It is -
0.0122 for the total event period. Nevertheless, it shows positive CAAR value
(0.0086) prior to the event date (T0 to T-4). Therefore, there is a negative impact on
share prices and the return after the announcement of the all modified audit report at
the CSE. However, as appear in the Table IV-2, it is remarkable to note that the p-
value is higher than .05, which is .421 for the “Total” for the event period. This fact
leads to the acceptance of the null hypothesis and the researcher reaches the same
conclusion that there is no significant effect of the Modified Audit Reports on shares
prices and returns for the Event Period.

According to the Panel C of Table IV-1 summarizes the direction of the ARs on the
event date. It provides average number of events which gain positive or negative ARs
on the event date. It indicates that 51% of average events from the sample are having
negative ARs on event date. On the other hand, 49 % of the events have negative
ARs. No Positive or Negative ARs plays significant role in connection with the effect
of all the Modified Audit Reports on share prices and the return on the event date.
Therefore, it is irrational to conclude that the overall market respond rate is negative
on publication of the Modified Audit Reports as a whole at the CSE.

4.3.2 The qualified audit report including one disclaimer of the opinion report
separately (“Qualified”)

According to Panel - A of Table IV-1 shows that the AAR for The qualified audit
report (Qualified) at the event date is positive (0.0061) and it exhibits a positive
impact to the share prices and the return. This is an unexpected result for bad
information. However, p-values (Sig. values) (.5003) is greater than .05. Therefore, it
could be concluded that, as a whole, at the 95% confidence level, the positive effect of the qualified audit report on share prices and returns at the event date is not significant. It is also evident that from Panel - A of Table IV-1, that some of the AAR’s of the “Qualified” are positive and others are negative during the event period and all the p-values are greater than .05. It means that there is no clear pattern of stock reactions when considering the “Qualified” within the event period and, at the 95% confidence level, there is no significant effect on the share prices and the returns of the corresponding companies during all days of the event period.

Panel - B of Table IV-1 shows the CAAR for different windows during the test period. The CAAR of the “Qualified” for the window period (T0 to T+1) is surprisingly +0.0048 and the CAAR for the window period of the (T0 to T+4) are -0.0188. It is -0.0017 for the total event period. Prior to the event date, (T0 to T-4) shows a negative CAAR value (0.0232). There is a negative impact on share prices and the return before and after the announcement of the “Qualified” at the CSE and also as a whole during the test period which is also having a negative CAAR. However, as the Table IV-2 shows, it is remarkable to find that the p-value is higher than .05, which is .943 for the “Qualified” for the event period. This fact leads to interesting conclusions that there is no significant effect of the Modified Audit Reports on shares prices and returns for the Event Period and also there is no immediate effect of the “Qualified” in the CSE.

The direction of the ARs on the event date (According to the Panel C) indicated that 56% of average events from the sample Qualified are having positive ARs on the event date. On the other hand, it is surprising to note that only 44 % of the events
have negative ARs. Therefore, it is not justifiable to conclude that the overall market respond rate is negative on publication of the Qualified Audit Reports when negative information content exists at the CSE.

4.3.3 The Unqualified Opinion Reports with Emphasis of Matter (Matter Emphasis)

According to Panel - A of Table IV-1, shows that the AAR for the Unqualified Opinion Reports with Emphasis of Matter (Matter Emphasis) at the event date is negative (-0.0089) and it exates a negative impact on the share prices and return. However, p-values (Sig. values) (.2048) is greater than .05. Therefore, it leads to the conclude that, as a whole, at the 95% confidence level, the negative effect of the “Matter Emphasis” on share prices and returns at the event date is not significant. As evident from Panel - A of Table IV-1 some of the AAR’s of the “Matter Emphasis” are positive and others negative during the event period and all the p-values are greater than .05. It means that there is no clear pattern of stock reactions when considering the “Matter Emphasis” within the event period and at the 95% confidence level, there is no significant effect on the share prices and the returns of the corresponding companies during all days of the event period. However, compared to other Categories, “Matter Emphasis” is having a greater negative impact on share prices and the return.

Panel - B of Table AAA shows the CAAR for different windows during the test period. The CAAR of the “Matter Emphasis” for the window period (T0 to T+1) is surprisingly -0.0113 and the CAAR for the window period of the (T0 to T+4) is -0.0255. It is -0.0230 for the total event period. Prior to the event date, (T0 to T-4) is
also shown a negative CAAR value (-0.0065). Therefore, it develops a negative impact on share prices and the return before and after the announcement of the “Matter Emphasis” at the CSE and also as a whole during the test period also having a negative CAAR. However, as shown in the Table IV-2, it is obvious that the p-value is higher than .05, which is .219 for the “Matter Emphasis” for the event period. This fact leads to the same conclusion that there is no significant effect of the Modified Audit Reports on shares prices and returns for the Event Period. There is no considerable immediate effect of the “Matter Emphasis” in the CSE also.

The direction of the ARs on the event date (According to the Panel C) indicated that 58% of average events from the sample Matter Emphasis are having negative ARs on the event date. On the other hand, only 42% of the events have positive ARs. Therefore, the majority of “Matter Emphasis” has a negative impact on share prices and the return in the CSE.

The main analysis statistically concluded that, there is no significant effect on the share prices and returns of the corresponding companies during all days of the event period. Further, it was concluded that there no considerable immediate effect to the share price and the return to the modified Audit Reports at the Event Date in the CSE. The impact of this conclusion is discussed under discussion chapter.
4.4 Other Analysis

Objective of this section is to further corroborate this with the result of the main analysis.

4.4.1 *t*-test Analysis for the difference between Two Day Cumulative Average Abnormal Return (CAAR) and Zero

This analysis is to find whether there is any effect on the Cumulative Average Abnormal Return (CAAR), and the researcher calculated this effect for each two opposite days around the announcement day within the test period. This analysis was for Modified Audit Reports Companies under three categories such as, for all Modified Audit Reports Companies together (Total), for only the Qualified Audit Reports (Qualified) and for only the Unqualified Audit Reports with Emphasis Matter companies (Matter Emphasis) separately during the test period. One sample *t*-test model was used to calculate the effect to CAAR and its significant (Sig.). Therefore, 04 set of days such as T1 and T-1, T-2 and T-2, T-3 and T-3, T-4 and T-4, have been tested under category.

**IV-3: *t*-test result for the CAAR for each two opposite days around the Event Day**

<table>
<thead>
<tr>
<th>Days</th>
<th>Total (53)</th>
<th>Qualified (27)</th>
<th>Matter Emphasis (26)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ARR</td>
<td>Sig.</td>
<td>ARR</td>
</tr>
<tr>
<td>Ti_1</td>
<td>0.0053</td>
<td>0.5976</td>
<td>0.0096</td>
</tr>
<tr>
<td>T2_2</td>
<td>(0.0066)</td>
<td>0.3436</td>
<td>0.0033</td>
</tr>
<tr>
<td>T3_3</td>
<td>0.0021</td>
<td>0.7298</td>
<td>(0.0018)</td>
</tr>
<tr>
<td>T4_4</td>
<td>(0.0118)</td>
<td>0.1496</td>
<td>(0.0189)</td>
</tr>
</tbody>
</table>

In accordance with the Table IV-3, there are positive CAARs from T1_1 and T3_3 and
negative CAARs from T2_2 and T4_4 on the all Modified Audit Reports Shares (Total) as a whole. There are positive CAARs from T1_1 and T2_2 and negative CAARs from T3_3 and T4_4 on the Qualified Audit Reports (Qualified). The CAAR value for the “Matter Emphasis” also has both positive and negative signs. However, the $p$-values (Sig.) are greater than 0.05 for each time and category. Therefore, the researcher finds it difficult to statistically conclude that CAARs values are significant at the 95% confidence level, for any positive or negative effects.

However, CAAR value of the “Matter Emphasis” for the days T2_2 is 0.0820. Therefore, at the 90% confidence level, it is possible to statistically conclude that the effect of the “Matter Emphasis” on share prices and returns is significant. In the words, there is information content in the “Matter Emphasis” in the event date at the CSE.

4.5 Summary

This chapter, the Effect of Modified Auditors' Report on Share Prices was analyzed in CSE. There are three main analysis, they are the Graphical Analysis, Main Analysis and the Other Analysis. For the analysis purpose, the total sample was divided in to three categories. Firstly, the whole data set as one including all the modifications, Secondly, all the qualified audit opinion report including a disclaimer of opinion report separately, and thirdly, all the unqualified opinion reports with the emphasis matter that has identified as separate category. The first category consisted with 53 modified reports and the second and third categories had 27 and 26 in order.

The graphical analysis concludes that both AAR and CAAR depict a pattern from the event date (T-0) where AAR is negative for all three set of data categories and it
appears a negative effect on the share prices and the return of the Modified Audit Reports after the event date in the CSE.

The main analysis tested the behavior of the daily AAR, daily CAAR in different window periods surrounding the event date and the direction of ARs on the modified audit report publication dates and the significance of the AAR and CAAR for each category. The main analysis could statistically conclude that, there is no significant effect on the share prices and the returns of the corresponding companies during all days of the event period. Further, it concluded that there no considerable immediate effect of the modified Audit Reports at the Event Date in the CSE.

The direction of the ARs on the event date indicated that no positive or negative ARs play a significant role in connection with the effect of all the Modified Audit Reports on share prices and return on the event date. The majority of Matter Emphasis Reports has negative impact on share prices and the return in the CSE and the majority of Qualified Audit Reports shows a positive impact on share prices and return in the CSE. Therefore, direction of AAR at the event date is inconsistent.

The other analysis attempted to test the effect of the CAAR on two opposite days each around the event day within the test period. Here also, the researcher cannot statistically conclude that CAARs values are significant at the 95% confidence level, for any positive or negative effects. However, the CAAR value of the “Matter Emphasis” for the days T2_2 at the 90% confidence level statistically concluded that the effect of the “Matter Emphasis” on share prices and returns is significant.
Chapter V - Discussion

5.1 Introduction

This chapter develops discussions over the findings with available literature, both global and local context and also the possible managerial implications relevant related to the research problem and the context.

5.2 Discuss the findings with the available literature

The primary objectives of this study is to investigate the effect of the modified audit reports on shares prices and return in the CSE as a developing and untested market and to test whether the Sri Lankan market is efficient in the semi-strong form of the EMH as a developing market.

Further, the research was able to investigate that most of the developed markets in the world have studied on the relationship between audit report and share prices and return and there are no studies in Sri Lankan context in this regards.

Most of the previous studies have focused for attention on only one category of the modified audit reports, either all the modified audit report together or only the qualified audit report separately or unqualified report with emphasis of matters separately or any other similar category. However, in this study, the total modified audit report is divided into three categories upon the modification to the audit report such as first, all the modified Audit Report as one category; second, all the qualified audit report including a disclaimer of opinion; and thirdly, the unqualified reports with emphasis matter/s. Therefore, as researcher believes, this study enables to develop a comprehensive analysis by taking to account the different nature of audit modifications.
5.3 Discussion of Findings

The analysis was divided into three categories such as Graphical Analysis, main Analysis and other analysis. T-test method was used to check the significant of the ARs and CAARs.

The graphical analysis for all three set of samples showed negative AARs. However, during the test period, the AAR before and after the event date is fluctuating without a specific pattern and the researcher notices that some observations before and after the declaration date have negative and positive signs. This result is almost consistent with many empirical findings such as Moradi et al. (2011), Panayiotis Tahinakis (2010), Al-Thuneibat et al. (2008) and many others. However, Graphical analysis brings a greater negative effect on share prices of the Audit Reports with Emphasis Matter in the event period. Most of the previous studies also have concluded that the Audit Reports with Emphasis Matter have the information content (Lai et al. 2009, Elliott et al, 2011).

As Moradi et al. (2011), Panayiotis Tahinakis (2010), Al-Thuneibat, Khamees and Al-Fayoumi (2008) and many others have concluded, in this study, the researcher concluded that, according to the t-test analysis the difference between AAR and Zero is not significant and therefore, there is no information content in the tree categories of audit reports discussed above. The same conclusion was given by the analysis of the CAAR for different windows during the test period for three different samples. Even there are negative CAARs for each category of samples, it is not statistically significant.

There is a negative impact on the ARR at the event date for the total modified audit
reports together as well as Matter Emphasis Reports while AAR of the qualified audit reports sample at the event date is positive. However, there is no significant AAR or immediate effect at the event date for any category. This is further emphasized by the CAAR analysis with zero at the T0 to T+1 window period three different samples. Even, audit reports are modified due to material misstatement made by the company and it is not fully, instantaneously and unbiased reflect the share prices of respective companies. The results of the analysis (Table IV-1) are not consistent with the semi-strong form of EMH. This result is consistent with the conclusion about the EMH of the Sri Lankan capital Market by the previous studies, such as Dissabandara (2001), Dissabandara et al. (2010), etc...

The t-test analysis for the difference between Two Day CAAR and Zero has tested the effect for each two opposite days around the announcement day within the test period. According to this analysis also, the researcher concluded that there no significant effect for any type of modified audit report on share prices and returns or there is no information content in the any type of modified audit report during the all days of the test period. This conclusion also complies with Moradi et al. (2011), Panayiotis Tahinakis (2010), Al-Thuneibat, Khamees and Al-Fayoumi (2008) and many other previous studies.

5.4 Discussion of the Methodology Applied and Its Implication of the Study

There are three different approaches commonly used to examine the existence of abnormal stock returns to the qualified audit report disclosures (Ittonen, 2012). They are firstly, traditional short-window event studies, secondly, the long event window approach; thirdly, indirect approach. This study used the short-window event study
method.

Stock prices can be used to gain significant insight into corporations and how an event specifically affects a company (Anderson-Weir, 2010). According to the efficient market theory, the stock prices represent all available information about each company (Fama, 1970). Using all available information a security’s price should, theoretically, represent the expected net present value of all future cash flows (Bromiley & Marcus 1989). When unanticipated or unpredictable news becomes available this should result in stock market adjustments to the prices of affected stocks. The traditional short-window event studies are the most commonly used and the very powerful test (Ittonen 2012).

The event study methodology has been repeatedly used many times in the past to successfully evaluate the information content of the audit report as Al-Thuneibat et al. (2008), Ameen et al (1994), Anvarkhatibi et al. (2012), M. R. Ahmadi et al. (2014), Martinez et al. (2004), Moradi et al. (2011), Syou-Ching Lai et al. (2009) and many others. One of the important strengths of an event study is the inference of causality that comes from the timing of the event and the corresponding change in stock return and this is important to show a correlation, and also to provide evidence of the direction of causality (Anderson-Weir, 2010). One potential weakness arising in the event study methodology arises from the possibility of another event happening during the event period (Klassen & McLaughlin, 1996), for examples, an earnings announcement, mergers & acquisition announcement, changes of main business, etc...
5.5 Discussion on the Selected Event Date

In Market based study or short-window event study, the identification of the event date is one of the most fundamental issues, since, assuming efficient markets, the stock market will quickly digest any new and relevant information and the stock price will be instantly re-estimated. Ittonen (2012) in his literature review have summarized the alternative event dates such as the date of the balance sheet, the date of the end of the field work, the date of writing the report and submitting to the client, earning Announcement, the date of delivering the audited annual report to the CSE, the date of Annual General Meeting (AGM), etc. This study the researcher has selected the date of delivering the audited annual report to the CSE as the event date for this study. As stated by Anderson (2010), a good way to determine the relationship between an event and a company is to look at the change in the stock price following the event being the public knowledge. As used by many studies and given in the conclusion, most suitable event date has been selected for this study.

However, the audit reports are publicly available together with annual report and there is much more information also included in the annual report. Therefore, it is difficult to distinguish the effect of audit opinion to the share prices on the date of delivering the audited annual report to stock Exchange.

5.6 Selection of Sample

All the audited annual reports of the companies listed on the CSE from 2010 to 2014 that had been published in the CSE website (www.cse.gov.lk) have been selected as the sample. As far as concern the audit modifications, it was taken only the first time modification to the audit report for the sample as to test only the impact of newly
information was taken. When there is more than one modified report in a specific company within the test period has been considered as a separate event, when there is no continuous modification to the report. Therefore, the sample is totally consisted with new modified audit reports or new information. However, due to inherent limitation, the sample does not have any adverse opinion audit report and only one disclaimer of audit opinion report is available and the total modification to audit report is almost limited to two modifications such as the qualified audit report and the unqualified audit report with emphasis of matter.

5.7 The Possible Reasons for Inconclusive and Inconsistent Conclusions

In theories, it is highlighted that modifications in the audit report act as the material negative information on the share price and the returns. However, most of the Studies covering various event periods and several countries have concluded that there is no significant effect on share prices and returns by modification to the audit reports or conflicting, hence it impossible to reach a single conclusion.

Robertson (1988) has indicated that the financial analysts did not make any significant distinctions among different types of audit report qualifications. Al-Thuneibat (2008) has suggested that the readers of the audit report do not understand its meaning or appreciate its value and recommend and highlighted that there is a need for educating the users of the audit report regarding its role. Tahinakis et al. (2010) has indicated that audit reports have limited informational content for investors and do not form a part of their decision making process and this may be due to the lack of understanding for the contents, importance and value of such reports.

Houghton (1983) has highlighted in his study that, 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 have been more important than the audit report. Ittonen (2012) in his literature review too states that the certain environmental and institutional factors such as clarity of the event date, concurrent disclosures, predictability of the report, trading volume and availability of daily quotes of the underlying stocks, frequency, recurrence and type of qualified audit reports, and availability of related disclosures, significantly affect the measurement of stock market reactions and interpretation of the empirical findings. Moradi et al. (2011) suggests that the users of audit reports do not perceive their information or appreciate its value. An experimental study of users’ responses to qualified audit reports in China conducted by Lin et al. (2003) suggests that the US style qualified audit reports have fairly limited "information content” to the users in contrast to the present Chinese auditing environment and therefore, it exacts a need to further improve Chinese auditing standards and practices. Novoselova and Soklim (2011) add that investors mainly rely on the financial figures and the director’s declarations of the preliminary reports, while the final Going Concern Opinion is unable to deliver any new information content which is expected by the market participants. And also they have stated that when the information is sufficiently announced, predetermines the expectations of the going concern in a timely manner and if the financial markets are not absolutely efficient, thus it takes longer time to detect the stock market reaction since the prices are unable to incorporate the new information immediately in a short-term period.

Hence, for this study, there is no information content in the modified audit reports on the share prices and the returns in the listed companies in the CSE. There may be many
possible reasons that could have caused the impact direct or indirect as mentioned above.

When the researcher had an internal discussion with the financial analysts and the other users of Annual Reports, they too have indicated that they place less prominent on the audit reports reasons such as few dominant investors in the CSE may early response and manipulate the normal behavior of the market and general investors follow the dominant investors; Possibility to leakage the information to investors through other sources since there is a considerable time gap between event date and audit report announcement date; Most of the shares are not regularly trading in the market and only few shares has dominated in the market; Most of the listed companies act as normal private company even they have listed in the CSE, other information in the audited financial statement given to the respondents was more important than the audit report; etc..

5.8 Managerial Implications

As the study concludes, there is no information content in the modified audit reports in the CSE. If the audit report has no information content, there is no need for the audit process (Salehi, 2008). Therefore, the audit professionals and professional regulatory bodies such as CA Sri Lanka, may have to rethink about the content of the audit report as well as the way in which their audited financial statements provide enough information to the reader, adaptation of Auditing Standards as suit to local context and how to enhance the awareness of the readers including investors.

The users of the financial statements in Sri Lanka should show their keen interest on the conclusion on audit modification, especially, investors in the CSE. The regulators
of Sri Lankan Stock Market should take in to account the possibility of insider dealing or any other information leakages and the possible measures to prevent such situation. Market analysts, brokers and other related parties would be required to find the event date for the negative information on modified audit reports with the intention of improving the correctness of the predictions about the stock market behavior.

5.9 Summary

This chapter provided an extension discussion over the findings, with referring to literature in local and global. The result of the Graphical analysis, the main analysis and the other analysis on three different samples have been the purpose of the discussion in order to identify whether there is any information content in the modified audit report and to also test whether the Sri Lankan Capital market is Efficient at Semi-Strong Form of EMH. Results show that there is no information content in the modified audit report in the CSE and no Sri Lankan Capital market is Efficient at Semi-Strong Form of EMH. Next, further was discussed the methodology applied and its implication of the study results together with the selection of the event date and the sample. Finally, the different views of the previous studies, the managerial implications on research findings were taken in to consideration.
Chapter VI : Summery & Conclusion

6.1 Introduction

This chapter is a brief introduction to the research problem, its objectives, analysis and the findings. It also gives a conclusion on the study and the direction for the future researches.

6.2 Summary of the study

Introduction:

There are three objectives to achieve in this study. They are to understand the effect of the modified audit reports on shares prices and returns or information content of the modified audit reports via a comprehensive analysis of past literature, to evaluate this effect through the investigation of the effect of the modified audit reports on share prices and return in Listed Companies (LC) in the CSE as a developing and untested market and finally and to test whether the Sri Lankan market is efficient in the semi-strong form of the Efficient Market Hypothesis (EMH). The finding of this study is undubtly important to the parties who use the audited financial statement in their decision making process, especially, for Investors, share brokers, analysts, regulators in the stock market, government, professional in accounting and auditing fields etc. who show their serious attention on audit reports when engaged in decision making.

As far as the researcher has observed, most of the countries in the world have studied the impact of the audit opinion modification to share prices, and no studies parallel is seen in Sri Lankan Context despite enough empirical studies in global context. However, there are some empirical to test whether the Sri Lankan market is efficient in
the semi-strong form of the EMH.

*The Efficient Markets Hypothesis (EMH):* concludes that the current stock prices fully reflect available information about the value of the firm, and there is no way to earn excess profits. Fama (1970) has identified three form of market efficiency, such as Weak-form efficiency, Semi-strong-form Efficiency, Strong-form Efficiency. The researcher has concluded that Sri Lankan Capital Market is not efficient in the semi-strong and all the publicly available information are not fully, instantaneously and unbiasedly reflected in the share prices.

**Previous Studies:** Any new information, good or bad, must react immediately after the awareness. Theories explains the modified audit reports as the information source to the share market with negative impact to the share price and as a result, should be negatively treated. However, contradictory and inconsistent conclusions are in the previous studies in the area of audit reporting and behavior of the share prices. And most of the previous studies have encouraged to test same in different markets and environments. Three different approaches have been used by the previous studies to examine the existence of the abnormal stock returns in response to a modified audit report disclosures namely Traditional short-window event studies; Long event window approach; Indirect approach. The traditional short-window events study method the most commonly used method had been used in this study as well. It has found that indirect approach is consistent in support for the hypothesis that qualified audit reports are relevant to investors while other two approaches have mixed conclusion. The previous studies about the capital market efficiency of Sri Lankan capital market have produced mixed conclusions.
**Event Date:** The selection of correct event date is critical. Different event dates have been used by the previous researchers some of the examples are the date of signing the audit report, the announcement date of the audit report at the stock exchange, the date of the annual general meeting etc. The announcement date of audited financial statement in the stock exchange is the date where the audit report is publicly available to the investor and was selected as the event date for this study.

The modified audit reports also could be identified in different ways, they are for the examples, qualified reports; the disclaimer of opinion reports; and the adverse opinion reports and the unqualified reports with the emphasis of matters. Most of previous studies have taken only one or few categories together for their analysis. However, in this study, all the modified audit reports have been considered together and also the qualified audit reports and the unqualified audit reports with the emphasis of matter separately treated leading to different analyses related to the subject of the study.

**The Sample:** The sample was derived from Annual reports available in the CSE website (www.cse.gov.lk) for the companies listed in the CSE from the year 2010 to 2014. There were 172 modified audit reports corresponding to 71 companies which comprise 78 qualified opinion reports, 4 disclaimers of opinion reports, 1 adverse opinion report and 89 emphasis matters report during the test period. Only the first time modification was taken to the sample as to test only the impact of newly information. However, 17 companies who had their reports modified were excluded from the sample in the study because of the date of disclosing the reports with the CSE were not clear and then, 60 modified audit reports corresponding to 54 companies were identified with full information. However, 07 modified reports (corresponding
to 06 companies) out of 60 were further excluded from the sample due to the high volatility of the share prices during the estimation period so as to exclude the effect of contaminated events. The final sample is consisted with 53 modified audit reports corresponding to 48 companies.

**Equation and Formulas:** Few equations were derived to analyze the data such as Actual Return, Return on the Market Portfolio, Regression Line Parameters ($\alpha$ and $\beta$), Expected Return, Abnormal Return, Arithmetic Mean of the Abnormal Return (ARR), the Cumulative Average Abnormal Return (CAAR). The estimation period is to estimate the parameters of the regression line ($\alpha$ and $\beta$) for a period of 60 days before the commencement date of the event period. A shorter estimation period was selected to mitigate the effect of high volatility of the share prices of the CSE. The test period consisted of four stock market working days before and after the date of disclosing the financial statements (event date) by the CSE. A shorter event period was selected to mitigate the contaminated events happening during the test period.

**Data:** The information gathered to test include; All the Audited Annual Reports issued by the Listed Companies in the CSE; the dates of receiving the modified audit reports by the CSE; Daily prices of Listed companies' securities; All the daily reports issued by the CSE, from 01st January 2010 to 31st December 2014.

**Analysis:** Total sample (53) was divided into three main categories. Firstly, the whole data set as one includes all the modification (53), Secondly, all the qualified audit opinion report including the disclaimer of opinion reports and the adverse opinion reports separately (27). Thirdly, all the unqualified opinion reports with the emphasis
matter (26). The analyses were divided into three main categories such as the Graphical Analysis, the Main analysis and other analysis.

The graphical analysis concludes that both AAR and CAAR show a pattern from the event date (T-0) that AAR is negative for all three set of data categories and it causes a negative effect on share prices and the return of the Modified Audit Reports after the event date in the CSE.

The main analysis is tests the behavior of the daily AAR, the daily CAAR in different window periods surrounding the event date and direction of ARs on modified audit report publication dates and tested the significant of the AAR and CAAR for each category. All the main analysis statistically concludes that, there is no significant effect on the share prices and the returns of the corresponding companies during all days of the event period. Further, it concludes that there is no considerable immediate effect of the modified Audit Reports at the Event Date in the CSE.

The direction of the ARs on the event date indicates that no positive or negative ARs have a significant part in connection with the effect of all the Modified Audit Reports on the share prices and the return on the event date. The majority of Matter Emphasis Reports has a negative impact on share prices and the return in the CSE and the majority of Qualified Audit Reports has a positive impact on the share prices and the return in the CSE. Therefore, the direction of AAR at the event date is inconsistent.

The other analysis attempted to test the effect of CAAR in each two opposite days around the event day within the test period. Here also, the researcher was unable to statistically conclude that CAARs values are significant at the 95% confidence level, for
any positive or negative effects. However, CAAR value of the “Matter Emphasis” for the days T2_2 at the 90% confidence level statistically concludes that the effect of the “Matter Emphasis” on share prices and returns is significant.

6.3 Conclusion of the study

All three categories of reports such as all the modified audit report together and also qualified audit reports and unqualified audit reports with emphasis of matter separately, are leading to three different types of analyses related to the subject of the study. Test results show that all three categories of reports do not have a significant impact on the share prices and the returns at the 95% confidence level. However, at the 90% confidence level, it could be statistically concluded that the effect of the unqualified audit reports with the emphasis matter on share prices and returns is significant, at two day opposite, before and after the event date.

Therefore, it could be concluded that modified audit reports do not have a significant impact on the share prices and the returns of the companies listed on the CSE or there are no information content in the modified audit report in the CSE. However, there is a slight negative impact of the unqualified audit reports with the emphasis matter on share prices and the returns of the companies listed on the CSE or there is a slight negative information content in the unqualified audit reports with emphasis matter in the CSE.

Further, it revealed that there is no considerable immediate effect on the share prices and the return on modified Audit Reports at the Event Date in the CSE since the audit modifications are not fully, instantaneously and un-biasedly reflected by the share prices of the respective companies. Thus, this result is not consistent with the semi-
strong form of EMH. Hence, it achieve a one of research objective that it is irrational to concludes that Sri Lankan Capital Market is efficient in Semi-Strong of EMH. Refer to objectives.

According to the internal discussions held with financial analysts and other users of Annual Reports, in the CSE, there many reasons such as few dominant investors in the CSE are possible for early response and the manipulation of the normal behavior of the market and general investors following the dominant investors; Possibility to leakage the information to investors through other sources since there is a considerable time gap between event date and audit report announcement date; irregular trading in the market and domination of few shares in the market, acting of the most of the listed companies as normal private company though listed in the CSE, provision of other information in the audited financial statement given to the respondents was more important than the audit report, etc..

6.4 Limitation of the study

The following limitations have been noticed in this analysis:

i. Selection of event date is critical for the event study methodology. The announcement date of the audited financial statement in the CSE has been selected as the event date for this analysis. Nevertheless, the actual event date might differ rarely in some occasions.

ii. It is needed that dividends to be considered in calculating the return of the stock. However, the dividend has been ignored in this study due to the timing differences of dividends declaration and the unavailability of data on these dividends. This had been the practice in the similar extant studies.
iii. Audit Reports of the company are filed in the stock exchange together with Financial Statements. Financial Statements may include more price sensitive information other than audit modifications, such as dividend notice, other earning announcement, etc. Therefore, the effect of audit modification may disappear from the analysis.

iv. Other events happening during the event period have been disregarded in this analysis. This may lead to the disappearance of the effect of the audit modification on the share price and the return during the event period.

v. Matters affected to modify the audit report could be public information prior to filing in the CSE through various sources, such as through the interim financial statements, corporate announcement of the Securities Exchange commission, paper articles, some media releases, etc. Therefore, reasons based on audit modification may not be new information to the market.

vi. Rules and regulations of the authorities such as the price ban, and the market manipulation of powerful investors could be affected to the normal behaviour of the market. Those have been disregarded in this analysis.

6.5 Direction for Future Research

Based on the conclusions of the study, the researchers recommend for extending this study to investigate the effect of modified audit reports on share prices and returns during other time periods and using different test periods. And also most of the previous studies have done for the developed markets. Therefore, the researcher recommends testing the market reactions to the modified audit reports in other untested developing markets.
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Appendix I:

Alpha and Beta ($\alpha$ and $\beta$) Value of the Regression Line (Main Test)

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Appendix I:
Alpha and Beta (α and β) Value of the Regression Line (Main Test)

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Appendix II:

Alpha and Beta ($\alpha$ and $\beta$) Value of the Regression Line (Additional Test)

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Connecting
Appendix II:
Alpha and Beta ($\alpha$ and $\beta$) Value of the Regression Line (Additional Test)

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