Auditor's Opinion and Market Reaction of Companies Listed on the Tehran Stock Exchange (TSE)

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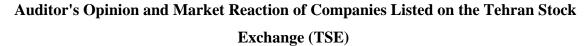**M.A. in Industrial Management-Financial Branch**

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Abstract

This research investigates the influence of auditor's opinion on stock market reaction in companies listed on the Tehran Stock Exchange (TSE). To test research hypotheses, financial information of the companies listed on the TSE during the period of 2011-2015 was used. The final research sample consisted of 125 companies that were selected after imposing desired restrictions and using systematic sampling elimination method. The present research is applied in terms of purpose and descriptive (non-experimental) in terms of the method of data collection. Collected data was analyzed using SPSS23 software. The results show that audit opinion can influence abnormal return of the company.

Keywords: auditor's opinion, market reaction, Tehran Stock Exchange (TSE).

Introduction

Undoubtedly, auditing is a reassuring process that reveals the reliability and relevance of the information of the financial statements. Since the interests of shareholders and managers are in conflict, auditing has gained a special importance to overcome this conflict. As an efficient mechanism, auditing informs shareholders whether directors managed the company based on the interests of the shareholders or not. Hence, auditing is a reassurance to shareholders and other stakeholders who are contracting with the company (Rezaei and Shahroodi, 2014). The brokerage theory recognizes the auditor as an independent representative of shareholders and other beneficiaries controlling the accuracy, reliability and relevance of the information provided and presented by the business unit managers. However, due to the fact that the audit involves close relationship among an auditor and the business unit managers, it is assumed in this theory that the auditors may not be able to maintain their independence in their work, and may not do their job properly, and in other words, they may act in line with their own interests as well as the interest of managers (Banimahd, 2011). In general, it can be said that annual reports of companies are based on a set of technical rules and accepted accounting principles or financial reporting standards depending on the company's framework and characteristics. In theory, the association of accounting reports as a source of information for financial markets is just one aspect of the roles that auditors can play in the field of regulated and free markets. Another role can be contribution to management in the field of supervision. Therefore, agency costs are reduced, financial information is provided, and users and auditors achieve a consensus (Ianniello and Galloppo, 2015). Independent auditors do this by presenting their opinion about financial information in the form of an audit report. The manner of presenting opinion is definite whose intention is generally clear in a large extent to all users, including investors. Therefore, audit report represents the risk of information (conformity between claims and reality). As the final product of audit process, audit report has the nature of a public commidity (service) since making use of it does not prevent the use of any other public service and its consumption is not under the monopoly of any consumer. Like other goods and services, this public commodity must have a proper quality to keep it in continuous demand. If auditing is considered as a monitoring tool
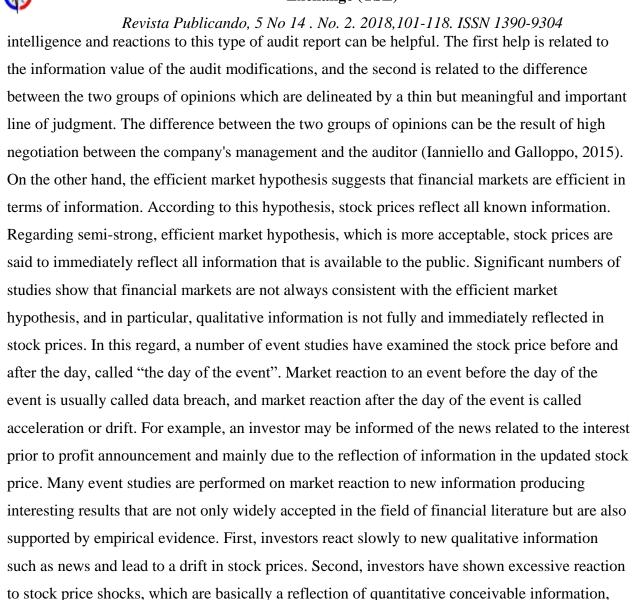
that assumes multiple roles that are mentioned, then, assuming the stability of other conditions, financial statements that are audited with high quality will have greater reliance and reliability on the part of consumers of this service (Gholami et al., 2013). Considering the discussed issues and the important role that auditors' opinion play in financial markets, this study seeks to investigate the influence of the auditor's opinion on the stock market reaction in companies listed on the TSE. In order to achieve this goal, companies listed on the TSE are considered as population and some of them are also selected as sample. It is attempting to use the updated models presented in the articles to examine this issue in Iran. In any case, the question that the research seeks to answer is presented as follows: Does the auditor's opinion influence the stock market reaction?

Theoretical foundations of research

Annual reports of companies are approved based on the rules called "accounting principles" and criteria of "International Financial Reporting Standards". These rules and principles depend on the characteristics of the companies and the international framework. Local or international officials demand that financial statements of business units are reported in a timely manner so that they can inform a wide range of stakeholders. Some similarities and differences are expected to exist in the annual process of public reporting. Among tools used by legislators and supervisors to improve the reputation of financial statements, mandatory auditing performed by external audit firms plays a key role. In the final stage, audit process is completed and concluded after the audit report. These reports are available to the public. Required prerequisites for performing empirical investigations on the information content of audit reports in capital markets include the type of opinions and timing of these audit reports. Among the questions and issues of audit research, one of the questions is related to the effect of the information content obtained from the constraints and obligations of audit reports on investment decisions. In other words, what is the effect of qualified opinion on stock price?

Audit opinions are divided into two groups:

1) modified opinion (including the exceptions of adversary opinion and disclaimer of opinion)

2) unmodified opinion (with emphasis on the article about uncertainty about going concern opinion or disturbances in this group which is a very important article because companies that receive type-2 opinion can be in margin and close to this type of opinion. Therefore, market

intelligence and reactions to this type of audit report can be helpful. The first help is related to the information value of the audit modifications, and the second is related to the difference between the two groups of opinions which are delineated by a thin but meaningful and important line of judgment. The difference between the two groups of opinions can be the result of high negotiation between the company's management and the auditor (Ianniello and Galloppo, 2015). On the other hand, the efficient market hypothesis suggests that financial markets are efficient in terms of information. According to this hypothesis, stock prices reflect all known information. Regarding semi-strong, efficient market hypothesis, which is more acceptable, stock prices are said to immediately reflect all information that is available to the public. Significant numbers of studies show that financial markets are not always consistent with the efficient market hypothesis, and in particular, qualitative information is not fully and immediately reflected in stock prices. In this regard, a number of event studies have examined the stock price before and after the day, called "the day of the event". Market reaction to an event before the day of the event is usually called data breach, and market reaction after the day of the event is called acceleration or drift. For example, an investor may be informed of the news related to the interest prior to profit announcement and mainly due to the reflection of information in the updated stock price. Many event studies are performed on market reaction to new information producing interesting results that are not only widely accepted in the field of financial literature but are also supported by empirical evidence. First, investors react slowly to new qualitative information such as news and lead to a drift in stock prices. Second, investors have shown excessive reaction to stock price shocks, which are basically a reflection of quantitative conceivable information, which itself leads to the phenomenon of return patterns (Mashaiekh et al., 2013).

Research background

In this section, a number of studies in the field of research are mentioned. In this regard, and in the domain of national research, Aghaei and Babaei (2014) have found that companies that have experienced declines in audit opinion released their financial reports later than the year before, and this relationship is based on the amount of change in audit opinion. However, no evidence was found proving the impact of improvements in the audit opinion on timely profit. In general, the findings manifest that good news was released sooner and bad news was released later. Bulu

et al. (2013) have stated that there is a negative significant relationship between abnormal return and the degree of conservatism. Moreover, investigating the effect of time intervals of research variables in the successive years revealed that there is a causal (mutual) relationship between the two main variables of the research indicating the significant role of designing accounting standards in the performance of capital markets, adjustment of financing costs, and consequently, creation of a dynamic economy in the country. The results of the research carried out by Rezaei and Shahroodi (2014) indicate that there is a significant relationship between the change in auditor's opinion and timeliness of disclosure. That is companies that receive better (higher quality) opinion as compared with the previous year disclose their financial data earlier than the year before, and companies that receive worse (poorer quality) opinion than last year disclose their financial data later than the year before. Furthermore, there was a significant and reverse relationship between quality reduction of the auditor's opinion and timeliness of disclosure. However, no significant relationship was found between the amount of quality enhancement (improvement) of the auditor's opinion and the timeliness of disclosure. Banimahd et al. (2013) showed that there is a direct relationship between auditor's change and the change in audit opinion. In addition, there is a direct relationship between the size of the company and the change in audit opinion. Company's loss, age, and duration of audit engagement have a negative and inverse relationship with the change in audit opinion. Change of auditor has the most relationship with the change of audit opinion. Direct relationship between change of auditor and change in audit opinion confirms the phenomenon of selecting the opinion in the Iranian audit market.

In the case of international studies, Ianniello and Galloppo (2015) have also proved that audit report has information content for investors' decisions. Moreover, the results show that there is a positive and significant relationship between unmodified opinion and uncertainty or financial crisis. Frendy (2014) has shown that Japanese investors do not react to the information that is being related to the auditors' negative or neutral reputation. In fact, it can be said that Japanese investors do not consider reputation announcements as sufficient reasons to change their expectations. Farzinfar (2013) stated that there is a significant relationship between stock returns and auditor's opinion. In fact, it can be said that for aware auditors of the company, auditor's

opinion serves as a special message. Anvarkhatibi et al. (2012) reported that there is no significant relationship between auditor's opinion and stock returns. In general, the results indicate that there is no relationship between auditor's opinion and stock returns and prices. Moradi et al. (2011) have stated that modified auditor's opinion does not affect stock returns and prices. In other words, the auditor's opinion does not contain any information content for users. Lin et al. (2011) found that companies with financial constraints become comfortable after adjustments are made in auditor's opinion. This case indicates that the adjusted auditor's opinion contains a few economic implications. In addition, they have shown that after 2006, adjusted auditor's opinion did not have any impact on companies with financial constraints. Itonn (2009) showed that there was no statistically significant abnormal negative reaction to audit report notices, but some evidence of an increase in systematic risk and fluctuation was observed after the audit report date. In addition, there is some evidence indicating that information setting and cost of representative's debt affect abnormal return, changes in systematic risk, and fluctuation. It is confirmed that the audit reports that are being examined had an information link for investors. Factors related to information setting as well as the cost of debt of company representative are related to unusual returns. Finally, Martinz et al. (2003) stated that modified audit reports do not have any information value for investors. An analysis on the levels of all modified audit reports showed that these reports lacked information content for investors. The reason for this finding can be attributed to this issue that the effect of a special type of required condition can be canceled as a result of the density of another type of different required condition. Perhaps, either because the questioned required condition has been raised only in quantitative situations or because of the fact that required condition with positive effects has been adjusted by other required conditions with negative effects.

Considering topics discussed in the sections of theoretical foundations of research and research background, the research hypothesis is presented as follows:

➢ Type of auditor's report (unqualified and modified) has a significant effect on the stock price which appears as an abnormal return on normal stock returns.

Research methodology

The methodology of this research is of correlation type in terms of nature and content which uses data extracted from financial statements of the companies listed on TSE to analyze correlations. This research will be carried out within the framework of deductive-inductive reasoning. The reason for using correlational method is to discover the correlational relations between variables. Correlation research is one kind of descriptive research. In the present research, first, the correlation between research variables is tested and, in the case there is a correlation between research variables, multiple regression models will be estimated. On the other hand, the present study is post-event (quasi-experimental), which is carried out based on the analysis of past and historical information (corporate financial statements). Moreover, this research is an analytical causal desk study and is considered as an applied research in terms of objective and descriptive-correlation research in terms of methodology.

Statistical population and sampling method

The statistical population of this research includes all companies listed on the TSE. The period of research is from the beginning of 2011 to 2013. Furthermore, in this research, a sample of 125 companies has been selected based on the following criteria from the statistical population of the companies listed on the TSE:

1. Regarding the time period of access to the information (i.e. 2011-2015), the company should be listed on the TSE before 2011 and its name should not be deleted from the list until the end of 2015;

2. In order to increase the alignment and matching capability of company selection, the corporate fiscal year should end in March each year;

3. Due to the lack of clarity of the boundaries between operating activities and financing of financial companies (investment companies, financial intermediation, etc.), these companies have been excluded from the sample;

4. The companies whose information was incomplete for calculating the initial variables of the financial statements are excluded from the sample;

5. Companies should have not stopped working or changed the course of their activities.

Operational definition of variables:

Independent variable: Auditor's opinion

In this study, type of auditor's opinion is the independent variable and includes qualified and unqualified opinions. Qualified opinion indicates that the company's financial statements are in accordance with accepted accounting principles and are shown in a desired manner from all significant aspects. An unqualified opinion is a kind of independent auditor's opinion on the financial statements prepared by the investigating economic entity that is issued due to the deviation from the accounting standards in the preparation of financial statements, the creation of limits on proceedings by the entity that is under investigation, and the creation of limits in investigation by factors outside the entity which is under investigation (inherent ambiguity). Modified opinion should be stated when the auditor concludes that a qualified opinion cannot be stated while the effect of any disagreement with the management or limitation on the scope of the review is not so significant and inclusive (fundamental) that requires an adversary opinion or disclaimer of opinion (Noorzad Dolatabadi et al., 2013). In this study, the regression model is examined twice and separately, first, for qualified opinion, and then for modified opinion. In each of the models, variable of opinion (qualified or modified) is considered as 1, otherwise it is considered as zero. In this way, the model is double-analyzed and the results are compared.

Dependent variable: Market reaction

To measure market reaction, abnormal return was used for 4 days, ± 7, ± 5, and ± 3. Here, the day zero denotes the date of the auditor's opinion. The abnormal return (AR) of company j on day t is defined as follows:

$$AR_{jt} = r_{jt} - E(r_{jt})$$

r_{jt}: Continuous compound return for the stock of company j;

$E(r_{jt})$: Expected return for the stock of company j based on the market model.

For each day in event period, the Average Abnormal Return (ARR) is as follows:

$$AAR_t = \frac{\sum_{j=1}^{j=N_t} AR_{jt}}{N_t}$$

N_t: The number of observations that are greater than the average of AR on day t. In addition, the cumulative abnormal return for company j is calculated on days (t1, t2) as follows:

$$CAR^{j}_{t_1,t_2} = \sum_{t=t_1}^{t_2} AR_{jt}$$

The cumulative average of abnormal returns on days (t1, t2) is calculated as follows:

$$CAAR_{t_1,t_2} = \frac{\sum_{j=1}^{j=N} CAR^{j}_{t_1,t_2}}{N}$$

Data analysis

Since companies are examined in two ways according to the auditor's opinion, therefore, in this section, firstly, the qualified opinion, and then the modified opinion are examined. The results obtained for these groups are presented.

Qualified opinion

Descriptive statistics of the research

In this research, the indicators of median, minimum, maximum, mean, standard deviation, skewness, and kurtosis are used to define frequency distribution (Table 1). These distributions are in cumulative form for the statistical sample of the study. The results of the whole sample indicate that that 481 of the selected companies have received qualified opinion and 269 companies have received modified opinion. Therefore the table can be presented as follows:

Table 1. Distribution of companies according to the auditor's opinion

Index	Number	Percent
Qualified opinion	481	0.641
Modified opinion	269	0.358
Total	750	0.100

Descriptive statistics of research variables are examined in the following:

Table 2. Frequency distribution of research variable

Variable	Cumulative abnormal return of 7 days later	Cumulative abnormal return of 5 days later	Cumulative abnormal return of 3 days later	Cumulative abnormal return of 3 days earlier	Cumulative abnormal return of 5 days earlier	Cumulative abnormal return of 7 days earlier
Symbol	CAAR +7	CAAR +5	CAAR +3	CAAR -3	CAAR -5	CAAR -7

Observations	481	481	481	481	481	481
Mean	0.353	0.294	0.208	-0.0222	0.01368	0.0703
Median	0.330	0.339	0.26606	0.233	0.173	0.133
Standard deviation	1.361	1.563	2.192	1.946	1.600	1.520
Skewness	0.127	0.036	0.062	-0.445	-0.753	-1.053
Kurtosis	8.297	7.623	8.775	5.515	3.402	5.809
Minimum	-6.285	-8.132	-10.896	-8.201	-7.291	-9.953
Maximum	8.284	8.318	11.998	10.106	6.840	6.055

In this section, 481 observations out of a total of 750 years-companies that received qualified opinion are examined. Among the studied companies, the averages of cumulative returns for the 7 days earlier and later equal (0.0703) and (0.353), respectively. Moreover, the medians of cumulative abnormal return of 5 days earlier and later of desired companies equal (0.173) and (0.393), respectively. Finally, the maximum of cumulative abnormal return of 3 days earlier and later equal (10.106) and (11.998), respectively.

Inferential statistics of research

Normality of data

In this research, Kolmogorov-Smirnov test was used to study the normality of the data of the research variables. The results are presented in the following. The significance level is less than 0.05 for all variables, so the null hypothesis stating that data is normal will be rejected; therefore, data distribution is not normal. According to the results obtained for this test, nonparametric methods are used in the following to examine the research hypotheses and the differences between the groups. Among nonparametric tests, Wilcoxon test is selected as an appropriate test to examine the differences between the two groups.

Table 3. Results obtained from Kolmogorov-Smirnov test

Variable	Cumulative abnormal return of 7 days later	Cumulative abnormal return of 5 days later	Cumulative abnormal return of 3 days later	Cumulative abnormal return of 3 days earlier	Cumulative abnormal return of 5 days earlier	Cumulative abnormal return of 7 days earlier

Symbol	CAAR +7	CAAR +5	CAAR +3	CAAR -3	CAAR -5	CAAR -7
Observations	481	481	481	481	481	481
Test statistic	0.145	0.163	0.177	0.216	0.179	0.159
Significance	0.000	0.000	0.000	0.000	0.000	0.000

Research hypothesis: Type of auditor's report (qualified and modified) has a significant effect on stock prices which appears as an abnormal return on normal stock returns.

In order to analyze the hypothesis of the research, the differences in cumulative abnormal return in three periods of ±7, ±5, and ±3 were compared. The results of the Wilcoxon test for comparing the differences between the groups of this section are presented in Table 4:

Table 4. Test results of 7 days earlier and 7 days later

Index	Statistic Z	Significance level	Result
Cumulative abnormal return ±7	-3.294	0.001	Approved
Cumulative abnormal return ±5	-3.295	0.001	Approved
Cumulative abnormal return ±3	-2.587	0.010	Approved

Regarding the significance level of the Z test for Wilcoxon, which is estimated to be less than the type I error of 0.05, it can be concluded that adversary hypothesis is rejected and, therefore, the auditor's report has a significant effect on the abnormal return of the stock. In this way, it can be concluded that the type of auditor's report (qualified) has a significant effect on stock prices, which appears as an abnormal return on normal stock returns (approval of the first hypothesis).

Modified opinion

Descriptive statistics of the research

In this research, the indicators of median, minimum, maximum, mean, standard deviation, skewness, and kurtosis are used to define the frequency distribution of research variables (Table 5). These distributions are in cumulative form for the statistical sample of the study.

Table 5. Frequency distribution of research variables

Variable	Cumulative abnormal return of 7 days later	Cumulative abnormal return of 5 days later	Cumulative abnormal return of 3 days later	Cumulative abnormal return of 3 days earlier	Cumulative abnormal return of 5 days earlier	Cumulative abnormal return of 7 days earlier
Symbol	CAAR +7	CAAR +5	CAAR +3	CAAR -3	CAAR -5	CAAR -7
Observations	269	269	269	269	269	269
Mean	0.0560	-0.002	-0.218	-0.637	-0.354	-0.126
Median	0.2741	0.270	0.250	0.192	0.205	0.261
Standard deviation	2.474	2.814	4.055	4.862	3.513	2.748
Skewness	-5.574	-8.433	-9.378	-8.744	-7.249	-6.435
Kurtosis	54.616	102.038	118.221	89.616	65.593	55.269
Minimum	-26.970	-35.961	-53.941	-53.355	-35.357	-26.384
Maximum	5.204	5.763	7.870	4.363	3.305	3.487

In this section, 269 observations out of a total of 750 years-companies that received modified opinion are examined. Among the studied companies, the averages of cumulative returns for the 7 days earlier and later equal (0.560) and (-0.126), respectively. Moreover, the medians of cumulative abnormal return of 5 days earlier and later of desired companies equal (0.270) and (0.205), respectively. Finally, the maximum of cumulative abnormal return of 3 days earlier and later equal (4.363) and (7.870), respectively.

4.5. Inferential statistics of research

4.5.1. Normality of data

In this research, Kolmogorov-Smirnov test was used to study the normality of the data of the research variables. The results are presented in the following. The significance level is less than 0.05 for all variables, so the null hypothesis stating that data is normal will be rejected; therefore, data distribution is not normal. According to the results obtained for this test, nonparametric methods are used in the following to examine the research hypotheses and the differences between the groups. Among nonparametric tests, Wilcoxon test is selected as an appropriate test to examine the differences between the two groups.

Table 6. Results obtained from Kolmogorov-Smirnov test

Variable	Cumulative abnormal return of 7 days later	Cumulative abnormal return of 5 days later	Cumulative abnormal return of 3 days later	Cumulative abnormal return of 3 days earlier	Cumulative abnormal return of 5 days earlier	Cumulative abnormal return of 7 days earlier
Symbol	CAAR +7	CAAR +5	CAAR +3	CAAR -3	CAAR -5	CAAR -7
Observations	269	269	269	269	269	269
Test statistic	0.206	0.222	0.245	0.240	0.253	0.243
Significance	0.000	0.000	0.000	0.000	0.000	0.000

Research hypothesis: Type of auditor's report (qualified and modified) has a significant effect on stock prices which appears as an abnormal return on normal stock returns.

In order to analyze the hypothesis of the research, the differences in cumulative abnormal return in three periods of ± 7, ± 5, and ± 3 were compared. The results of the Wilcoxon test for comparing the differences between the groups of this section are presented in Table 7.4:

Table 7.4. Test results for 7 days earlier and 7 days later

Index	Statistic Z	Significance level	Result
Cumulative abnormal return ± 7	-0.772	0.440	Rejected
Cumulative abnormal return ± 5	-1.392	0.164	Rejected
Cumulative abnormal return ± 3	-1.932	0.053	Rejected

Regarding the significance level of the Z test for Wilcoxon, which is estimated to be greater than the type I error of 0.05, it can be concluded that adversary hypothesis is rejected and, therefore, the auditor's report does not have a significant effect on the abnormal return of the stock. In this

way, it can be concluded that the type of auditor's report (modified) has a significant effect on stock prices, which does not appear as an abnormal return on normal stock returns (rejection of the first hypothesis). According to the results obtained in this section, it can be said that the auditor's opinion has a significant effect on the stock price, which appears as an abnormal return. In fact, the obtained evidence showed that this issue was firmly approved in companies that received qualified opinion in periods prior and after the auditor's opinion.

Conclusion

The results of the Wilcoxon test for companies that received qualified opinion indicated that the significance level of Z test for Wilcoxon was significantly smaller than the type I error of 0.05. In this way, it can be concluded that adversary hypothesis is rejected and, therefore, the auditor's report has a significant effect on the abnormal return of the stock. In other words, type of auditor's report (qualified) has a significant effect on stock price, which appears as an abnormal return on stock returns. However, the results of the examinations which carried out on companies that received modified opinion indicated that significance level of the Z test for Wilcoxon is estimated to be greater than the type I error of 0.05; therefore, it can be concluded that adversary hypothesis is rejected and, hence the auditor's report does not have a significant effect on the abnormal return of the stock. In this way, it can be concluded that the type of auditor's report (modified) has a significant effect on stock prices, which does not appear as an abnormal return on normal stock returns. According to these results, it can be stated that in general, the auditor's opinion has had a significant effect on the abnormal return of companies during the investigation period. Therefore, generally, it can be stated that the auditor's opinion contains content information for investors and analysts of the stock exchange while this is not true for modified opinion. The following cases can be mentioned as the main reasons for not paying attention to the financial statements of modified audit report: investors and users of the auditor's report are not informed in a timely manner, information is not available, users lack sufficient knowledge to analyze the audit report and apply it in investment decisions, and finally, investors are not trained in the stock exchange. In this regard and according to the results of this study, Moradi et al. (2010) stated that the stock market shows a significant reaction to this information and the market behavior is not effective in the above-mentioned events. In international studies, Ianniello

and Galloppo (2015) also stated that the audit report has information content for investor decisions. Furthermore, the results manifest that unmodified opinion has a positive and significant relationship with uncertainty or financial crisis. Farzinfar (2013) found a significant relationship between stock returns and the auditor's opinion. However, contrary to the results of this study, Anvarkhatibi et al. (2012) revealed that there is not a significant relationship between auditor's opinion and stock returns. Moradi et al. (2011) also stated that modified auditor's opinion does not affect stock returns and prices. Itonn (2009) found that there is not any statistically significant negative abnormal reaction to the audit report notices. Moreover, Martinz et al. (2003) showed that modified audit reports lack information value for auditors.

Research recommendations

1. Given that research hypothesis is approved, it is recommended that investors and analysts take more account of the auditor's opinion because the auditor's opinion (modified opinion) contains information content.

2. Given that the effect of modified opinion on abnormal returns was rejected, it is recommended that investors and users increase their knowledge of such information. Having enough knowledge in this area can help them make the right decisions. In addition, the Stock Exchange organization can raise the level of knowledge of investors and analysts by holding training courses.

Furthermore, regarding the results of this research and the questions raised during the research for the researcher, the following recommendations are suggested to complete this research and prepare the context for further research in the areas related to this research:

 1. To carry out the present research on different industries in the Tehran Stock Exchange in order to control the impact of industry.

2. To investigate the effect of external supervisions, such as institutional shareholders and type of auditor, as well as internal supervision, such as the independence of the board of directors and audit committees on the relationship between the auditor's opinion and abnormal returns of companies.

3. To investigate the effect of the auditor's opinion on other financial and accounting variables, such as company risk, information asymmetry, and company investment.

4. To investigate the adjusting effect of corporate governance on the relationship between auditor's opinion and abnormal return.

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