Stock market reaction to auditor opinions – Italian evidence

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Abstract

Purpose – The purpose of this paper is to examine investor reactions to auditor opinions containing qualifications or an emphasis of matter paragraph related to going concern uncertainty or financial distress. In particular, abnormal returns are analyzed around audit report dates.

Design/methodology/approach – The event study methodology, focusing on a short event window, was used to determine whether there is an immediate market reaction to the audit report announcement, as might be expected assuming efficient stock markets.

Findings – Overall, this analysis shows that the audit reports investigated have information content for investment decisions. In particular, the qualifications expressed in the audit report have a negative effect on stock prices. It is also shown that an unqualified opinion with an emphasis of matter paragraph regarding going concern uncertainty or financial distress has a positive effect on stock prices. These results also elucidate the distinction between different types of opinions in the Italian context.

Research limitations/implications – This paper has attempted to limit the possible concurrent effects on stock prices using a short window event study methodology. However, the possibility that some other event may have occurred during this event window cannot be excluded. Among the policy implications coming from this research, it is argued that the authorities should regulate the public disclosure of audit reports, so that the information becomes available to the audited company and the other stakeholders on the same day, which, in theory, would be the day that the audit process concludes with the signing of the audit report.

Originality/value – The findings of this paper show the relevance of audit reports, distinguishing the different impacts based on the types of audit opinions issued in a specific jurisdiction (qualified and unqualified with an emphasis of matter paragraph).

Keywords Audit reports, Emphasis of matter paragraph, Going concern, Italian stock exchange, Market reaction, Qualified audit opinions

Paper type Research paper

1. Introduction

It is generally recognized that companies' annual reports are drawn up according to a set of technical rules, labeled the local generally accepted accounting principles (GAAP) or international financial reporting standards (IFRS), depending on the institutional framework and firms' characteristics. At the same time, local or international authorities require business entities' financial statements to be published in a timely manner to inform a wide range of stakeholders. For example, the First European Directive of 9 March 1968 requires Member States to take measures to ensure compulsory disclosure of several types of information by companies, including accounting documents for each financial year. Therefore, similarities and differences are expected in the process of making annual reports available to the public. Among the tools used by regulators to improve the reliability of financial statements, a key role is played, in theory, by the

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mandatory audit performed by an external independent audit firm. The audit process concludes with the issuance of an audit report, which is available to the public. The types of opinion and the timing of this report's publication are two fundamental prerequisites to undertaking empirical investigation on the issue of the information content of audit reports in capital markets. We perform such an analysis in the Italian context, responding to a call for research from Ittonen (2012).

In substance, the objective of this paper is to investigate whether certain types of audit opinions do convey new information, as revealed in stock prices. In Italy, the mandatory audit was legally introduced with Law No. 216 of 1974, which was implemented by Presidential Decree (D.P.R.) No. 136 of 1975. At the beginning of the 1980s, this new institutional tool was operational in the Italian context. Among the questions addressed in auditing research, one regards the influence of the information content from the qualifications contained in audit reports for investment decisions in capital markets; in other words, what is the effect, if any, of qualified audit opinions on stock prices? For example, in the USA, mandatory audits of financial statements were established with the Securities Act of 1933 and the first study to address some aspects this issue was published by Baskin (1972) approximately 40 years after the initial introduction of the mandatory audits. As summarized by Craswell (1985) and Ittonen (2012), most studies address the Anglophone countries. We believe it is of interest to address the same question in the Italian context because Italy belongs to the group of the most industrialized countries in the world (the so-called G7), at least during the period under investigation. Moreover, some local institutional features (Section 2) may be of interest for international readers who want to understand the role of audit opinions in the context of specific jurisdictions. In particular, following the Italian standard format of the audit report, we distinguish audit opinions in two main groups:

(1) qualified opinions (including "except for", adverse opinions and disclaimers of opinion); and

(2) unqualified opinions with an emphasis of matter paragraph related to going concern uncertainty or financial distress.

This distinction is important because companies receiving type (2) opinions (technically not qualified) could be on the border of a type (1) opinion (legally more severe). Therefore, understanding the market reactions to this type of audit report can offer us at least two contributions. The first contribution refers to the information value of audit qualifications, and the second is related to the difference between the two groups of opinions separated by a thin but significant line and the auditor's judgment. The distinction between the two groups of opinion is likely to be the outcome of a high level of negotiation between company management and the auditor (Beattie *et al.*, 2001; Kleinman and Palmon, 2001). It is of interest to examine the market perception of these audit reporting behaviors because we do not know if they are relevant for investors or, subsequently, in which direction.

To empirically analyze our research questions, we used a sample of audit opinions issued on published financial statements during the period 2007-2010. This period begins after legislation reforms in 2005 and 2006 (following the Parmalat scandal) and before the full application of Legislative Decree No. 39 of 2010, which was implemented in Italy with the new VIII European Directive. This period is also characterized by a financial crisis that triggered a debate on the role of the audit function, including a call

for the improvement of the audit profession, which may have increased the attention of the auditors when expressing their opinions.

Following prior research, we have used the event study methodology; in particular, we have focused on short event window abnormal stock returns to determine whether there is an immediate market reaction to the audit report announcement, as might be expected assuming efficient stock markets. This choice is motivated by the Italian institutional setting, which allows us to accurately identify the audit report event day (Section 2).

Overall, our analysis shows that audit reports investigated have information content for investment decisions. In particular, qualifications expressed in the audit report have a negative effect on stock prices. We also show that an unqualified opinion with an emphasis of matter paragraph on going concern uncertainty or financial distress has a positive effect on stock prices. These results also elucidate the distinction between different types of opinion in the Italian context.

The paper continues as follows. Section 2 describes the audit report format and disclosure to the public in the Italian institutional setting. Section 3 briefly discusses previous research and hypothesis development. Section 4 is devoted to the research design and methodology. Section 5 presents the results, followed by the conclusions.

2. The audit report format and disclosure in the Italian institutional setting

The standard audit reports we have analyzed are regulated by Consob (the Italian Securities and Exchange Commission) Communication No. DAC/99088450 of December 1, 1999, based on article 156 of Legislative Decree No. 58 of 1998, also named the Consolidated Law on Finance (*Testo Unico sulla Finanza* – TUF), which was substantially effective during the period under investigation. According to the Italian legislation, the auditor can express four types of opinion: an unqualified opinion, a qualified opinion, an adverse opinion or a disclaimer of opinion.

The qualified opinion uses the expression "except for" and refers to noncompliance with accounting standards, disagreement in the accounting standards choice or in its application and insufficient disclosure provided in the annual accounts; or scope limitation in the acquisition of audit evidence. These concerns are evaluated by the auditor and, if in his/her opinion, they do not impact the reliability of the annual report in its entirety, a qualified opinion is expressed, otherwise an adverse opinion or disclaimer of opinion must be communicated. For conciseness, we use the expression qualified opinions or qualifications to refer to all three types of severe opinion mentioned above, unless we mention them separately to express our arguments.

An option available in the Italian audit environment is the emphasis of matter paragraph. In the judgment of the auditor, if it is necessary, after the opinion paragraph, an emphasis of matter paragraph may be added to present significant information already disclosed in the annual account that the auditor wants to underline for the benefit of the financial statement users. A particular issue that can be investigated is the uncertainty related to the going concern or financial distress judgment of the audited company. In these cases, if the auditor is persuaded that appropriate behavior (action plan), accounting treatment and disclosure were adopted by company management, an unqualified opinion is expressed and, at the judgment of the auditor, an emphasis of matter paragraph is added. If, in the opinion of the auditor, the uncertainty has not been

properly disclosed and the behavior (action plan) and accounting treatment by company management are not adequate, a qualified opinion is expressed in the form of "except for" or an adverse or disclaimer of opinion for uncertainty on the going concern principle, when its impact is believed to be significant for the annual accounts in its entirety.

It is important to underscore that with the emphasis of matter paragraph, the auditor does not provide additional information to that already disclosed in the annual report and does not change the opinion paragraph. In this reporting context, a standard unqualified (clean) opinion, including an emphasis of matter paragraph related to going concern or financial distress, is legally closer to the non-serious qualification group than to the modified opinion notion expressed in other regulatory environments. For example, in ISA (UK and Ireland) 700 issued in December 2004, para. 29 (the same concept is expressed in the March 2009 version, para. 45), an auditor's report is considered to be "modified" in the following situations, *Matters That Do Not Affect the Auditor's Opinion*:

- emphasis of matter; *Matters That Do Affect the Auditor's Opinion*;
- qualified opinion;
- disclaimer of opinion; or
- adverse opinion.

In the USA, SAS No. 58 describes the various audit opinions: unqualified, explanatory language added to the auditor's standard report (a broader concept than an emphasis of matter paragraph), qualified, adverse, disclaimer. In this reporting context, the emphasis of matter paragraph is only one of the circumstances in which to add explanatory language.

This provision is confirmed by the regulatory changes introduced by Legislative Decree No. 39 of 2010, adopting the European Directive 2006/43/EC on statutory audit in Italy. In the regulation regarding the opinions in the audit report (article 14), it is confirmed that an emphasis of matter paragraph is not legally a qualification.

For the traditional corporate governance model, the Italian civil code (article 2364) provides that the ordinary shareholders meeting must approve the company's annual accounts within 120 days of the year end and the close of accounts. It is possible under specific conditions to extend the previous term to 180 days, and, in this case, the management report must explain the motivation for the delay. The annual financial statements and accompanying notes, the management report, the *collegio sindacale* (translated in English as the internal statutory board of controllers or internal statutory board of auditors) report and the audit report must be available to shareholders at least 15 days before the date of the annual general meeting of shareholders (article 2429 of civil code). Article 154-ter of Legislative Decree No. 58 of 1998 (TUF) provides that within 120 days of the fiscal year end, listed companies must make available to the public the annual financial reports using several means of communication, including the publication on the Web site of each company. The annual financial reports include a draft of the separate and consolidated (if applicable) financial statements and related notes approved by the board of directors and the management report. In addition, the audit report must be available to the public within the same term: 120 days of the fiscal year end. The lag time between the publication of these documents and the date of the

annual shareholders meeting has been set at least 21 days since March 20, 2010 (Legislative Decree No. 27 of 2010); previously, it was at least 15 days. From this legislative framework, it can be conjectured that the audit report should be disclosed at least 15 or 21 days before the annual shareholders meeting, and this can be interpreted as the event date; this approach was partially followed by Pucheta Martínez *et al.* (2004) and Soltani (2000) for the cases of Spain and France.

However, because this is a minimum requirement, it is possible that the audit report announcement date is earlier than the standard 15 or 21 days before the annual shareholders meeting. It is worth noting that if the audit report is disclosed fewer than 15 or 21 days before the annual shareholders meeting, the approval of the annual report can be appealed according to the civil code (article 2377). Moreover, Consob Regulation No. 11971 of 1999, article 66, provides that listed companies should promptly disclose to the public significant events and circumstances with a specific press release. As a consequence, it is reasonable to use the audit report date as the event day because the company should promptly communicate this information to the public. This interpretation is in line with Consob Communication No. DME/6064291 of July 28, 2006, where it is written that if the audit firm expresses an adverse opinion, a qualified opinion ("except for") or a disclaimer of opinion after the approval of the draft financial statements, the listed company must immediately communicate this circumstance to the market. The minimum content of the press release is the type of opinion and a copy of the audit report (article IA.2.9.5 Operative Manual of Italian Stock Exchange Regulation). Other audit opinions that may be relevant should be treated in the same way. It can be reasonable to assume that this treatment (immediate press release) applies to the unqualified opinion with an emphasis of matter paragraph related to going concern uncertainty or financial distress. However, this choice was left to the discretion of the company, which evaluates whether this information is relevant for investors. In a subsequent Consob Communication No. DME/9081707 of September 16, 2009, it was formally clarified that the unqualified opinion with an emphasis of matter paragraph related to a going concern issue must be promptly disclosed.

This regulatory framework induced us to primarily use the audit report date (signature date by auditors) as the event day and to analyze the market reaction by subdividing the audit opinions into two main groups:

(1) qualified opinions (including "except for", adverse opinions and disclaimers of opinion); and

(2) unqualified opinions with an emphasis of matter paragraph related to going concern uncertainty or financial distress.

This approach is linked to the Italian institutional setting. Previous studies, driven by their institutional contexts, tended to analyze only qualified opinions, even though they mention the difficult interpretation of the emphasis of matter paragraph (Pucheta Martínez*et al.*, 2004; Soltani, 2000). From the Consob annual reports, it is possible to infer that, in general, the vast majority of listed companies receive an unqualified opinion. Severe opinions are rare in the form of qualified, adverse and disclaimers of opinion (Consob, 2011; Di Pietra, 2013).

With reference to the Italian market, Gualandri and Venturelli (2013) and Venturelli (2012) discuss how the Italian financial market is characterized by the insufficient role of institutional investors, the embryonic state of the corporate bond market and the virtual

non-existence of commercial paper markets. In addition, they underline that the level of indebtedness (financial liabilities/gross domestic product [GDP]) of non-financial corporations is lower than that of all other Euro area states except Germany. This debt is mostly provided by the bank lending channel (54 per cent of total financial liabilities in 2011). Moreover, Barucci *et al.* (2005) show that the Italian national financial system is characterized by concentrated ownership and weak investor protection. Indeed, Silvestri and Veltri, (2011) report that the dimensions of the Italian market, in equity terms, is nearly half the size of Germany, one-third that of the US and one-fourth of the UK. Starting also with this evidence, Nobes and Parker (2010) classify Italy as a weak equity market, together with Belgium, France, Germany, Austria and Japan. In particular, Brealey *et al.* (2006) qualify the Italian market as bank-oriented, whereas the US market is market-oriented, providing firms with easier access and multiple access points to funding sources. In conjunction with these features of the financial market, Italian corporate governance is characterized by strong connections between ownership (family owned, high ownership concentration) and control of firms (Bianchi *et al.*, 2001), while the Anglo-Saxon markets show a broader ownership of the share capital. In such a context, external auditing can play a role as a monitoring tool to mitigate type II agency problems (Ianniello, 2013).

3. Background and hypothesis development

In theory, the relevance of audit reports as source of information for the financial markets is only one aspect of the possible roles that auditing can play in the context of a free and regulated market. The additional roles can be identified in the contribution to monitoring management, thus reducing agency costs, and to providing financial information producers, users and auditors with insurance against claims if something goes wrong with the information concerned (Wallace, 2004). In this paper, we emphasize the additional information source provided by the auditing function to facilitate investor decision-making. Therefore, in the theoretical framework of market-based accounting research (Lev and Ohlson, 1982), we focus on market reaction that can be ascribed to the information content in the auditor's report. For the purpose of our study, the accounting and auditing literature has provided two types of analysis:

(1) experimental studies, examining the decision-makers' (loan officers, financial analysts) reaction to a change in the types of audit opinion; and

(2) archival studies that try to capture the stock market reaction around the audit report information announcement.

According to Bessell *et al.* (2003), the majority of experimental studies conclude that financial statement users do not give additional credence to the qualification/modification in the auditor's report. However, some studies provide evidence that non-standard audit reports are relevant to the financial statement users' decision-making process (LaSalle and Anandarajan, 1997; O'Reilly, 2010). Duréndez Gómez-Guillamón (2003) in a survey study shows that the auditor's report has relevance in investment and lending decision.

The other type of study focuses on the financial market reaction when a firm receives a non-standard opinion with qualifications belonging to different level of severity. The behavior of investors can be considered to reveal whether the audit opinion serves the information role as suggested in theory (Wallace, 2004). In particular, our attention is

focused on the research approach examining abnormal stock returns in a short event window around the report announcement. These studies (Baskin, 1972; Firth, 1978; Chow and Rice, 1982; Dodd *et al.*, 1984; Dopuch *et al.*, 1986; Loudder *et al.*, 1992; Herbohn *et al.*, 2007) are primarily conducted in the UK, USA and Australian contexts. However, other papers have analyzed the situations in France (Soltani, 2000), Spain (Pucheta Martínez *et al.*, 2004), China (Chen *et al.*, 2000; Czernkowski *et al.*, 2010; Pei and Hamill, 2013), Jordan (Al-Thuneibat *et al.*, 2008) and Taiwan (Hsu *et al.*, 2011). Overall, these studies report mixed results, as corroborated by previous meta-analyses on stock price reactions to qualified opinions (Craswell, 1985; Ittonen, 2012).

Previous inconclusive empirical research on the market reaction to auditors' qualifications has been explained in an equilibrium analytical model by Melumad and Ziv (1997). They theoretically show that it is possible that the market reaction to qualified audit reports can be either positive or negative for *ex post* avoidable qualifications (e.g. qualifications for asset realization, timing of revenue recognition, amount of reserves for future losses, GAAP compliance). In the case of *ex post* unavoidable qualifications (including those for future financing, going concern and unquantifiable uncertainties), market reaction should be negative.

From previous literature and theory, we can conclude that when, after assessing both public and private information, the auditor questions the firm's financial viability or the true and fair view of the financial position and performance expressed in the published financial reporting, there can be a potential impact on the financial market by signaling that earnings are noisier and/or less persistent than previously assumed by investors (Choi and Jeter, 1992). From the Italian regulatory environment surrounding the audit process, we use the (a) qualified audit opinion ("except for"), (b) the adverse audit opinion, (c) the disclaimer of opinion, and (d) the unqualified opinion with an emphasis of matter paragraph related to going concern uncertainty or financial distress. It is widely believed that qualifications (including types of opinion a, b, c) in the audit report convey adverse information about the firm (Chow and Rice, 1982). For these reasons, we formulate in its alternative form the following:

H1. Qualifications ("except for", adverse opinions and disclaimers of opinion) in audit reports related to going concern uncertainty or financial distress have a significant effect on share prices, as revealed by abnormal returns for the common stock of firms.

As common in the literature (Pucheta Martínez *et al.*, 2004; Pei and Hamill, 2013), this hypothesis can be further disentangled to investigate the relevance of different types of opinions, so we formulate in its alternative form the following:

H1a. Qualified audit reports ("except for") related to going concern uncertainty or financial distress have a significant effect on share prices, as revealed by abnormal returns for the common stock of firms.

H1b. Disclaimers of opinion related to going concern uncertainty or financial distress have a significant effect on share prices, as revealed by abnormal returns for the common stock of firms.

It was also our intention to test the hypothesis relative to adverse opinions; however, we could not because we found only one available observation that had received such an opinion (Section 4.1.).

In the Italian institutional setting, as already discussed in Section 2, the unqualified opinion with an emphasis of matter paragraph related to going concern uncertainty or financial distress deserves to be investigated separately because the auditor's report is technically unqualified, but it may be a relevant signal for the market. For this reason, we formulate in its alternative form the following:

H2. Unqualified opinions with an emphasis of matter paragraph related to going concern uncertainty or financial distress have a significant effect on share prices, as revealed by abnormal returns for the common stock of firms.

4. Research design and methodology

4.1 The data sample

Our sample contains companies that list on the Italian Stock Exchange and had qualifications ("except for", adverse opinions and disclaimer of opinions) in their annual audit reports and an unqualified opinion with an emphasis of matter paragraph related to going concern uncertainty or a financial distress issue from 2007 to 2010. We based our selection on data reported in Consob annual reports (2008-2011) (Di Pietra (2013)) and a manual analysis of the audit reports published during the period under investigation. We excluded companies with an audit report mentioning that the firm is under a legal procedure in the framework of the bankruptcy law. In this way, we can eliminate conditions where the independent auditor's disclosure would be unlikely to have any information content.

Starting from a potential 1,125 firm-year observations, considering all listed companies during the period under investigation as provided in the statistics of the Italian Stock Exchange (www.borsaitaliana.it), we obtained 139 observations from 66 unique business entities. However, missing data on stock prices reduced our sample to 97 observations from 41 unique firms. In particular, 83 (86 per cent) firm-year observations are drawn from the standard segment of *Borsa Italiana's* equity market (MTA – *Mercato Telematico Azionario*) and 14 (14 per cent) observations refer to the "star" segment of the MTA dedicated to midsize companies of high quality in terms of transparency, disclosure and governance. Table I reports the total number of listed companies, the number of sample companies by year and the types of audit opinions. We observe a quite even distribution over the year, with the exception of the pick in 2008, probably due to the effect of the financial crisis beginning at the end of 2007. From Table I, it can also be observed that auditor opinions containing severe qualifications ("except for", adverse opinions and disclaimers of opinion) represent on average approximately 5 per cent (54/1,125) of the total opinions issued, thus confirming that these types of opinions are rare.

In addition, Table II shows some descriptive statistics on the fundamental variables most used in describing sample firm characteristics in papers addressing auditor opinion (Hsu *et al.*, 2011; Taffler *et al.*, 2004). Overall, our sample shows high variability in terms of size (total assets and market value). As expected during a period of financial crisis, firm performance (return on asset) on average is negative (−8.6 per cent), with the majority of firm-year observations reporting a loss (88 per cent). As shown in Table III, the worst financial conditions are observable in the group of companies receiving a disclaimer of opinion, while a relatively better performance is linked to a less severe qualified ("except for") audit opinion. The firm-year observations belong to the following industrial sectors: agriculture, forestry, fishing and mining, 3 (3 per cent);

Number of listed companies	2007 272	2008 261	2009 296	2010 296	Total 1125
Number of companies receiving the types of opinion under investigation					
A – "Except for"	10	4	6	4	24
Missing data	(7)	(1)	(1)	(1)	(10)
Remaining observations	3	3	5	3	14
B – Adverse opinion	0	1	1	2	4
Missing data	0	(1)	0	(2)	(3)
Remaining observations	0	0	1	0	1
C – Disclaimer of opinion	2	9	8	7	26
Missing data	(1)	(5)	0	(1)	(7)
Remaining observations	1	4	8	6	19
Total	12	14	15	13	54
Missing data	(8)	(7)	(1)	(4)	(20)
Remaining observations	4	7	14	9	34
D – Unqualified with an emphasis of matter paragraph on going concern or financial distress	20	27	17	21	85
Missing data	(9)	(10)	(1)	(2)	(22)
Remaining observations	11	17	16	19	63
Total	32	41	32	34	139
Missing data	(17)	(17)	(2)	(6)	(42)
Remaining observations	15	24	30	28	97

Table I.
Sample description

Variable	Mean	SD	Minimum	Maximum
BS_TOT_ASSET (million euros)	456.5	956.8	10.6	5,769.8
CUR_MKT_CAP (million euros)	173.0	382.2	5.3	2306.2
RETURN_ON_ASSET (ROA) (%)	−8.6	13.5	−62.8	20.5
FNCL_LVRG (ratio)	9.3	11.5	1.2	64.4
PX_VOLUME (number of shares)	384,568,767	1,370,000,000	128,676	861,000,000
LOSS (= 1) No. 85 (88%)				

Notes: Variable definitions: BS_TOT_ASSET is the total of all short- and long-term assets as reported on the Balance Sheet. CUR_MKT_CAP is the last available observation for market value measured by market capitalization. RETURN_ON_ASSET (ROA) (net operating income/total assets) is an indicator of how profitable a company is relative to its total assets. FNCL_LVRG (financial leverage) is calculated using the following formula: average total assets/average total common equity, where total common equity = share capital and additional paid in capital + retained earnings. PX_VOLUME is the total number of shares traded on a security on average by day. LOSS = taking the value (1) for companies reporting loss, (0) otherwise All data are drawn from Bloomberg Ltd Data Service, and Aida database, Bureau van Dijk. Description of types of opinion: A = "except for"; B = adverse opinion; C = disclaimer of opinion; and D = unqualified opinion with an emphasis of matter paragraph on going concern uncertainty or financial distress

Table II.
Sample descriptive statistics: $N = 97$ firm-year observations

manufacturing, 37 (38 per cent); transportation, communications, electric, gas and sanitary services, 12 (12 per cent); wholesale trade, 8 (8 per cent); retail trade, 4 (4 per cent); finance, insurance and real estate, 10 (10 per cent); and services, 23 (24 per cent).

Variable	Types of opinion A + B + C + D (n = 97)	D (n = 63)	C (n = 19)	A (n = 14)	A + B + C (n = 34)
BS_TOT_ASSET (million euros)	456.5	434.5	205.4	922.6	497.3
CUR_MKT_CAP (million euros)	173.0	144.9	60.0	462.1	232.7
RETURN_ON_ASSET (ROA) (%)	−8.6	−8.7	−16.4	2.5	−8.5
FNCL_LVRG (ratio)	9.3	8.1	10.1	7.2	9.1
PX_VOLUME (number of shares)	384,568,767	433,794,415	452,552,179	70,466,759	26,418,4485
LOSS (=1) number (%)	85 (88%)	60 (95%)	17 (89%)	7 (50%)	25 (74%)

Notes: Variable definitions: BS_TOT_ASSET is the total of all short- and long-term assets as reported on the Balance Sheet. CUR_MKT_CAP is the last available observation for market value measured by market capitalization. RETURN_ON_ASSET (ROA) (net operating income/total assets) is an indicator of how profitable a company is relative to its total assets. FNCL_LVRG (financial leverage) is calculated using the following formula: average total assets/average total common equity, where total common equity = share capital and additional paid in capital + retained earnings. PX_VOLUME is the total number of shares traded on a security on average by day. LOSS = taking the value (1) for companies reporting loss, (0) otherwise All data are drawn from Bloomberg Ltd Data Service, and Aida database, Bureau van Dijk. Description of types of opinion: A = "except for"; B = adverse opinion; C = disclaimer of opinion; and D = unqualified opinion with an emphasis of matter paragraph on going concern uncertainty or financial distress

Table III. Sample descriptive statistics: N = varies

4.2 Methodology

One of the major methodological issues in previous research is the identification of the audit report date (event date). In this respect, following the discussion in Section 2, we have identified the date of the auditor's signature indicated in the report as the audit report day (event date). This approach may accurately identify the audit report announcement (event date) in the Italian context and allows us to use a short event window to reduce the potential effects of other relevant events and circumstances that may occur with a larger event window. This approach helped us to solve the concern that methodology should control the unique stock price effect of the audit opinion. For example, Firth (1978) analyzes stock fluctuations 20 days before and after the audit report day, while Ball *et al.* (1979) use an event window of four weeks before and after the event day.

We analyzed audit reports on separate and consolidated financial statements, but we included in our analysis only observations coming from consolidated annual reports and separate financial statements in cases where the consolidated account was not available. To use both audit reports would have the effect of almost doubling the observations because we observed the same opinion expressed in both consolidated and separate audit reports.

We did not distinguish between qualifications issued for the first time and those that are recurrent. Some studies used only first-time qualifications (Ameen *et al.*, 1994; Dodd *et al.*, 1984; Loudder *et al.*, 1992), while other authors tested their hypotheses separately for first-time qualifications and those that are recurrent (Pucheta Martínez *et al.*, 2004;

Soltani, 2000). These approaches explicitly or implicitly assume that, in the subsequent years after a qualified opinion, the audit report may have less relevance. It is not our intention to test this assumption.

We use an event study methodology to analyze whether auditor opinions produce an impact on stock markets. In this stage of our analysis, we assess the effect of auditor opinions on the stock prices of the interested firm sample. For each piece of news relative to single auditor opinions, we estimate the abnormal return of a company with respect to a general equity index (market return, e.g. FTSE MIB). Therefore, the focus of this paper is not on the long-term market reaction surrounding the announcement date. We justify the short-window event approach in three ways. First, according to some studies (McWilliams and Siegel, 1997), conclusions from an event study are valid when it is assumed that there are no confounding effects from other events during the event window. The longer the time period used to measure the information content of qualified audit opinions, the more difficult it is for researchers to isolate the impact of one particular event. Therefore, a short time period or window reduces the likelihood that results may be sensitive to other confounding events. Second, some previous studies (Hsu *et al.*, 2011; Pucheta Martínez *et al.*, 2004; Taffler *et al.*, 2004) investigated abnormal stock returns in a short event window around the expected audit report disclosure. Last, as Brown and Warner (1985) showed, using a long event window severely reduces the power of the test statistic, Zt.

Using this methodology, we have one observation for each auditor opinion, giving 97 total observations. For each type of auditor opinion, we estimate the Abnormal Return (AR), which is the forecast error of a specific normal return-generating mode, adopting the market model (MacKinlay, 1997). Normal returns for every *i-th* observation (R_{it}) – that is, the firm's stock return – as a function of the market portfolio return (R_{Mt}), represented by the Italian equity market index, namely, FTSE MIB40, are as follows:

$$R_{it} = \alpha_i + \beta_i R_{Mt} + \varepsilon_{it} \qquad E(\varepsilon_{it}) = 0, \text{var}(\varepsilon_{it}) = \sigma_{2\varepsilon i} \tag{1}$$

The market model parameters are obtained using the daily log returns of firm stock returns and the Italian equity market index, which represents the market portfolio over a 252-day estimation period, ending 20 days before the announcement. ARs are then obtained as the difference between the actual stock return and the return predicted by the market model:

$$AR_{it} = R_{it} - (\hat{\alpha}_i + \hat{\beta}_i R_{Mt}) \tag{2}$$

ARs are cumulated over a time period (Cumulative Abnormal Return, CAR) around the announcement date ($t = 0$). Following Aït-Sahalia *et al.* (2012), we focus on the following short event windows: seven-day (−1; +5), five-day (−1; +3), three-day (−1; +1) and one-day (0; 0). As a robustness check, we also estimate CARs on (−1; 0). For each event window, CARs are obtained as follows:

$$CAR_i(t_1, t_2) = \sum_{t=t_1}^{t_2} AR_{it} \tag{3}$$

where t_1 and t_2 are the start and end dates of the considered window. ARs can be aggregated on a time or a cross-section basis for a portfolio of N observations. The Cumulative Average Abnormal Return (CAAR) is calculated as follows:

$$CAAR(t_1, t_2) = \frac{1}{N}\sum_{i=1}^{N} CAR_i(t_1, t_2) \tag{4}$$

After the calculation of CAARs, we test the hypothesis of a market reaction significantly different from zero. As noted by Cummins and Weiss (2004), various studies have documented a variance increase in ARs during the days near the event with respect to the estimation period. If hypothesis testing is conducted without considering this increase in variance, results can be biased in the direction of a too frequent rejection of the null hypothesis in favor of the alternative. To overcome this limitation and avoid considering a null value creation or destruction as significant, we follow the approach first proposed by Mikkelson and Partch (1988) and then adopted, in some recent studies (Harrington and Shrider, 2007; Mentz and Schiereck, 2008), suggesting the use of the Boehmer *et al.* (1991) test statistic. First, we calculate a standardization factor:

$$SR_i = \frac{CAR_i(t_1, t_2)}{\hat{\sigma}_{\varepsilon_i}\sqrt{T_s + \frac{T_s^2}{T} + \frac{\sum_{t=t_1}^{t_2}\left(R_{Mt} - T_s(\bar{R}_M)\right)^2}{\sum_{t=1}^{T}\left(R_{Mt} - \bar{R}_M\right)^2}}} \tag{5}$$

where $\hat{\sigma}_{\varepsilon_i}$ is the standard deviation of abnormal returns estimated using the market model; T_s is the number of days in the considered event window (t_1, t_2); T is the number of days in the estimation period; R_M is the market portfolio return and $\bar{R}_M$ is the average market portfolio return during the estimation period. Then, the Z statistic (with a t-distribution with T-2 degrees of freedom and converging to a unit normal) is determined as follows (Mentz and Schiereck, 2008, p. 207):

$$Z = \frac{\frac{1}{N}\sum_{i=1}^{N} SR_i}{\sqrt{\frac{1}{N(N-1)}\sum_{i=1}^{N}\left(SR_i - \sum_{i=1}^{N}\frac{SR_i}{N}\right)^2}} \tag{6}$$

A recent study by Kolari and Pynnönen (2010) proposes a new test statistic that modifies the one suggested by Boehmer *et al.* (1991) to include a possible cross-sectional correlation among abnormal returns. The adjusted test statistic is obtained applying the following correction factor to the above defined Z:

$$\sqrt{\frac{1 - \bar{r}}{1 + (N-1)\bar{r}}} \tag{7}$$

where $\bar{r}$ is the average of the sample cross correlations of the estimation period residuals, and N is the number of observations in the considered sample.

In addition to the event dates mentioned above, we perform our analysis using an alternative set of data. When available, we have collected the date of the press release disclosing the audit report to the public. Missing data are replaced by the audit report date. Normally, this report announcement day is the same as the audit report date signature or few days after. However, we cannot exclude the possibility that the audit opinion somehow is known to the market before the press release. For this reason, we consider the primary analysis to be the one with the audit report date and use the press release date as an additional test.

Moreover, we also perform the analysis considering opinions issued by a Big 4 audit firm; in this way, we intend to show whether a signal coming from a large audit firm has a stronger impact on the capital market. However, this analysis must be interpreted with caution because the Big 4 strongly dominates the audit market for Italian listed companies (Consob, 2011).

In terms of audit opinions, a different approach should use a criteria of classification based on the notion of modified audit opinions (Bradshaw *et al.*, 2001). In this case, an unqualified opinion with an emphasis of matter paragraph would be grouped with the strictly qualified opinions. This direction of analysis (more focused on the level of information/alert role of the audit report) is not in line with the Italian audit reporting regulations. However, we also perform a test pooling all of the opinions considered to be one group of qualified/modified opinions.

5. Empirical results

5.1 Market reaction to auditor opinions

In this section, we present our empirical findings. We test the stock price reaction to auditor opinions by measuring the market reaction for different event windows. When we focus on the effect of different types of auditor opinions (Table IV) on the firm stock price, we report different results according to different combinations for types of auditor opinions. According to *H1*, the results show (Table IV, column (A + B + C) that qualifications in audit reports provide investors with information content, strongly in our longer event windows, in terms of lower returns, so we can state that *H1* is validated. These results confirm that audit qualifications, in general, do convey a negative impact on stock prices. Looking at the specific type of qualifications, we turn to *H1a* and *H1b*. Different types of qualified audit reports may provide information content to investors in terms of abnormal returns. Table IV, column (C) shows that stock prices are associated with a reduction in the return (statistically significant at the 1 per cent confidence level or lower in the two-, five- and seven-day event windows) when a disclaimer of opinion is issued; therefore, *H1b* is also corroborated. However, with reference to *H1a*, a qualified audit report ("except for") does not show any significant stock price impact (Table IV, column A), so *H1a* is not confirmed. This evidence shows, as intuitively expected, that, in an Italian audit report, a more serious qualification (disclaimer of opinion) has more relevance in comparison to an "except for" form of qualification.

When we consider *H2*, Table IV, column (D) shows that the auditor's decision to release an unqualified opinion with an emphasis of matter paragraph related to going concern or financial distress significantly increases the stock price return in two

Event window	A + B + C + D (n = 97)		Types of opinion D (n = 63)		C (n = 19)		A (n = 14)		A + B + C (n = 34)	
	Z-stat	CAAR	Z-stat	CAAR	Z-stat	CAAR	Z-stat	CAAR	Z-stat	CAAR
(−1, + 5)	0.10	0.00	1.22	0.02	−2.84	−0.04***	−0.28	−0.00	−3.02	−0.04***
(−1, + 3)	0.99	0.01	2.04	0.02**	−2.88	−0.05***	0.92	0.01	−1.36	−0.02
(−1, + 1)	0.91	0.00	1.48	0.01	−1.05	−0.02	−0.45	−0.01	−1.06	−0.01
(0, 0)	0.93	0.00	1.40	0.00	−1.17	−0.01	−0.63	−0.01	−1.25	−0.01
(0, + 1)	1.05	0.00	2.01	0.01**	−1.98	−0.02*	−0.78	−0.01	−1.92	−0.01*
(−1, 0)	0.82	0.00	1.03	0.00	−0.36	−0.01	−0.31	−0.01	−0.46	−0.01

Notes: Significant at: *10, **5 and ***1% levels. Description of types of opinion: A = "except for"; B = adverse opinion; C = disclaimer of opinion; and D = unqualified opinion with an emphasis of matter paragraph on going concern uncertainty or financial distress

Table IV.
Stock price response to auditor opinions: CAAR and Z-Stat– audit report *date*

windows, so we can state that *H2* is corroborated. This result can be explained because in a moment of financial distress, the auditor used the emphasis of matter paragraph instead of a qualification in the audit report. In these cases, the auditor's decision may increase confidence that with a financial or industrial plan, the company could overcome its temporary financial difficulties. Thus, the positive market reaction appears to be interpreted as indicating the possibility for future recovery.

Overall, we can state that audit reports investigated have relevance (*H1*, *H1b* and *H2* are supported) in two opposite directions depending on the two groups of opinions analyzed. In line with some previous studies (Dopuch *et al.*, 1986), we report negative price reactions to audit qualifications (*H1* and *H1b*). With reference to *H2*, we show positive price reactions to unqualified opinions with an emphasis of matter paragraph about going concern or financial distress. In particular, our evidence shows the relevance of the specific audit environment regulating the standard audit report. In our case, the auditor's discretion is evidenced in the unqualified audit report with an emphasis of matter paragraph related to going concern issues or the financial distress of the audited firm. When the relevance of the financial difficulties, in the auditor's opinion, does not indicate the need for a more severe opinion, this opinion is positively evaluated by the market. In other words, the auditor's doubt about the ability of a company to continue to exist does not reach a level of severity such that he or she issues a qualified opinion, and this is seen by the market as offering the possibility of the firm's recovery. The auditor may have evaluated mitigating factors such as the company's ability to cut costs, sell assets or obtain additional credit. The reliability of this information may not be easy to evaluate by external investors and analysts.

We recognize that the disclosure of going concern uncertainties is highly controversial because it could implicate situations in which firms may go bankrupt without any warning about going concern problems in an independent audit report. The Italian institutional setting has offered the possibility of analyzing audit behavior where the auditor's responsibility to evaluate and disclose a going concern can result in a qualified opinion or an unqualified opinion with an emphasis of matter paragraph. It appears that the auditor's evaluation of uncertainties is relevant for the market. This relevance supports the idea that an independent auditor has intimate knowledge of the client's activities and future plans (Menon and Schwartz, 1987). Our results show that an unqualified opinion with an emphasis of matter paragraph about going concern or financial distress can be viewed as a favorable evaluation concerning going concern status, especially among distressed firms. This result is somehow similar to that of Jones (1996), which examined a sample of 86 financially distressed firms that received a clean opinion and the market response to the release of the opinions.

5.2 Additional tests

In addition to the primary analysis, we perform a test pooling all of the opinions considered as one group of qualified/modified opinions. We find that auditor decisions do not produce a statistically significant market reaction (Table IV, columns A + B + C + D). These results can be explained by the dissimilar nature of qualifications and unqualified opinions with emphasis of matter paragraphs in the Italian context (Ianniello, 2012), and thus, mixing the two groups of opinions does not produce a clear signal.

We also run two additional tests, considering abnormal returns calculated starting from a press release and opinions released by a Big 4 auditor. For the latter issue, in a recent study, Cascino *et al.* (2014) report that Big 4 auditors in Italy tend to have a compliance score that is approximately 24 percentage points higher than their non-Big 4 peers. Table V shows that the effect of a Big 4 auditor is similar to the general results; however, caution must be used in interpreting these results because Big 4 auditors dominate the audit market for Italian listed companies.

With reference to the press release dates, in our sample, these data are available for 71 observations. To keep the size of the original full sample (97 observations), we substitute missing data (26 observations) using the same audit report dates. The results from this additional test reported in Table VI, overall, confirm the previous results[1].

6. Conclusion and implications

Our research focuses on the stock price reaction to auditor opinions in the Italian context. In particular, we analyzed two types of auditor opinions: qualifications ("except for", adverse opinions, disclaimers of opinion) and unqualified opinions with an emphasis of matter paragraph related to going concern uncertainty or financial distress. In the Italian regulatory environment, the first group is legally more severe, while the second group can signal a peculiar situation of the audited firm. Our general conclusion is that qualifications in the audit report convey a negative impact on stock price. In detail, we show that when the qualification is an "except for" qualification, there is no impact on stock prices, while the strongest negative influence is found for the disclaimer of opinion. However, unqualified opinions with an emphasis of matter paragraph on going concern uncertainty or financial distress have a positive impact on stock prices. Therefore, in both cases, we can state that audit reports investigated provide information value to investors. In the European context, our results are in line with Soltani (2000) but in contrast with Pucheta Martínez *et al.* (2004). It is important to stress that we used an event date methodology adequate to the specific institutional context, solving the event date problem common in this type of study (Ittonen, 2012). When the relevance of the financial difficulties, in the auditor's opinion, does not drive toward a more severe opinion, this behavior is positively evaluated by the market. In other words, the auditor's doubts about the ability of a company to continue to exist does not reach a level of severity at which he or she should issue a qualified opinion, and this is seen by the market as indicating the possibility of the firm's recovery. It appears that the auditor's evaluation of uncertainties is relevant for the market. The levels of professional skepticism and prudent judgments exercised by the auditors reveal that the uncertainty is not so serious that it forces the auditor to express a qualified or disclaimer of opinion on the financial statements examined. Instead the auditor issues an unqualified opinion with an emphasis of matter paragraph, and this behavior is positively evaluated by the market. In other words, the choice of not qualifying the audit report may be interpreted as a positive outlook leading to better market response.

This finding supports the idea that an independent auditor has intimate knowledge of the client's activities and future plans (Menon and Schwartz, 1987). Our results show that an unqualified opinion with an emphasis of matter paragraph on going concern or financial distress can be viewed as a favorable evaluation concerning going concern status, especially among distressed firms. We can also argue that investors are able to appreciate the substantial value of audit opinions when a choice is made between the

Event window	A + B + C + D (n = 79) Z-stat	CAAR	D (n = 57) Z-stat	CAAR	Types of opinion C (n = 11) Z-stat	CAAR	A (n = 11) Z-stat	CAAR	A + B + C (n = 22) Z-stat	CAAR
(−1, + 5)	0.11	0.00	1.35	0.00	−3.62	−0.045***	−0.01	0.00	−2.50	−0.01**
(−1, + 3)	0.89	0.00	1.89	0.02*	−2.10	−0.04**	1.85	0.02*	−2.46	−0.06**
(−1, + 1)	0.96	0.01	1.34	0.01	−1.10	−0.02	1.3	0.01	−1.26	−0.03
(0, 0)	0.85	0.00	1.43	0.01	−0.62	−0.01	1.38	0.01	−1.57	−0.02
(0, + 1)	1.02	0.01	1.77	0.01*	−1.68	−0.02*	1.74	0.01*	−1.75	−0.03*
(−1, 0)	0.85	0.00	1.11	0.01	−0.27	−0.01	1.06	0.01	−1.00	−0.02

Notes: Significant at: * 10, ** 5 and *** 1 % levels. Description of types of opinion: A = "except for"; B = adverse opinion; C = disclaimer of opinion; and D = unqualified opinion with an emphasis of matter paragraph on going concern uncertainty or financial distress.

Table V.
Stock price response to auditor opinions: CAAR and Z-Stat– Big 4

Table VI.
Stock price response to auditor opinions: CAAR and Z-Stat–Press Release Date

	A + B + C + D (n = 97)		D (n = 63)		Types of opinion C (n = 19)		A (n = 14)		A + B + C (n = 34)	
Event window	Z-stat	CAAR	Z-stat	CAAR	Z-stat	CAAR	Z-stat	CAAR	Z-stat	CAAR
(−1, + 5)	0.11	0.00	1.15	0.02	−3.12	−0.05***	0.03	0.00	−2.80	−0.04***
(−1, + 3)	1.13	0.01	2.42	0.02**	−2.78	−0.04***	−0.84	0.00	−2.13	−0.02**
(−1, + 1)	0.50	0.00	1.17	0.01	−1.56	−0.02	−1.28	−0.01	−1.33	−0.01
(0, 0)	0.71	0.00	0.95	0.00	−0.28	0.00	0.51	0.00	−0.25	0
(0, + 1)	0.85	0.01	1.93	0.02*	−1.71	−0.02*	−0.87	−0.01	−1.58	−0.01
(−1, 0)	0.56	0.00	0.72	0.00	−0.31	0.00	−0.83	0.00	−0.2	0

Notes: Significant at: *10, **5 and ***1% levels. Description of types of opinion: A = "except for"; B = adverse opinion; C = disclaimer of opinion; and D = unqualified opinion with an emphasis of matter paragraph on going concern uncertainty or financial distress

two groups of opinions separated by a thin but significant line and the auditor's judgment. This result is somehow similar to that of Jones (1996), which examined a sample of 86 financially distressed firms that obtained a clean opinion and the market response to the release of this opinion. Different empirical evidence is found in China by Chen *et al.* (2000), where unqualified opinions with explanatory notes have a negative effect on stock prices. They also report anecdotal evidence suggesting that Chinese auditors may use unqualified opinions with explanatory notes as a convenient alternative to qualified opinions so as not to lose their clients while avoiding direct violations of auditing standards. Comparing Chen *et al.*'s (2000) results with our evidence, it is clear that auditing standards may be implemented in different ways and, as a consequence, that market perception may differ depending on the institutional setting. This framework may justify the effort to obtain consistency in the implementations of common international rules. For example, the European Union, with the new Directive 2014/56/EU of 16 April 2014, is trying to make the audit report more informative for investors, providing them with relevant information about the audited company beyond a mere standardized opinion on the financial statements.

In an environment such as Italy, where the ownership of listed companies is highly concentrated and where type II agency problems often arise between controlling and minority shareholders, it appears that audit opinions signal information that is useful to investors. Considering the three incentives for hiring auditing services (signaling, agency costs and insurance hypothesis) proposed in the academic literature (Dye, 1993; Wallace, 2004), we are able to show that auditors are capable of providing a signal to the market based on the auditor's access to inside company information and, particularly, when the audit opinion is the outcome of a high level of negotiation between company management and the auditor (Beattie *et al.*, 2001; Kleinman and Palmon, 2001). Our results confirm that auditing as independent verification provides an additional information source in a situation in which debatable decisions are taken, considering both economic and social perspectives (Lee, 1993).

Financial market consequences are relevant for regulators, so, among the policy implications stemming from our research, we emphasize that authority should regulate the timing and procedure for the public disclosure of audit reports in a way that would make the information available to the audited company and other stakeholders on the same day, which, in theory, is the day on which the audit process concludes with the signature of the audit report. For example, the audit firm could disclose the audit report to the public when it is delivered to the audited company; this regulation change would be in line with the view of financial auditing engaged and paid for by the audited firm but also implemented in the public interest to increase the credibility of published financial statements.

We tried to limit the possibility of concurrent effects on stock prices using a short window event study methodology; however, we cannot exclude the possibility that some other event may have occurred during our event window. Although there are many benefits to using event studies in research, including allowing for a simple and easy interpretation of results, there are some limitations to this methodology. First, the event study approach depends strictly on the hypothesis of market efficiency. This assumption is not valid in many situations because prices do not instantly or fully reflect all available information. Second, the methodology provides estimates of the short-run impact on stock prices, failing to consider any calendar time clustering of events that

could affect a single firm's stock in close succession, resulting in abnormal returns that are not caused by the specific event of interest and cross-sectional dependence (Cable *et al.*, 1999). Third, the results of the event studies are sensitive to changes in research design. Variations in the length of the estimation window, models of expected returns and test periods are commonly found in event studies. A different choice for each of these aspects will result in vastly different results for abnormal returns and statistical tests.

Note

1. To test for industry effects, we considered that among the ten observations coming from the finance, insurance and real estate group, two belong to finance (banks) and eight refer to real estate. On this issue, we note that results (not tabulated) in terms of Z-stats are in substance unchanged if we exclude two observations belonging to the finance sector.

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