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Do modified audit opinions for Shanghai listed firms convey heterogeneous information?

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ABSTRACT

This study investigates market reactions to different types of modified audit opinions (MAOs) and unqualified audit opinion with explanatory notes, i.e. quasi-qualification – a unique feature of China's institutional environment. We find that quasi-qualifications contain more significant negative information than clean audit opinions, but less than that in other types of qualified audit opinions. Further, we provide evidence that audit opinions possess significant information heterogeneity in the Shanghai stock market.

1. Introduction

Chinese companies issuing A-shares are required to publish summarized financial statements that are based on Chinese GAAP, while companies issuing B-shares are required to prepare two sets of statements conforming to Chinese GAAP and IFRS.[2] Since 2004, Chinese GAAP statements must be audited by a CPA firm or a Big 4 firm designated or approved by the Ministry of Finance (MoF) and the China Securities Regulatory Commission (CSRC). Summaries of the financial statements must be published in at least one of the securities newspapers or a journal selected by the CSRC by April 30 of the following accounting year.[3] An institutional feature of financial reporting in China is the requirement that firms publish their financial statements and auditors' reports simultaneously.

There are four categories of audit qualification in China. In increasing severity, these are: qualified, qualified with explanatory notes, disclaimer and adverse. In addition, there is the quasi-qualification (an unqualified opinion with explanatory notes), which is a unique feature of the Chinese market. The official guidance from the Chinese Institute of Certificate Public Accountants (CICPA) indicates that this qualification should be issued for events and/or transactions that '*do not have direct influence on financial statements but are important enough to be explained*'.[4] An example of this type of quasi-qualification occurs where financial statements are inconsistent with GAAP but in a way that is acceptable to the auditor. One view is that this is a convenient alternative to a qualified opinion that minimizes the probability of losing clients while at the same time avoids a direct violation of auditing standards (Chen, Su, & Zhao, 2000). For example, a company which receives a

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[2] Since February 2001, the CSRC has allowed domestic investors to trade B-shares which were originally restricted to foreign investors only. A-shares were issued for domestic investors only before 2002. Since 2002, the CSRC allowed the licensed foreign investors, who are called as the Qualified Foreign Institutional Investors (QFII), to buy and sell A-shares in both Shanghai and Shenzhen markets.
[3] There are seven securities newspapers and one journal selected by the CSRC. They are: China Securities News, Shanghai Securities news, Securities Times, Financial Times, Economic Daily, China Reform, China Daily and securities Markets Weekly (Journal).
[4] CICPA Auditing Standard Committee (1996, p. 211).

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qualified opinion must publish the full text of the auditors' report in selected journals and provide an explanation to the CSRC and shareholders at the Annual General Meeting (AGM). None of these action are required for unqualified opinions with explanatory notes (UOEN).

According to an information content perspective, accounting uses the language and algebra of valuation to convey information (Christensen & Demski, 2003). The audit report, which is formed within the norms of a professional, standardized language and basic concepts and is transmitted to the capital market through the company's financial reporting supply chain, should have a wealth of information content. Therefore, it is reasonable to suggest that different types of (qualified) audit opinions should contain different types of (bad) news to the investors. For example, the bad news contained in a qualified opinion should be less severe than that in a disclaimer, whilst an UOEN should be less severe than qualified opinions. In another words, if the market is efficient, it should have different reactions to the announcements of different types of audit opinion.

There are a number of studies examining the market reaction to the publication of audit information for firms listed on the Chinese stock market (Chen & Wang, 2001; Chen et al., 2000; Li, 1999; Lin, Tang, & Xiao, 2003; Song & Yun, 2005). These studies contain consistent findings. Firstly, they report a significant negative contemporaneous relationship between market returns and modified audit opinions (MAOs) (Chen et al., 2000; Li, 1999; Song & Yun, 2005). Secondly, they support the value relevance of the audit report and that auditing as an institution played a significant role in the emerging Chinese economy (Chen et al., 2000; Song & Yun, 2005). They do not, however, address significantly different market reactions to disclosures of UOENs and types of qualified opinions, based on the theory of 'a credible signal' under the asymmetric information framework (Akerlof, 1970; Spence, 1973; Stiglitz & Weiss, 1983).

We report three significant findings. First, we confirm the value relevance of MAOs, which is consistent with the findings from other studies (Chen et al., 2000; Li, 1999; Song & Yun, 2005) for the Chinese stock market. However, on average, the issuance of MAOs on the Shanghai market leads to an approximate 12% decline in returns, vis-à-vis returns from firms with a clean audit opinion. This result is significantly higher than findings in other studies; for example, a 2% decline in Chen et al. (2000). The more negative reaction may reflect the issuance of more severe audit opinions from 1998 onwards as well as an improved ability by investors to distinguish qualified audit opinions from clean opinions after 1998.

Secondly, we find that UOENs contain significant negative information and thus affect investors' pricing decisions. This result confirms that UOENs should be seen as quasi-qualifications and is consistent with findings from other studies (Chen et al., 2000; Song & Yun, 2005). However, our study goes beyond prior research and finds that the quasi-qualifications contain less significant information content than other types of qualified opinions. This result is contrary to, for example, Chen et al.'s (2000) finding that 'no significant difference is found between market reaction to qualified opinions and market reaction to unqualified audit opinions with explanatory notes' (p. 429). This new and different finding may indicate a significant improvement in investors' understanding of the distinction between quasi-qualification and MAOs over the period of 1998–2005.

Finally, we find that there is a significant degree of information heterogeneity across audit opinions. The degree of market reaction is in general consistent with the order of severity of audit qualifications, so that disclaimer opinions trigger the most significantly negative impacts on stock prices and quasi-qualifications contain the least severe negative information to investors. This evidence is the first confirming the information heterogeneity across audit opinions for the Shanghai market.

The remainder of this paper is organized as follows. Section 2 is a synopsis of the auditing literature, focusing specifically on China's markets. The latter part of this section develops our primary testable hypotheses. Section 3 outlines the research design, sample selection process and data. Our empirical findings are reported in Section 4, while Section 5 summarizes and discusses these results within the context of the extant literature.

2. Literature review and hypothesis development

2.1. Literature

Healy and Palepu (2001) suggest a schematic role of disclosure and financial intermediaries in the workings of a capital market. Their model encapsulates the flow of capital from households to firms and the flow of information from business to savers and intermediaries. In a developed economy, firms communicate with investors by a variety of means including regulated financial statements and voluntary disclosure. At the same time information intermediaries attempt to gain as much information as possible from any source relevant to their portfolio of firms. Collectively, the flow of information helps to resolve the "lemons" problem and contributes to well-functioning capital markets (Akerlof, 1970). In developed markets, the flow of information has increased to the extent that the declining value-relevance debate of earnings and book values emerged (Collins, Mayhew, & Weiss 1997; Francis, Schipper, & Vincent, 2002). In contrast, over the period of this study, financial institutions, markets and associated professions in China were at the nascent stages of development. China's economic reforms provided a skeletal financial infrastructure relative to that discussed in Healy and Palepu (2001). From a purely theoretical perspective, it would be expected that in a less competitive information environment, investors would value regulated financial statements more highly than in a competitive information environment.

A salient feature of the early literature is the paucity of evidence linking audit qualification to contemporaneous stock prices. Alderman's (1977) seminal paper finds little evidence of the informational value of audit qualifications. Martinez, Martinez, and Benau (2004) also report no information value of audit qualifications for investors in the Spanish capital market.