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## The Effect of Audit Report Type and Audit Report Paragraphs on Financial Distress among Firms Listed on the Tehran Stock Exchange

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### Abstract

Considerable researches have been devoted to predicting financial distress by using financial ratios and there is a little knowledge about this issue and how report paragraphs and information may contribute to predict companies' insolvency. The major purpose of this study is to explore the effects of audit report types, pre-opinion paragraphs, special emphasis paragraphs, and other explanatory paragraphs on financial distress among firms listed on the Tehran Stock Exchange. The research period is from 2011 to 2018 and the sample consists of 107 firms which are selected using a purposeful sampling method. Results of multiple regression analysis shows there is not any significant association between audit report type, the number of pre-opinion paragraphs, special emphasis paragraphs and other explanatory paragraphs with financial distress.

**Keywords:** Audit Report Type, Audit Report Paragraphs, Explanatory Paragraphs, Financial Distress.

## Introduction

In the last decades, financial distress prediction models development has been attracted to many researchers (Altman, 2018). Although there are many prediction models which convey useful information to investors, there is motivation to concern other sources of information such as audit report paragraphs to examine this issue (Amani and Fadlalla, 2017). The value of audit report paragraphs and information has been the interest of researchers for about 30 years. For the most part after the year 2001, the auditing profession was under pressure. Moreover, investors and users anticipate the auditors to supply caution signs in audit report (Geiger and Rama, 2005), in order to assess the risks and make rational decisions concerning the maintenance or sale of their shares. In fact, the auditing profession plays a vital role in ensuring financial information quality. Auditors verify the financial statements to mitigate errors and misstatements and also discretionary accruals (Bratten et al. 2013).

Some researchers have examined the association between qualified audit report and companies' financial distress. Hopwood et al. (1989) found that financially distressed companies have more possibility for receiving a qualified audit report in one year before default. Geiger and Rama (2005) investigated the relationship between financial distress and audit opinions and they found that this relationship can vary according to the regulative structure of audit report. Altman et al. (2010) found audit reports have high predictive ability and companies by some qualifications or going concern are more likely to be financially distressed. Cenciarelli et al. (2018) concluded companies audited by big audit firms and also industry-expert auditors have less possibility to be financially distressed. In the research by Munoz-Izquierdo et al. (2019), the audit paragraphs have combined by financial ratios for explaining financial distress. They found that financial distress can be explained by some information in the audit report. In fact, users and investors need to have enough auditing and accounting knowledge to know how to understand and interpret audit report paragraphs and content.

This article is follow-up research to Munoz-Izquierdo et al (2019) and uses different paragraphs of an audit report for financial distress estimation. Therefore, the major objective of the study is to examine the effect of audit report type, pre-opinion paragraphs, special emphasis paragraphs, and other explanatory paragraphs on financial distress. In fact, this study attempts to ascertain whether the market reaction to publishing adjusted audit report or explanatory paragraphs is rational. In the next parts, the prior studies, literature

and conceptual framework for developing research hypotheses are explained. Afterward, the research method including population, sample selection process and the type of research are explained. Research results are explained in the next part. Finally, the conclusions and discussion of study, limitations and suggestions for future study are explained in the final part.

### **Literature Review**

Based on audit standard No.700 auditors are liable to assess the coordination of accounting procedures by accounting standards, adequacy of accounting procedures disclosure, the rationality of financial estimations by management, the adequacy of information exposed in financial statements and reliability and comparability of information provided in financial statements to help users. The auditor provides an unqualified opinion when financial statements are prepared according to accounting standards from all important aspects. Based on audit standard No. 705, the aim of auditor by providing the adjusted report is to express that, financial statements could not be free of material errors and misstatements and the auditor is unable to gain sufficient and suitable pieces of evidence to conclude about favorability of financial statements. In fact, the adjusted report represents a hesitation about financial statements' information content and allows the users of financial statements to be aware of the existence of risk in financial statements (Chen et al., 2014).

Moreover, based on audit standard No. 706, auditors put special emphasize paragraphs and other explanatory paragraphs in an audit report to attract the attention of investors and users. If the auditor is uncertain about the future consequences of legal claims or explicit actions of regulatory authorities that have the main impact on the financial position of the company or other uncertainty about persistence of the company's activity, the special emphasize paragraph need to be used. In addition, the other explanatory paragraphs are used by the auditor when financial statements are arranged by specific purposes. Based on audit standard No. 706, the multiplicity of special emphasize paragraphs reduce the information effectiveness of these issues, and thus, the auditor should avoid presenting this paragraph in his report as far as possible. Feng et al. (2016) concluded that an auditor becomes more conservative and give a more adjusted report during the financial crisis to aware users about an unusual risk and the low quality of financial statements' information.

Prior researches found an association between audit quality, qualified audit reports and financial distress (Arnedo-Ajona et al. 2012). Cenciarelli et al. (2018) investigated the association between auditors' individual

characteristics and the likelihood of companies' bankruptcy. They found that auditors' characteristics can affect the likelihood of bankruptcy. Their results show that bankruptcy forecast models may become more valuable if these models are complemented by audit information. Munoz-Izquierdo et al. (2019) investigated the efficacy of external auditing report for bankruptcy prediction. They found that by using artificial intelligence techniques, the bankruptcy can predict by type of audit opinion, matter sections and the numbers of comment disclosed within the audit report. Reviewing the literature shows that the impact of the type of audit report and different paragraphs after and before audit opinion paragraphs on financial distress is rarely investigated and some studies only investigated the effect of the type of audit report on financial distress. However, there seems to be no compromise on the information content of reports paragraphs about distress situations. Therefore, due to the importance of different explanatory paragraphs in an audit report that auditors attempt to inform users about the problems in financial statements by using them, in this research this issue is investigated. Therefore, in order to investigate the effect of audit report type and different audit report paragraphs on the financial distress of firms listed on the Tehran Stock Exchange, the research hypotheses are as follows:

H<sub>1</sub>: There is a significant relationship between audit report type and financial distress of firms listed on the Tehran Stock Exchange.

H<sub>2</sub>: There is a significant relationship between the number of pre-opinion paragraphs and financial distress of firms listed on the Tehran Stock Exchange.

H<sub>3</sub>: There is a significant relationship between special emphasis paragraphs and financial distress of firms listed on the Tehran Stock Exchange.

H<sub>4</sub>: There is a significant relationship between other explanatory paragraphs and financial distress of firms listed on the Tehran Stock Exchange.

## **Research Method**

This study is applied research in terms of objective and a post-event in terms of data type because past data are used for testing hypotheses. Multiple regression model is used to examine hypotheses by using Eviews software. The population in this study is all firms listed on Tehran stock exchange from 2011 to 2018 and the sample includes 107 firms from various industries. To choose samples, the purposeful sampling method is used. It means that there are some limitations and firms considering the following features are selected:

- Selected firms are not financial institutions, banks and leasing.

- They listed on Tehran Stock Exchange from 2010 and remained until the end of 2018.

- During the research period, their stock trading has not stopped more than 6 months.

- In terms of comparability, their financial year ends to march.

Based on these limitations, 107 firms are selected as research sample and the research data are collected using Rahavard Novin database and www. Codal.ir website. The research model is as follow:

$$P_{SCORE} = \alpha_0 + \alpha_1 AUDOPN + \alpha_2 AUDATT + \alpha_3 AUDEMP + \alpha_4 AUDOTH + \alpha_5 BIGAUD + \alpha_6 LOSS + \alpha_7 TURN + \alpha_8 SIZE + \alpha_9 LEV + \varepsilon \quad (1)$$

Where:

$P_{SCORE}$  is the dependent variable and it is measured by the following model:

$$P\text{-score} = 3.20784 k_1 + 1.80384 k_2 + 1.61363 k_3 + 0.50094 k_4 + 0.16903 k_5 - 0.39709 k_6 - 0.12505 k_7 + 0.33849 k_8 + 1.42363 k_9 \quad (2)$$

Where:

$K_1$ : Earnings before interest and tax to total assets ratio

$K_2$ : Retained earnings to total assets ratio

$K_3$ : Working capital to total assets ratio

$K_4$ : Market value of equity to total liabilities ratio

$K_5$ : Earnings before interest and tax to sales ratio

$K_6$ : Total current assets to total currents liabilities ratio

$K_7$ : Net profit to sales ratio

$K_8$ : Total liabilities to total assets ratio

$K_9$ : Firm Size

If  $P \geq 15/8907$ , the firm is not financially distressed and if  $P < 15/8907$ , then the firm is financially distressed.

**Audit report type ( $AUDOPN$ )** is an independent variable and it is a dummy variable taking a value of 1 if the audit report is qualified to report and 0 if the audit report is the unqualified report.

**Pre-opinion paragraph ( $AUDATT$ )** is the independent variable and it is

calculated by the number of paragraphs before the opinion paragraph.

**Special emphasize paragraph (*AUDEMP*)** is the independent variable and it is calculated by the number of special emphasize paragraphs after opinion paragraph.

**Another explanatory paragraph (*AUDOTH*)** is the independent variable and it is calculated by the number of other explanatory paragraphs.

Control variables are:

**Audit firm size (*BIGAUDIT*)**: it is equal to 1 if the audit firm is an audit organization and 0 otherwise.

**Loss (*LOSS*)**: it is equal to 1 if the firm has loss and 0 otherwise.

**Auditor switch (*TURN*)**: it is a dummy variable taking a value of 1 if the audit firm is changed and 0 otherwise.

**Firm size (*SIZE*)**: log of total assets

**Leverage (*LEV*)**: total liabilities divided by total assets

## Research findings

Table 1 represents the descriptive statistics of variables.

Table 1. Descriptive Statistics of Research Variables

Variables	Mean	Max	Min	SD
AUDOPN	0/546	1	0	0/498
AUDATT	1/481	16	0	1/942
AUDEMP	1/274	9	0	1/416
AUDOTH	0/557	9	0	1/019
LEV	0/638	3/06	0/013	0/30
SIZE	13/996	19/15	10/03	1/58

Source: Compiled by author

As table 1 shows 55 per cent of firms received adjusted audit opinion and the mean for pre-opinion paragraphs is 1. The maximum of special emphasize paragraph is 9 and the mean is 1.

To analyze research data, some pre assumptions of multivariable regression are investigated through the normality analysis, the multicollinearity analysis and variance homogeneity analysis. First, for the purpose of analyzing the normality of the data, Jarque-Bera is used. Based on the results of this analysis, the Jarque statistic with a probability of 0.00 shows that research data

are normal. Also, Brosh-GadFerry analysis is used to detect heterogeneity of variance. Results of this test indicate that the variances are heterogeneous. The Brosh-GadFerry analysis is used also for testing the multicollinearity between research variables. If the probability value is more than five per cent, then the assumption zero of the test for multicollinearity is rejected and, conversely, if the probability of the statistics is less than five per cent, multicollinearity is not rejected. Due to the result which is greater than five per cent and is 0.146, there is no multicollinearity.

To determine the type of data, f-limer and hasman tests are used. The results show that the data are panel and the fixed effect should be used. Table 2 represents the result of f-limer and hasman test.

Table 2. The results of f-limer and hasman test

<b>Model</b>	<b>Statistic</b>	<b>prob</b>	<b>result</b>
F-limer	2/273	0/00	Panel
Hasman	176/13	0/00	Fixed Effect

Source: Compiled by author

The results for testing research hypotheses (logistic regression analyses) are representing in table 3.

Table 3. The results of data analysis for testing research hypotheses

<b>variables</b>	<b>Coefficient</b>	<b>Z-statistic</b>	<b>P-value</b>
c	25/26	6/112	0/000
AUDOPN	-1/154	-1/500	0/133
AUDATT	-0/022	0/092	0/926
AUDEMP	0/323	1/710	0/087
AUDOTH	0/098	0/459	0/645
TURN	0/145	0/285	0/775
LEV	-13/657	5/801	0/000
LOSS	0/030	0/020	0/983
SIZE	-1/362	-5/335	0/000
BIGAUD	0/512	0/636	0/524
McFadden R-squared: 0/8829			
LR statistic: 962/3696			
Prob: 0.00			

Source: Compiled by author

Table 3 indicates that LR Prob is 0 and is less than 0/05 error levels and the research model as a whole is meaningful and reliable. Regarding the first

hypothesis, based on the results in table 3, the p-value is more than 0.05 (p-value, 0.133) for the audit report type. Therefore, there is no significant association between report type and financial distress. Also, regarding the second hypothesis, the p-value is more than 0.05 (p-value, 0.926) for the number of pre opinion paragraphs. Thus, there is not any significant association between the numbers of pre opinion paragraphs and financial distress. Moreover, regarding the third hypothesis, the p-value is more than 0.05 (p-value, 0.087) for special emphasize paragraphs. Thus, there is no significant relationship between special emphasize paragraphs and financial distress. Finally, regarding the fourth hypothesis, the p-value is more than 0.05 (p-value, 0.645) for other explanatory paragraphs. Thus, there is no significant relationship between other explanatory paragraphs and financial distress. The  $R^2$  is 0.88 which show that 88 per cent of changes in the dependent variable is explained by changes in independent variables.

## Conclusion and Discussion

In this research, the effects of audit report type, pre-opinion paragraphs, special emphasize paragraphs and other explanatory paragraphs on financial distress among firms listed on the Tehran Stock Exchange are investigated. According to signalling theory, receiving positive news and information through audit report about management performance may lead to abnormal stock return and also, receiving negative news through audit report about management performance may lead to negative reaction and stock return may decrease. In Iran stock market, the audit report is an important informational resource about firms listed on the Tehran Stock Exchange.

This information is published at least once a year and many users make decisions based on this information. Thus, the type of published audit report about one company can transfer good or bad news about that company to users of financial reports and also may inform users about a financial situation like financial distress. If the audit report is an unqualified report without any explanatory paragraph, the quality of financial reporting is good and users can make decisions with assurance. Otherwise, if the audit report is qualified or adjusted audit report with many explanatory paragraphs, the quality of financial information is under question. In other words, adjusted audit reports can convey bad news about the financial situation of the company.

The results indicate that there any significant association between audit report type, pre-opinion paragraphs, special emphasize paragraphs and other explanatory paragraphs and financial distress, which are not consistent with the

research of Geiger and Rama (2006). Also, according to Kanyat Aarat (2018), after the 2008 financial crisis, small auditors compared to the four largest auditing firms have provided more conservative reports on the continuation of corporate activity, while smaller auditing firms, prior to the 2008 financial crisis, made more errors in assessing continuity of activity. In Iran, there is still little sensitivity to the financial distress of firms. As many large Iranian firms have the requirements set of Article 141 of business law, but no action has been taken to declare them bankrupt, so auditors' sensitivity to the lack of continuity of their operations may be lessened and they are confident about bankruptcy which does not happen and therefore they do not adjust the audit reports in this regard. The only research related to this issue in Iran was done by Bani Mahd and Akbari in 2010 and the results indicated that there is any significant association between the variables of Altman bankruptcy index and auditor change.

Considering the results, it is suggested to consider audit report type and information in paragraphs for audit firms rating by audit organization. Also, there is a suggestion for stockholders to obtain knowledge by audit report types and different paragraphs and explanatory information which are published in the audit report to know about firms' financial situation and future risks about their investments.

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