THE EFFECT OF MODIFIED AUDIT OPINIONS ON SHARE PRICES FOR COMPANIES QUOTED AT THE NAIROBI STOCK EXCHANGE

BY

TANUI CHRISTOPHER KIPKOSGEI

D61/71929/2008

A Management Research Project submitted in Partial Fulfillment of the Requirements for the Award of the Degree of Master of Business Administration of the University of Nairobi

NOVEMBER 2010

DECLARATION

This research project is my original work and to the best of my knowledge has not been presented for the award of a degree in any university.

Signed:..... Date:.....

TANUI CHRISTOPHER KIPKOSGEI

This research work has been submitted for examination with my approval as the University Supervisor.

Signed:..... Date:.....

HERICK OCHIENG ONDIGO

LECTURER, SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI

DEDICATION

To my wife Julie Tanui for her overwhelming support and encouragement throughout the research study, my daughter Cheryl Chemutai for enduring my absence at the time I was undertaking the course work and the research project.

ii

ACKNOWLEDGEMENTS

First of all, I would like to thank Our Almighty God for the good health and care that He has given me in my pursuit of MBA at the University of Nairobi.

I am heartily thankful to my supervisor, Herick Ondigo, whose encouragement, guidance and support from the initial to the final level enabled me to develop an understanding of the subject.

I want to give my thanks to my family for their moral support during the period of study and my friends who assisted me in one way or another in realizing this dream. To my wife Julie and daughter Cheryl for their constant reminder of the need to realize this achievement.

I am grateful to the Nairobi Stock Exchange for the provision of their valuable data that was necessary for this research project to be successful.

I am also grateful to the University of Nairobi community for enabling me realize the dream of pursuing a masters degree without compromising their academic standards. I am thankful to my supervisor and Chairman of Department for guiding me through the rigorous corrections of this document.

I have to write down my gratitude here to my mother who let me learn everything important that cannot be learned in schools, silently. I am happy to write this in a place where it can never be erased.

Lastly, I offer my regards and blessings to all of those who supported me in any respect during the completion of the project.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF ABBREVIATIONS

ANOVA	Analysis of Variance
ASE	American Stock Exchange
CAPM	Capital Asset pricing Model
CMA	Capital Markets Authority
CPA	Certified Public Accountant
EMH	Efficient Market Hypothesis
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
GCO	Going Concern Opinion
IAS	International Accounting Standards
ICPAK	Institute of Certified Public Accountants of Kenya
IMF	International Monetary Fund
ISA	International Standards on Auditing
MAO	Modified Audit Opinion
NSE	Nairobi Stock Exchange
NYSE	New York Stock Exchange
SAS	Statements on Auditing Standards
SPSS	Statistical Package for Social science
SSE	Shanghai Stock Exchange
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
US	United States

ABSTRACT

The study was conducted with the objective of investigating the effects of Modified Audit Opinions on share prices.

A survey was carried out on 49 companies that were continuously listed at the Nairobi Stock Exchange during the period of study. The data collected was on audit opinions, daily share prices, closing share prices, average weekly share prices, shares outstanding and book value of equity. The data collected was analyzed using descriptive statistics, correlation analysis, ANOVA and regression analysis. The mean and standard deviation were calculated and compared for closing share prices, book value of equity, shares outstanding and weekly average share prices. Correlation analysis was done to determine the strength of the linear relationships between the audit opinions and the closing share prices, shares outstanding, book value of equity and average weekly share prices.

The findings of the study revealed that there is a very weak negative relationship between audit opinions and share prices and that the audit opinion only accounted for a very small percentage of the change in share prices. The ANOVA results indicated that these results were statistically insignificant and varied with the different dependent variables.

Based on these research findings, it was concluded that there is a weak negative relationship between audit opinions and share prices. The study recommends the strengthening of the regulatory role of ICPAK to ensure that audit reports that are released to the public are devoid of collusion between company management and auditors. The study also recommends that CMA should make it mandatory for all quoted companies to file interim audit reports during the financial year so that this information is reflected in share prices in a timely manner.

CHAPTER ONE

1.0 INTRODUCTION

1.1 Background to the study

Independent auditing is a widely-used monitoring device to reduce agency costs and increase firm value when managers do not own all of the shares. Auditors' ability to discover and report breaches of contract or violations of Generally Accepted Accounting Principles (GAAP) by management are key indicators of their competence and independence (Chen et al., 2000). It is argued that both external auditors (which serves as an external monitoring function) and managerial ownership (which serves as an internal monitoring function) affect firm value, while internal monitoring by managers and external monitoring by auditors were viewed as substitutes or complements (Saibal, 2007).

An accurate valuation of firms largely depends on the reliability of the firm's historic financial information and this information is usually audited by an independent external auditor. Managers of small private firms often prepare their financial statements to minimize profits and, therefore, taxes. However, managers of large private firms tend to want higher profits to increase their stock price. Therefore, a firm's historic financial information may not be accurate and can lead to over- and undervaluation. In an acquisition, a buyer often performs due diligence to verify the seller's information (Swanson et al., 2008).

Financial statements prepared in accordance with generally accepted accounting principles (GAAP) often show the values of assets at their historic costs rather than at their current market values. For instance, a firm's balance sheet will usually show the value of land it owns at what the firm paid for it rather than at its current market value. But under GAAP requirements, a firm must show the values of some types of assets—securities held for sale, for instance—at their market values rather than at cost. When a firm is required to show some of its assets at market value, some call this process "mark-to-market." But reporting asset values on financial statements at market values gives managers ample opportunity to slant asset values upward—to artificially increase profits and stock prices. Managers may be motivated to alter earnings

upward so they can earn bonuses. Despite the risk of manager bias, investors and creditors prefer to know the market values of a firm's assets—rather than their costs—because the current values give them better information to make decisions (Swanson et al., 2008).

The Companies Act, Chapter 486 of the Laws of Kenya, 1959 require that all limited liability companies should prepare annual financial statements which reflect a true and fair view of the financial position of the company and have their annual reports audited by independent Certified Public Accountants. The primary role of external auditors is to express an opinion on whether an entity's financial statements are free of material misstatements and to underwrite the credibility of the financial reports so that users can be assured that what they are reading is what they think they are reading. The assurance that accounting standards have been adhered to, and that statutory and professional rules have been complied with, give reader's confidence that the reports are a 'true and fair' representation of the affairs of the business (Nicholson, 2007).

The primary role of the independent auditor today is the verification of financial statements. The audit is an important part of the capital market framework as it not only reduces the cost of information exchange between managers and shareholders but also provides a signalling mechanism to the markets that the information which management is providing is reliable. The auditor provides independent verification on the financial statements of a company and as a result, the audit loses its value when such independence which gives credibility to the financial statements, is undermined. According to accounting literature, the traditional role of the audit was mainly the detection and prevention of fraud. The move to verification of financial statements arose from the growing investment in the railway, insurance and banking industry. Suggestions have been made that this situation occurred because in these particular industries, the shareholding was more dispersed and more priority given to financial performance rather than on management's honesty. Bank failures such as those of BCCI and Johnson Matthey resulted to a re-think of the objective of an audit to include the detection and prevention of fraud (Ojo, 2009).

The role of the external auditor in the supervisory process requires standards such as independence, objectivity and integrity to be achieved. Even though the regulator and external auditor perform similar functions, namely the verification of financial statements, they serve particular interests. The regulator works towards safeguarding financial stability and investor interests. On the other hand, the external auditor serves the private interests of the shareholders of a company. The financial audit remains an important aspect of corporate governance that makes management accountable to shareholders for its stewardship of a company. The external auditor may however, have a commercial interest too. The debate surrounding the role of external auditors focuses in particular on auditor independence (Ojo, 2009).

It is therefore of great interest to examine whether an auditor's report is value relevant in a market where market mechanisms to a large extent prevails over government controls. Evidence of whether investors distinguish between different contents and forms of MAOs will enhance our understanding of the auditor's role in the market place (Chen et al., 2000). The Kenyan stock market is characterized by the less rigorous enforcement of financial reporting requirements, as compared to more developed economies like the US. The credibility of financial statements published by listed Kenyan companies is sometimes perceived to be questionable, and auditors are considered to lack independence and professionalism by both investors and regulators. Furthermore, the market is dominated by individual investors who have limited resources for, and little experience of, using financial information. Given that these conditions tend to reduce the valuation effect of auditors' opinions, finding a significantly negative market reaction to MAOs would provide compelling evidence for the importance of auditing as an institution in an emerging market (Rahman, 2001).

This study investigates the effects of modified audit opinions (MAOs) on share prices for firms quoted at the Nairobi Stock Exchange. Previous studies in this area found a significantly negative association between MAOs and cumulative abnormal returns after controlling for effects of other concurrent announcements. These studies did not observe significant differences between market reaction to non-GAAP and GAAP violation related MAOs**.** They also found no significant difference between market reaction to qualified opinions and to unqualified opinions with additional explanatory note(s) (Chen et al., 2000).

1.2 Statement of the Problem

Considerable empirical evidence supports a contemporaneous or delayed correlation between accounting earnings and stock price changes (Ball & Brown, 1968; Ohlson, 1979; Holthausen & Verrecchia, 1988; Lev, 1989; Ryan, 1995; among others). However, earnings explain only a small portion of the variation in returns at the earnings announcement date. This has led to a search for models to incorporate "non-earnings" information (Beaver, 1981; Lev & Ohlson, 1982), an important source of which is the auditor's opinion. A qualified audit opinion has the potential to affect expectation by signaling to the market that earnings generated by the firm are noisier or less persistent (or both) than previously assumed by investors (Choi & Jeter, 1992).

Empirical studies on the association between MAOs and stock returns report mixed results. Chow & Rice (1982) and Dodd et al. (1984) find no significant market reaction. Dopuch et al. (1986), Choi & Jeter (1992) and Loudder et al. (1992) report negative price reactions to MAOs. Abdel-Khalik & Wu (1996) and Shen (1996) report that there is no evidence that accounting information does affect Chinese investor's pricing decisions. Contrary to Taffler, Lu and Kausar's, 2004 U.K. results providing evidence of significant negative abnormal returns subsequent to going concern opinions, Maria Ogneva and K.R. Subramanian, 2007 find no such evidence in the U.S. and Australia. Al-Thuneibat, Ali A.; Khamees, Basheer Ahmad; Al-Fayoumi and Nedal A., 2008 conclude that there is no clear or significant effect of a qualified audit opinion on share prices and returns. Ferdinand A. Gul, 2009 shows that ``except for audit qualification affected share price estimates.

An audit report is one of the mechanisms whereby potential conflict of interest between shareholders and managers can be controlled (Chan & Walter, 1996). Modified audit opinions, if interpreted by the market as bad news about the company, are likely to induce negative stock price changes, because the reported earnings are believed to contain more transitional components than those of other companies. Although Kenyan investors may perceive auditors to be more objective and neutral than managers, they have been found to collude with managers in manipulating financial statements. In addition, Kenyan shareholders have a relatively short trading history and no significant exposure to MAOs. Therefore, it remains an empirical question whether MAOs, as an important source of non-earnings information, can be captured by investors in a timely fashion in an emerging market and whether they have significant negative effects on firm value. However, little empirical research has been conducted in this regard partly

due to a lack of understanding of the institutional setting of the Kenyan capital market and partly due to lack of understanding of the information content of audit reports and annual accounts.

This study therefore seeks to more closely examine whether modified audit opinions affect investor's pricing decisions in the Kenyan stock market. The study attempts to answer the question, do modified audit opinions affect share prices?

1.3 Objective of the study

To investigate the effects of modified audit opinions on share prices for firms quoted at the Nairobi Stock Exchange.

1.4 Importance of the study

Investors: Both individual and institutional investors will find information in this study that is useful in evaluating and measuring their investments' performance at the stock market in relation to the performance of the Nairobi Stock Exchange. The study will also enable investors to determine whether the contents of the audit reports are relevant to investment decision making in the stock market.

Auditors: The study will provide a framework for evaluating the relevance of audit reports in the Kenya stock market. It will therefore enable auditors understand the role of audit opinions in the stock market and assist them in developing guidelines for presenting the annual audit reports and audited financial statements in a way that can easily be understood by investors and other stock market players.

Regulators: The Capital Markets Authority and the Institute of Certified Public Accountants will be able to understand how audit reports are value relevant in an emerging stock market and thereby develop appropriate policies and guidelines aimed at improving compliance with applicable accounting and auditing standards.

Management of Nairobi Stock exchange: The management will understand how modified audit opinions influence the performance of the Nairobi Stock Exchange in terms of the effects of audit reports on pricing of shares.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction

This chapter reviews the literature on types of Modified Audit Opinions, Efficient Market Hypothesis, Behavioral Finance theory, Adaptive Market Hypothesis, Institutional Framework of Auditing in Kenya and the empirical literature on market response to modified audit opinions. It also focuses on empirical literature on effects of modified audit opinions on share prices which report conflicting results. The last part of this chapter gives a summary of the literature.

2.2 Types of Modified Audit Opinions

The most frequent type of audit report is referred to as the Unqualified Opinion, and is regarded by many as the equivalent of a “clean bill of health” to a patient, which has led many to call it the Clean Opinion, but in reality it is not a clean bill of health. This type of report is issued by an auditor when the financial statements presented are free of material misstatements and are represented fairly in accordance with the Generally Accepted Accounting Principles (GAAP), which in other words means that the company’s financial condition, position, and operations are fairly presented in the financial statements. It is the best type of report an auditee may receive from an external auditor (Messier et al., 2005).

Modified Audit Opinions (MAOs) include qualified audit opinions, disclaimer opinions, adverse opinions and unqualified audit opinions with additional explanatory notes. Certain circumstances require auditors to add explanatory notes to the standard report. Adding the additional notes is not regarded as a qualification because it does not lessen the auditors' reporting responsibility for the financial statements. Auditors add explanatory notes to an unqualified opinion to indicate: a division of responsibility with another CPA firm; to indicate an inconsistency in the application of accounting principles; to emphasize a matter; to justify a departure from officially recognized accounting principles and to refer to an uncertainty that could have a material impact on the financial statements. Usually, this additional information is included after the opinion paragraph (Messier et al., 2005).

A Qualified Opinion report is issued when the auditor encountered one of two types of situations which do not comply with generally accepted accounting principles, however the rest of the financial statements are fairly presented. This type of opinion is very similar to an unqualified or "clean opinion", but the report states that the financial statements are fairly presented with a certain exception which is otherwise misstated. The two types of situations which would cause an auditor to issue this opinion over the Unqualified opinion are: (i) A single deviation from GAAP – this type of qualification occurs when one or more areas of the financial statements do not conform with GAAP (e.g. are misstated), but do not affect the rest of the financial statements from being fairly presented when taken as a whole. (ii)Limitation of scope - this type of qualification occurs when the auditor could not audit one or more areas of the financial statements, and although they could not be verified, the rest of the financial statements were audited and they conform to GAAP (Venuti, 2004).

An Adverse Opinion is issued when the auditor determines that the financial statements of an auditee are materially misstated and, when considered as a whole, do not conform with GAAP. It is considered the opposite of an unqualified or clean opinion, essentially stating that the information contained is materially incorrect, unreliable, and inaccurate in order to assess the auditee's financial position and results of operations. Investors, lending institutions, and governments very rarely accept an auditee's financial statements if the auditor issued an adverse opinion, and usually request the auditee to correct the financial statements and obtain another audit report. Generally, an adverse opinion is only given if the financial statements pervasively differ from GAAP (Venuti, 2007).

A Disclaimer of Opinion, commonly referred to simply as a Disclaimer, is issued when the auditor could not form, and consequently refuses to present, an opinion on the financial statements. This type of report is issued when the auditor tried to audit an entity but could not complete the work due to various reasons and does not issue an opinion (Davis, 2007)

Statements on Auditing Standards (SAS) provide certain situations where a disclaimer of opinion may be appropriate: a lack of independence, or material conflict(s) of interest, exist between the auditor and the auditee (SAS No. 26); there are significant scope limitations, whether intentional or not, which hinder the auditor's work in obtaining evidence and performing procedures (SAS

No. 58); there is a substantial doubt about the auditee's ability to continue as a going concern or, in other words, continue operating (SAS No. 59); and there are significant uncertainties within the auditee (SAS No. 79).

Although this type of opinion is rarely used, the most common examples where disclaimers are issued include audits where the auditee willfully hides or refuses to provide evidence and information to the auditor in significant areas of the financial statements, where the auditee is facing significant legal and litigation issues in which the outcome is uncertain (usually government investigations), and where the auditee has going concern issues (the auditee may not continue operating in the near future) (SAS No. 59)

2.3 Theoretical Framework

2.3.1 Efficient Market Hypothesis

In finance, the efficient-market hypothesis (EMH) asserts that financial markets are "informationally efficient". The weak version of EMH supposes that prices on traded assets (*e.g.*, stocks, bonds, or property) already reflect all past publicly available information. The semi-strong version supposes that prices reflect all publicly available information and instantly change to reflect new information. The strong version supposes that market reflects even hidden/inside information. Therefore, according to theory, it is improbable to consistently outperform the market by using any information that the market already has, except through inside trading. Information or news in the EMH is defined as anything that may affect prices that is unknowable in the present and thus appears randomly in the future (Fama, 1970).

There is some disputed evidence to suggest that the weak and semi-strong versions are valid while there is powerful evidence against the strong version The hypothesis has been attacked by critics who blame the belief in rational markets for much of the financial crisis of 2007–2010, with noted financial journalist Roger Lowenstein declaring "The upside of the current Great Recession is that it could drive a stake through the heart of the academic nostrum known as the efficient-market hypothesis'' (Malkiel, 1987).

Beyond the normal utility maximizing agents, the efficient-market hypothesis requires that agents have rational expectations; that on average the population is correct (even if no one person is) and whenever new relevant information appears, the agents update their expectations appropriately. Note that it is not required that the agents be rational. EMH allows that when faced with new information, some investors may overreact and some may underreact. All that is required by the EMH is that investors' reactions be random and follow a normal distribution pattern so that the net effect on market prices cannot be reliably exploited to make an abnormal profit, especially when considering transaction costs (including commissions and spreads). Thus, any one person can be wrong about the market — indeed, everyone can be — but the market as a whole is always right. There are three common forms in which the efficient-market hypothesis is commonly stated — weak-form efficiency, semi-strong-form efficiency and strong-form efficiency, each of which has different implications for how markets work (Malkiel, 1996).

In weak-form efficiency, future prices cannot be predicted by analyzing price from the past. Excess returns cannot be earned in the long run by using investment strategies based on historical share prices or other historical data. Technical analysis techniques will not be able to consistently produce excess returns, though some forms of fundamental analysis may still provide excess returns. Share prices exhibit no serial dependencies, meaning that there are no "patterns" to asset prices. This implies that future price movements are determined entirely by information not contained in the price series. Hence, prices must follow a random walk. This 'soft' EMH does not require that prices remain at or near equilibrium, but only that market participants not be able to systematically profit from market 'inefficiencies' (Malkiel, 1996).

However, while EMH predicts that all price movement (in the absence of change in fundamental information) is random (i.e., non-trending), many studies have shown a marked tendency for the stock markets to trend over time periods of weeks or longer and that, moreover, there is a positive correlation between degree of trending and length of time period studied (but note that over long time periods, the trending is sinusoidal in appearance). Various explanations for such large and apparently non-random price movements have been promulgated. But the best explanation seems to be that the distribution of stock market prices is non-Gaussian (in which case EMH, in any of its current forms, would not be strictly applicable) (Lo et al., 2001).

In semi-strong-form efficiency, it is implied that share prices adjust to publicly available new information very rapidly and in an unbiased fashion, such that no excess returns can be earned by trading on that information. Semi-strong-form efficiency implies that neither fundamental analysis nor technical analysis techniques will be able to reliably produce excess returns. To test for semi-strong-form efficiency, the adjustments to previously unknown news must be of a reasonable size and must be instantaneous. To test for this, consistent upward or downward adjustments after the initial change must be looked for. If there are any such adjustments it would suggest that investors had interpreted the information in a biased fashion and hence in an inefficient manner (Fama, 1970).

In strong-form efficiency, share prices reflect all information, public and private, and no one can earn excess returns. If there are legal barriers to private information becoming public, as with insider trading laws, strong-form efficiency is impossible, except in the case where the laws are universally ignored. To test for strong-form efficiency, a market needs to exist where investors cannot consistently earn excess returns over a long period of time. Even if some money managers are consistently observed to beat the market, no refutation even of strong-form efficiency follows: with hundreds of thousands of fund managers worldwide, even a normal distribution of returns (as efficiency predicts) should be expected to produce a few dozen "star" performers (Fama, 1970).

Investors and researchers have disputed the efficient-market hypothesis both empirically and theoretically. Behavioral economists attribute the imperfections in financial markets to a combination of cognitive biases such as overconfidence, overreaction, representative bias, information bias, and various other predictable human errors in reasoning and information processing. These have been researched by psychologists such as Daniel Kahneman, Amos Tversky, Richard Thaler, and Paul Slovic. These errors in reasoning lead most investors to avoid value stocks and buy growth stocks at expensive prices, which allow those who reason correctly to profit from bargains in neglected value stocks and the overreacted selling of growth stocks (Shefrin, 2000).

Empirical evidence has been mixed, but has generally not supported strong forms of the efficient-market hypothesis. Dreman (1995) shows that low P/E stocks have greater returns. In

an earlier paper he also refuted the assertion by Ray Ball that these higher returns could be attributed to higher beta, whose research had been accepted by efficient market theorists as explaining the anomaly in neat accordance with modern portfolio theory.

2.3.2 Behavioral Finance Theory

Behavioral finance argues that some financial phenomena can plausibly be understood using models in which some agents are not fully rational. The field has two building blocks: *limits to arbitrage*, which argues that it can be difficult for rational traders to undo the dislocations caused by less rational traders; and *psychology*, which catalogues the kinds of deviations from full rationality we might expect to see for example prospect theory, regret and cognitive dissonance, anchoring, mental compartments, overconfidence, over- and under reaction, representativeness heuristic, the disjunction effect, gambling behavior and speculation, perceived irrelevance of history, magical thinking, quasimagical thinking, attention anomalies, the availability heuristic, culture and social contagion, and global culture. (Barberis et al., 2001).

Much of economic and financial theories presume that individuals act rationally and consider all available information in the investment decision-making process. However, studies done by Statman (1999), Tversky and Kahneman (1974) and Thaler (1994) suggest that this is not always the case and state that there is evidence to show repeated patterns of irrationality, inconsistency and incompetence in the way human beings arrive at decisions and choices when faced with uncertainty. Behavioural finance, a study of the markets that draws on psychology, is throwing more light on why people buy or sell stocks – and even why they do not buy stocks at all. There is also emerging evidence that institutional investors behave differently from individual investors, in part because they are agents acting on behalf of the ultimate investors.

The Efficient Market Hypothesis (EMH), based on information and rationality, dominated economic theory up to the 1980s. However, the EMH increasingly failed to explain market behaviour, perhaps most dramatically, being unable to explain why US share prices fell by over 30% during the 2-month period that preceded the crash of October 1987. Markets are neither perfectly efficient nor completely inefficient and evidence was mounting that even the Capital Asset Pricing Model (CAPM) is not a good description of reality. Behavioural finance attempts

to better understand and explain how emotions and cognitive errors influence investors (Statman, 1999).

Many researchers (e.g. Shiller, 1998) believe that the study of psychology and other social sciences can shed considerable light on the behaviour of financial markets as well as explain many stock market anomalies, market bubbles and crashes. Market efficiency survives the challenge from the literature on long-term return anomalies. Most important, consistent with the market efficiency prediction that apparent anomalies can be due to methodology, most long-term return anomalies tend to disappear with reasonable changes in technology. Most behavioural finance studies have been carried out in developed markets of Europe and the USA (e.g. Odean, 1999). Only a few studies have been completed in emerging markets (Fama, 1998).

2.3.3 Adaptive Market Hypothesis

The Adaptive Market Hypothesis is an attempt to reconcile theories that imply that the markets are efficient with behavioral alternatives, by applying the principles of evolution - competition, adaptation, and natural selection - to financial interactions. Under this approach the traditional models of modern financial economics can coexist alongside behavioral models. He argues that much of what behavioralists cite as counterexamples to economic rationality - loss aversion, overconfidence, overreaction, and other behavioral biases - are, in fact, consistent with an evolutionary model of individuals adapting to a changing environment using simple heuristics (Lo, 2004).

The Adaptive Markets Hypothesis can be viewed as a new version of the efficient market hypothesis, derived from evolutionary principles. "Prices reflect as much information as dictated by the combination of environmental conditions and the number and nature of "species" in the economy." By species, he means distinct groups of market participants, each behaving in a common manner (i.e. pension funds, retail investors, market makers, and hedge-fund managers, etc.). If multiple members of a single group are competing for rather scarce resources within a single market, that market is likely to be highly efficient, e.g., the market for 10-Year US Treasury Notes, which reflects most relevant information very quickly indeed. If, on the other

hand, a small number of species are competing for rather abundant resources in a given market, that market will be less efficient, e.g., the market for oil paintings from the Italian Renaissance. Market efficiency cannot be evaluated in a vacuum, but is highly context-dependent and dynamic. Shortly stated, the degree of market efficiency is related to environmental factors characterizing market ecology such as the number of competitors in the market, the magnitude of profit opportunities available, and the adaptability of the market participants (Lo, 2005).

2.3 Institutional Framework of Auditing in Kenya

Kenya has made progress in closing the gap between national accounting and auditing practices and international standards, notably by adopting the IASs and ISAs as national requirements. However, compliance with the requirements of IASs and ISAs is partial, due to enforcement mechanisms that continue to evolve and inadequate resources. In spite of these difficulties, institutional investors in Kenya perceive that the quality of financial reporting has significantly improved over the past nine years. Improvements are needed in the legal framework governing accounting and financial reporting, the professional education and training arrangements, the professional body, and the enforcement mechanism. Stakeholders in the country believe that successful completion of appropriate capacity-building initiatives, through implementation of an action plan, would help develop accounting and auditing practices and bring about improvements in compliance with the international standards within a period of three to five years (Rahman, 2001).

Kenya is a major economy in the East and Central African region, and its success in improving financial markets and economic performance is likely to have a significant demonstration effect on the region's economic development. Although the country has taken some measures to improve its economic governance, economic growth and various social indicators continue to decline. This is partly a reflection of how deeply entrenched many problems are, including in the area of financial accountability in both private and public sectors. Deep-seated skepticism on the part of private investors, specifically foreign private investors, about the possibility of successfully implementing reform initiatives has not yet been overcome, and private investment levels remain very low (World Bank Report, 2003).

Weaknesses in corporate governance practices, lack of pressure from the users of financial statements for high-quality information, and the general absence of transparency in the corporate sector, pervade the corporate financial reporting regime in Kenya. The fact that a number of banks failed in the late 1990s, and the audited financial statements did not provide early warning signals about these failures, has raised concerns among the general public about the quality of accounting and auditing in the country (Rahman, 2001).

The Companies Act requires all limited liability companies to prepare and present annual audited financial statements. The Kenyan Companies Act, which is substantially the same as the U.K. Companies Act of 1948, was not amended to reflect the requirements set by the Accountants Act. Consequently, there is lack of clarity concerning the statutory requirements on disclosures in the financial statements of limited liability companies (ICPAK, 2006).

The accounting profession is dominated by the four largest international accounting firms**.** These four firms are the auditors of most of the publicly traded companies in Kenya; about 50 companies are listed on the Nairobi Stock Exchange. Although Kenyan law does not address accounting standards for listed companies and banks, regulators use their supervisory mechanisms to insist on observance of the IASs. The Banking Supervision Department of the Central Bank of Kenya, using its legal authority to require individual banks to disclose information in a particular manner, imposes IAS requirements. Until recently, although there was no legal requirement to follow IASs, listed companies were advised by the Capital Markets Authority (CMA) to prepare financial statements in compliance with IASs. The revised rules of the CMA, effective in June 2001, have made IASs mandatory for accounting and financial reporting by all listed companies. Moreover, the Nairobi Stock Exchange (NSE) is issuing a manual that requires listed companies to follow IASs. Although adoption of IASs and ISAs was an important step in upgrading the financial reporting practices of Kenyan enterprises, there continue to be gaps in compliance with these standards. One problem is that the standards themselves need to be better disseminated (World Bank Report, 2004).

Although the ICPAK does not require its members to apply the IASs, the Companies Act nor the Accountants Act imposes on Kenyan companies a legal obligation to comply with the accounting

standards promulgated by the professional body. Therefore, Kenyan companies tend not to devote resources to ensuring compliance with the established accounting and reporting requirements. This is an important gap in the legal and regulatory framework that needs to be addressed. Auditors have failed to ensure compliance with IASs and ISAs. This may be due to an absence of demand for transparency and accountability, and capacity constraints among audit firms (Rahman, 2001).

The Capital Markets Authority (CMA) does not have an effective mechanism for monitoring compliance with reporting standards in financial statements issued by the publicly traded companies or for punishing issuers for infractions. In some cases where deficient financial reporting by listed companies was discovered and reported in the national press, the CMA did not take punitive action against the companies. The Central Bank of Kenya (CBK) has begun to review and approve draft annual audited financial statements before issuance by the concerned bank. For this purpose, CBK officials meet with the representatives of a bank and the bank's auditor and discuss various accounting and disclosure items in the financial statements. This is in addition to other requirements on banking supervision. The self-regulatory organizations do not monitor and enforce accounting and auditing standards. The Nairobi Stock Exchange (NSE) is satisfied if a listed company issues audited annual financial statements; it does not have any arrangement to improve the quality of financial reporting by the listed companies. ICPAK has not yet established a monitoring mechanism, making it difficult to identify and pursue violations of established rules and regulations (IMF/UNCTAD Report, 2007).

There are gaps between applicable accounting standards and actual accounting practices**.** While the adoption of the IASs has closed the gap between Kenyan and international accounting standards, the lack of implementation guidelines on the application of the standards and of a mechanism for providing interpretations means that different preparers and auditors of financial statements interpret and apply the IASs in different ways. The adoption of the ISAs was an important step in upgrading Kenya's auditing practices, but the lack of guidance on their application has resulted in implementation problems. Financial accounting practices are perceived to have improved significantly since ICPAK's decision to implement international standards in accounting and auditing. Financial reporting regime has experienced significant

changes over the past 9 years. Bank failures and reports about manipulation of asset valuation in the financial statements of some large enterprises in the late 1990s provide examples of the unsatisfactory quality of financial reporting. ICPAK's decision to introduce IASs and ISAs and the ensuing (largely voluntary) efforts has brought about improvements that represent a significant step forward. However, the investment community perceives that considerable further improvements are required (ICPAK, 2008).

2.4 Empirical Studies

The empirical association between MAOs and stock returns has been studied extensively in the finance literature (Baskin, 1972; Alderman, 1977; Firth, 1978; Chow & Rice, 1982; Dodd et al., 1984; Dopuch et al., 1986; Loudder et al., 1992; Choi and Jeter, 1992; among others). These studies report mixed results. While Chow & Rice (1982) and Dodd et al. (1984) find no significant market reaction, Dopuch et al. (1986), Choi & Jeter (1992), and Loudder et al. (1992) report negative price reactions to MAOs. Findings by more recent studies of significant negative market reaction to qualified audit opinions may be attributed to differences in research design (Choi & Jeter, 1992), additional control variables (Loudder et al., 1992), and different definitions of events (Dopuch et al., 1986). Based on pre-1995 data, Abdel-Khalik & Wu (1996) and Shen (1996) report that there is no evidence that accounting information is associated with stock prices. However, studies using more recent data suggest that accounting information does affect Chinese investors' pricing decisions (Liu, 1997; Sun et al., 1997; Wu & Huang, 1997). DeFond et al., (1999) study the behavior of auditor choice by listed Chinese companies and find that big audit firms lose their market share as a result of issuing MAOs. They describe this as clients' "flight from audit quality". Though DeFond et al. (1999) find that MAOs affect Chinese managers' behavior, so far their effect on Chinese investors has not been documented. The study by Chen et al. (2000) is the first to examine whether auditors' reports affect investors' pricing decisions in the Chinese stock market.

Chen et al. (2000) examine the market reaction to the initial announcement of MAOs in the Shanghai Stock Exchange over a three-year period (1995-97) and provide empirical evidence of the economic impact of auditors' reports in an emerging market. After controlling for the effect of changes in accounting earnings and other concurrent announcements, they find

that MAOs are associated with significantly negative market returns, and the investors did not show a negative market reaction to MAOs until the second year. They also find that a difference in market reaction between GAAP and non-GAAP related MAOs is not observed, and that a difference in market reaction between qualified opinion and unqualified opinion with explanatory note(s) is not observed either. Sensitivity tests show that the main results concerning negative market reaction to MAOs are robust. Based on the statistical significance of the test results, they conclude that Chinese investors have arrived at a convergent interpretation of MAOs in their investment decisions and, therefore, auditor reports have value relevance, and independent auditing as an institution plays an important role in the emerging Chinese stock market.

Lin et al. (2003) present the results of an experimental study on users' responses to the qualification of audit reports in China. By employing the type of audit report (e.g., unqualified vs. qualified auditor opinion) as a manipulated variable in the experiment, they found mixed responses from the participants towards the perceived impact of a qualified audit report on users' understanding and use of the financial statements. In general, Chinese users, credit and loan officers in particular, perceived a qualified auditor opinion as having a somewhat negative impact on the credibility of financial statements. However, no significant difference was found in users' investment or credit decisions with respect to their exposure to the financial statements accompanied by an unqualified or a qualified auditor opinion.

Tuttle and Vandervelde (2009) show that without warning of possible bankruptcies through a going concern opinion, market participants discount the stock price of all companies in the market, regardless of whether the company deserves such discounting. The lack of confidence in the market also results in a decrease in the number of market participants as the number of unexpected bankruptcies without the going concern opinion warning increases. Unlike a market without going concern opinions, when going concern opinions are issued to the market, the stock prices of companies not receiving such an opinion are not discounted. These results suggest that an important role for going concern opinions is to stabilize the broader market and not just to inform investors about companies with the going concern.

Chen et al. (2007) develop a model to show that auditing can reduce information divergence among investors to the extent that it increases the relative weight they place on common financial statement information as opposed to diverse non-accounting information. Therefore, both variability of stock returns and trading volume are expected to be lower for observations with audited financial statements. Consistent with their predictions, they find that audited observations are associated with lower stock returns variability and lower trading volume than non-audited firms, subsequent to their announcement of semi-annual financial statements. These results are robust to variations in event window length and specification of empirical measures. Our findings show the benefits of auditing in that it reduces perceived information risk in audited financial statements as well as reducing information divergence among investors.

Chen and Church (1996) investigate the association between going concern opinions and the market's reaction to bankruptcy filings. Firms receiving going concern opinions experience less negative excessive returns in the period surrounding bankruptcy filings than those receiving unqualified opinions. These results hold after controlling for the probability of bankruptcy, the market's reaction to news announcements occurring prior to bankruptcy and changes in stock price prior to the issuance of the auditor's report. Their results are consistent with going concern opinions having information value.

Ogneva and Subramanyam (2007) examine 12-month returns following disclosure of first-time going concern (GC) opinions in the U.S. and Australia. They find no evidence of significant negative abnormal returns associated with GC opinions in Australia. In the U.S., negative abnormal returns subsequent to GC opinions are sensitive to choice of expected returns—notably, there are no significant negative abnormal returns when using factor models or after controlling for momentum. Overall, contrary to Taffler et al. (2004) U.K. results, they were unable to document a market anomaly in the U.S. or Australia associated with GC opinions.

Elliott and Schaub (n.d) conclude that going-concern audit opinions of one firm influence stock prices of other firms in the industry. Average abnormal returns to rival firms are positive and significant at the .01 and .05 level for the SIC 8080 and SIC 8090 firms, respectively. This research supports similar findings of Lang and Stulz (1992) who found that rival firms in an

oligopolistic industry show a positive reaction to bankruptcy announcements. Implications of this study tend to support the efficient market hypothesis in that stock prices rapidly reflect all new information available. These findings are important to institutional and private investors of companies as they seek to maximize stock returns as audit information is announced. Stock prices are generally expected to increase in rival firms as going-concern audit opinions are announced by a competing firm.

Choi and Jeter (2002) document that the market's responsiveness to earnings announcements declines significantly after the issuance of qualified audit reports for a sample of 'subject to' qualifications and consistency qualifications. The results are consistent with a hypothesis that audit qualifications reduce the market's responsiveness to earnings announcements by altering the market's perception of earnings noise or the persistence of earnings, or both. Alternatively, a decline in earnings response coefficients may be observed because audit qualifications are more likely in firms that have undergone economic or structural changes and these changes, rather than the qualification per se, lead to decreased persistence or increased noise.

The finance literature extensively documents the existence of stock market anomalies, such as the January effect, the day of the week effect and the small firm effect. Many of these anomalies were discovered or clarified while investigating what has come to be known as the overreaction hypothesis. Schaub (2006) examines investor overreaction to going concern audit opinion announcements made in the major financial press. The evidence presented suggests the sell-off by investors on the announcement date is followed by a major buy-back of the announcing firms' shares over the next few days. For the 79 announcing firms in the sample spanning 1984 to 1996, nearly 70% of the average losses on the announcement date are recovered the five days following going concern audit opinion announcements.

Elliott et al. (2006) examine whether intra-industry information transfers from going-concern audit opinion announcements create contagion or competitive stock price reactions for other real estate firms operating in the same line of business. Using returns from publicly-traded land subdivision/development firms and Real Estate Investment Trusts, they find modest evidence

supporting a competitive effect among rival firms as a result of another real estate firm announcing the receipt of a Going Concern Opinion (GCO) from its independent auditors.

Citron et al. (2001) observe that prior research is ambiguous as to whether audit going-concern uncertainty opinions are associated with downward share price revisions. Their study overcomes problems encountered with conventional pair-matched methodologies, by working with a population of firms exclusively with going-concern audit opinions. They exploit a U.K. institutional curiosity whereby disclosure of a forthcoming going-concern opinion at the preliminary results stage is entirely discretionary. They find that firms pre-empting such disclosure in their preliminary announcement suffer a significant 3-day adverse market reaction of −8.1% compared with −1.9% for non-pre-empting firms. Non-pre-empting firms do eventually experience a significant price decline. However, this is postponed until first disclosure of the going-concern opinion in the annual report itself at which time the price reaction for pre-empting firms is negligible. Nevertheless, the financial and other characteristics of pre-emptors and non-pre-emptors differ in no apparent way. Their research design allows them to be far more definitive in concluding that going-concern opinions do convey relevant information to market participants. On this basis, any delay in the release of such price sensitive information is consistent with lack of price integrity.

Elliot (1982) provides results on the association between abnormal security returns and subject to audit reports. Such evidence is of interest to theorists who seek to develop more complete models of the role of the audit in information flows in security markets. He concluded that subject to opinions are issued in conjunction with several different types of uncertainties of differing economic significance and that significant negative abnormal returns are observed in the 45-week period before the subject to opinion is released, suggesting that certain uncertainties have economic significance but market participants learn of them and assess their implications for firm valuation using information which is available before the auditor's opinion.

Ameen et al. (1992) investigate the information content of the initial public announcement of an audit qualification for a sample of American firms traded over-the-counter. These firms have smaller predisclosure information sets than New York Stock Exchange (NYSE) and American Stock Exchange (ASE) firms. The results of research focusing on NYSE and ASE firms cannot,

therefore, be extended to the over-the-counter (OTC) market. When the qualification is not confined to a 'bad news' scenario, a significant market reaction to the announcement is found, indicating that audit qualification announcements for OTC firms do, indeed, have information content.

Gul (2009) in his paper reports the findings of an experiment designed to investigate the effects of an unqualified versus an "except for" qualified audit report on subjects' share price estimates and the moderating role of cognitive style in this relationship. Using ANOVA experimental design, 34 subjects were administered identical financial information on a hypothetical company except that 17 subjects received a qualified auditors' opinion and the other 17 received an unqualified auditors' opinion. In addition, the subjects in each group were classified as either field dependent or field independent on the basis of their scores in the Embedded Figures Test. Results showed that the "except for" audit qualification affected share price estimates and field dependence cognitive style interacted with qualified/unqualified audit opinion to also affect subjects' share price estimates.

Kausar et al. (2006) explore the medium-term market reaction to going-concern modified audit opinions and their withdrawal for a large sample of firms from 1994 to 2002. Results show asymmetric market response to these accounting system disclosures. The market underreacts to going-concern opinions, resulting in a subsequent downward drift of around -16% over the one year period subsequent to the going-concern opinion, but fully anticipates their withdrawal. This post-going-concern announcement drift is distinct from other established anomalies; however, it is limited to those going-concern cases with negative earnings surprise. Nonetheless, adjusting for transactions costs, the opportunity to earn profits by trading on this anomaly is limited and risky. Analysis of stockholder trading activities reveals that institutions reduce their holdings in such stocks on a timely basis in contrast to retail investors. The results are original, and indicate that auditors are providing clear messages to financial statement users in the going-concern context but their information content is not being fully impounded by the market on a timely basis.

Shevlin and Whittred (1984) employ a portfolio approach which controls directly for the sign (indirectly for the magnitude) of unexpected earnings, this study examined the stock market's

reaction to qualified audit reports. There is no substantive evidence that qualifications affect equity prices in the month of their announcement. However, there is evidence that firms that receive certain types of qualification experience negative abnormal returns in the twelve months preceding this event.

Fields and Wilkins (1991) study public announcements of 52 withdrawn `subject to' qualified audit opinions and document a statistically positive average announcement period abnormal return. Further withdrawals which are relatively less anticipated result in stronger positive abnormal performance upon announcement. The results suggest that withdrawn `subject to 'opinions are valuable to investors because they convey information which affect shareholder wealth.

Ghicas et al. (2008) examine how useful audit qualifications are to financial statement users. They analyze a sample of 204 firms that went public at the Athens Stock Exchange over the period 1987–2002. For 149 of these firms, auditors report quantitative estimates of the amount by which assets are overstated and/or liabilities are understated in reported financial statements. They find that underwriters and their affiliated analysts do not incorporate the negative information provided by these qualifications into offer prices and earnings forecasts. Investors, however, appear to efficiently impound the negative implications of the audit qualifications into stock market prices within the first day of trading. The results suggest that underwriters tend to align their interests with the interests of their clients, the old stockholders, at the expense of the new stockholders. They also suggest that the practice of reporting quantifiable qualifications in audit reports is valuable to investors given that they are disclosed by an expert.

Firth (1978) uses the market model to measure the abnormal returns associated with various types of qualification. He found that various types of qualifications had a significant impact on investment decisions while others had very little. There was no relationship between the accounting firm qualifying the accounts and the abnormal returns. The findings suggest that more information on the nature of audit qualifications should be given.

Al-Thuneibat, et al. (2008) undertook a study whose aims was to investigate the effect of the qualified audit reports on shares prices and returns in Jordan. A market-based study was conducted on the qualified audit reports of the shareholding companies in Jordan during the period 2000-2005. The conclusions of the study showed that there is no clear or significant effect of a qualified audit opinion on share prices and returns. Based on the conclusions of the study, the researchers recommend there is a need for further educating users of the role of the audit report and the need for extending this study to investigate the effect of the qualified audit reports on share prices and returns during other periods and using different test periods other than the announcement date. This study is original because it provides new evidence about the effect of qualified audit reports on shares prices and returns in a developing country.

Frost (1997) examines discretionary disclosures and stock price effects for 81 UK firms that received first-time modified audit reports during 1982–1990. Results indicate that these firms' managers are forthcoming about adverse developments, and appear to perceive the advantages of withholding negative news to be minimal. However, managers of many of the 58 stressed sample firms make disclosures about expected future performance that are overly optimistic relative to financial outcomes. As expected, stock market participants discount these stressed firms' positive tone disclosures. Evidence in this study confirms that there is a strong incentive problem with voluntary disclosure.

The findings of Mittelstaedt et al. (1992) are consistent with those of Baskin (1972). Both studies conclude that an audit opinion of “consistency modification” does not provide incremental information to the equity market. Another stream of research reports a positive association between several types of audit opinions and market reactions, as opposed to the weak market reaction to “consistency modification” opinions. The researchers argue that the market responds to “subject to” opinions by adjusting stock prices substantially. Several studies find that the market recognizes the economic value of the information conveyed in the qualified audit opinion by downwardly adjusting stock prices upon the announcement of a “subject to” audit qualification (Dodd et al. 1984; Dopuch et al. 1986; Loudder et al. 1992).

Dodd et al. (1984) find that the market reacts negatively to these two types of audit qualifications. They document the stock price adjustments upon the announcements of "subject to" or disclaimer audit opinions. Further examination shows that the magnitude of post-announcement abnormal returns varies in response to different types of audit qualifications and the pre-announcement price shifts. For instance, if a firm experiences stock price adjustments prior to the announcement of its audit qualification, the firm will suffer less significant post-announcement stock price decrease than has been predicted (Dodd et al. 1984).

In a similar vein, Loudder et al. (1992) provide evidence that the market reassessments of qualified firms' values occur both at the qualification disclosure dates and at the earnings announcement dates. The results also indicate that corresponding market reactions are sensitive to the way that the audit qualifications are announced (Loudder et al. 1992). For instance, a qualification announcement made in a media story or a qualification that is subsequently withdrawn tends to have stronger market responses (Loudder et al. 1992). Furthermore, the study argues that the elimination of "subject to" audit opinions might be premature and suggests that incorporating expectations into the event study model has methodological value (Loudder et al. 1992).

The mixed results of market reactions to audit qualifications on financial statements can be explained from multiple aspects. One explanation for the contradictory results is that the information included in one format (e.g., "consistency modification" qualification) is of less significance than another format (e.g., "subject to" qualifications). In addition, the market views the information contained in a "consistency modification" audit opinion differently from the information leading to a "subject to" audit qualification. A third explanation derives from market irresponsiveness because of the expectation gap. This perspective proposes that, the expectation gap between investors' perceptions of audit assurance and the assurance that auditors can actually provide, would lead to the market failure in detecting the informational content of audit reports (Mednick 1986; Hatherly et al. 1991; Epstein and Geiger 1994). While the investor misconception of audit services partly contributes to the widened expectation gap, many researchers start to question the economic value of audit services. Nair and Rittengerg (1987), in a laboratory setting, examine the informativeness of audit reports. Their results reveal that

skepticism over the effectiveness of communications between auditors and investors is on the rise (Nair and Rittengerg 1987).

Previous research (e.g., Holt and Moizer 1990; Schaub 2006a; Schaub 2006b) reveals that, investors and the market interpret a going-concern opinion as a signal of unsatisfactory firm performance. In their study of audit reports in the United Kingdom (U.K.), Holt and Moizer (1990) show that both professional investors and general investors are able to distinguish the wordings in different types of audit reports. Specifically, they confirm that going-concern qualifications make the users feel less confident in associated financial statements. Using a sample of United States (U.S.) firms, Schaub (2006) finds that a going-concern qualification contains information similar to the information conveyed by a "subject to" qualification prior to 1988, and they also confirm that the market responds similarly to those two types of audit qualifications.

Prior studies also find that a going-concern qualification is associated with severely negative market reactions and subsequent business failures. Applying a series of models on a set of U.K. data from 1977—1986, Citron and Taffler (1992) confirm the positive relationship between going-concern qualifications and subsequent business failures. In an investigation of the incremental information content of audit reports, Fleak and Wilson (1994) predict and confirm that going-concern qualifications are negatively associated with abnormal security returns.

Taffler et al. (2004) document that U.K. public firms receiving first time going concern audit opinions underperform the market during the 12 months subsequent to the audit report releases. In contrast, Ogneva and Subramanyam (2007) find little evidence to associate negative abnormal returns with going-concern opinions in both American and Australian stock markets. In their paper, Ogneva and Subramanyam (2007) provide a discussion that the U.S. firms demonstrate a certain degree of sensitivity to various return computations in the portfolio analyses, and the U.S. firms underperform portfolio or control firms when using the book-to-market and size-matching method. However, the computations using factor models (factor CAPM, Factor Fama-French, and factors Fama-French and momentum) do not support the association between going-concern qualifications and significant negative abnormal returns (Ogneva and Subramanyam 2007).

Investigating stock market anomalies and market overreactions to going-concern qualifications, Schaub (2006b) tests a model on a sample of U.S. firms from 1984—1996. The empirical results show that the negative market response upon the announcement of a going-concern qualification is offset by strong buy-back in the days following the announcement date (Schaub 2006b). Kausar and Taffler (2007), also based on a sample of U.S. firms, investigate the medium term market reaction to going-concern audit opinions. As opposed to the findings of Ogneva and Subramanyam (2007), their results indicate market under reactions to going-concern qualification disclosures. However, such post-going-concern announcement drifts do not create arbitrage opportunities and are limited to firms with negative earnings surprises (Kausar and Taffler 2007). They conclude that a going-concern qualification provides informational value to investors, but the time frame when the stock prices incorporate such information remains unclear (Kausar and Taffler 2007).

In Kenya, little empirical research has been conducted to establish the association between events or announcements and stock returns. Onyangoh (2004) evaluated the stock price reactions to earnings announcements for companies listed at the NSE. He found out that information about share price performance is incorporated in the bid and offer prices several days before the announcement date. Even if the announcement dates do not have information content, residual variance information measures show that time (number of weeks before and after announcement) is an insufficient predictor of the response coefficient.

Kiio (2006) in his study about market efficiency and the effects of cash dividend announcements on share prices of companies listed at the NSE, revealed negative excess returns for the dividend paying samples before the day of announcements and positive returns after the date of announcement. He found out excess returns for the cumulative market to be significant for the 10 days before and after dividend announcement for cash dividend paying firms. He concluded that dividend payment has a significant impact on share prices.

Mokua (2003) in his study between the years 1996 and 2001 set out to find out whether NSE exhibits the weekend effect on the securities traded, sampled 43 firms and tested their equity

stocks for equality or differences between samples mean returns. He investigated daily fluctuations individually, regressed Monday returns against the rest of the days and Friday returns against the rest of the days in turns. He also analyzed Monday and Friday returns at a time versus the rest of the days. He found no substantive evidence of the weekend effect on the NSE during that period. He found neither significantly high returns on Fridays nor low returns on Mondays.

Rasugu (2005) in his study of whether there exists a holiday effect at the NSE for the five year period between 1998 to 2002, evaluated the impact of the holiday effect on the common share returns of companies listed at the exchange. He compared the means for pre holiday days and other non-pre holiday days, pre holiday returns versus post holiday returns and mean returns of days surrounding public holidays and found no significant differences in the means of prices of the stocks traded at the NSE. Similarly, Kamau (2003) found no turn of the month and January effects while Kiweu (1991) found out that returns of stocks traded in the NSE follow a random walk.

2.5 Summary of Literature

Previous research has explored how the market interprets various audit qualifications on financial statements, including qualified opinions, adverse opinions, disclaimer opinions, "consistency modification" qualifications, "subject to" qualifications, and going-concern qualifications. Overall, studies investigating equity market reactions to audit qualifications on financial statements show mixed results. Some studies indicate that the market reacts weakly to qualified opinions, adverse opinions, and disclaimer opinions. Meanwhile, previous research suggests that a going-concern qualification provides useful information to investors and signals future business failure and bankruptcy (e.g., Elliott 1982; Dodd et al. 1984; Dopuch et al. 1986; Fields and Wilkins 1991; Loudder et al.1992; Jones 1996).

As described, previous research provides contradictory explanations as to market interpretations of audit qualifications. One stream of research argues that the market reacts weakly to the information contained in audit reports and audit opinions. For instance, the evidence provided by

Baskin (1972) indicates that audit opinions indicating "consistency modification" do not provide useful information in firm valuation. In assessing the informational significance of "consistency modification" audit opinions, Mittelstaedt et al. (1992) find that the equity market does not actively respond to "consistency modification" announcements. Their results imply that a "consistency modification" announcement is an event that conveys little information (Mittelstaedt et al. 1992).

Capital market researchers have constantly debated on the information content of going-concern opinions and different methods, such as return computation sensitivity partly accounts for the discrepancies (Ogneva and Subramanyam 2007). Prior studies also reveal that timing of the empirical tests is critical in exploring the association between audit opinion announcements and market return changes (e.g., Schaub 2006b). Researchers have selected audit opinion announcement dates as the dates to form event windows. Some studies suggest that, prior to public announcements of audit opinions, stock prices might have impounded information about the conditions leading to different opinions. The market unresponsiveness might result from the fact that the firms in these studies are large, and many other factors besides audit opinions affect these firms' valuations. The complexity of valuation processes might obscure the audit qualifications in empirical studies.

Previous research addressing market responses to firms listed in different stock exchanges would help in understanding the circumstances leading to different empirical results. For instance, as opposed to the mixed empirical results from samples of large firms in the New York Stock Exchange (NYSE) and the American Stock Exchange (ASE) with multiple information sources, small firms show significant market reactions to audit opinions. Prior literature also suggests that the market differentiates the reasons underlying qualified or adverse audit opinions. This study empirically examines whether negative abnormal returns are associated with modified audit opinions at the Nairobi Stock Exchange.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Introduction

This chapter focuses on how the study was carried out in assessing the effects of modified audit opinions on firm valuation. The chapter details how the research was designed, the time period, the population of the study and the sample size. It also looks at how the data was collected and analyzed.

3.2 Research Design

This was an event study. Event study methodology is interpreted as analyzing the market's reaction to 'events' or as an empirical investigation of the relationship between security prices and economic informational events. The event under investigation was the publishing of the annual audit reports or the announcement of modified audit opinions by firms listed at the Nairobi Stock Exchange. An event study is a statistical method to assess the impact of an event on the value of a firm. The basic idea is to find the abnormal return attributable to the event being studied by adjusting for the return that stems from the price fluctuation of the market as a whole. Event studies have been used in a large variety of studies, including mergers and acquisitions, earnings announcements, debt or equity issues, corporate reorganizations, investment decisions and corporate social responsibility .The event study methodology was used because the study analyzed the effects of the announcement of modified audit opinions (event) on share prices (McWilliams & Siegel, 1997).

The Financial Accounting Standards Board (FASB) and the Nairobi Stock Exchange strive to set reporting regulations so that financial statements and related information releases are informative about the value of the firm. In setting standards, the information content of the financial disclosures is of interest. Event studies provide an ideal tool for examining the information content of the disclosures. The objective of this study is to investigate the information content of the modified audit opinion announcements or to see if the releases of audit reports provide information to the marketplace. If so there should be a correlation between the observed change of the market value of the firm and the type of audit opinion (Mackinlay, 1997).

3.3 Population

The population of interest for the study consisted of all the 49 companies continuously listed at the Nairobi Stock Exchange (NSE, 2010).

3.4 Sample

Relevant data for this study were obtained from the Nairobi Stock Exchange. Listed companies are categorized into two market segments; Main Investment Market Segment (MIMS) and Alternative Investment Market Segment (AIMS). The study covered both segments in the period between 2004 and 2008. The segments were chosen because they represent the most active segments at the Nairobi Stock Exchange with increased number of transactions, higher market capitalization, higher values of shares traded, higher market liquidity and increased volume of shares traded. These variables are the traditional stock market performance indicators. The time frame was chosen because it represents a period of volatility in the Kenyan capital market which helps in identifying the various market responses to modified audit opinions and because it represents the contemporary capital market environment in terms of technological advancements, regulation, industry structure and financial innovation.

3.5 Data Collection

Audit reports and audited financial statements for the period of study were obtained from the Nairobi Stock Exchange. Secondary data on closing share prices, shares outstanding, book equity and weekly average returns on share prices were obtained from reports from the Nairobi Stock Exchange (NSE).

3.6 Data Presentation and Analysis

An analysis of the modified audit opinions and equity data were done using SPSS (Statistical Package for Social Science). Descriptive statistics and Regression analysis were run to explain the relationship between the dependent variable (asset return) and the independent variables (modified audit opinions). The estimated Regression model was as follows:

$$Y = \alpha + \beta_1 X_1 + \varepsilon$$

Where;

Y = the dependent variable (share price, book value of share, weekly average share price and outstanding shares)

α = constant

β_1 = coefficient of the independent variable

X_1 = independent variable (modified audit opinions)

ε = error term

To examine the audit opinions that drive asset returns, the study evaluated the marginal value of the audit opinions by comparing the correlation coefficients between the audit opinions and the returns. Existing multifactor models were applied as defined by the audit opinions examined to explain common variation of asset returns using time series regressions.

The audit opinions that were incorporated in the analysis include unqualified opinion, qualified opinion, adverse opinion, subject to opinion, disclaimer opinion, except for opinion, and more severe qualifications like going concern opinion, not true and fair opinion, and unable to form an opinion.

CHAPTER FOUR

4.0 DATA PRESENTATION AND ANALYSIS

4.1 Introduction

This chapter details the findings of the study as captured from the data collected from the NSE. The study aimed at finding out how modified audit opinions influences share prices at the Nairobi Stock Exchange. Data was collected on audit opinions, share prices, book value of equity, shares outstanding and weekly average share prices.

4.2 Data Organization

The data was collected from the Nairobi Stock Exchange. To assess the impact of the audit opinions on share prices, descriptive statistics were analyzed. The mean and standard deviation for the audit opinions, closing share prices, book value of equity, outstanding shares and weekly average returns were calculated and compared.

Regression analysis was done to determine the association between audit opinions and share prices, book equity, shares outstanding and weekly average prices and to test hypothesis. Correlation analysis was also done to determine the strength of the relationship between audit opinions and share prices, book equity, shares outstanding and weekly average prices. Pearson's correlation coefficient was used to gauge this strength.

Analysis of Variance (ANOVA) test was done to establish if the effect on share prices, book equity, shares outstanding and weekly average returns associated with the announcement of audit opinions was significant. For this analysis, the means for all the indicators were subjected to the ANOVA test. This aimed at revealing whether the changes in the dependent variables above were significant.

4.3 Analysis of Descriptive Statistics

One measure of location, mean, and one measure of dispersion, the standard deviation were studied and the results obtained are presented in Table 1 below. The mean is particularly an informative measure of the "central tendency" of the dependent variables if it is reported along with its confidence intervals. On the other hand, in a regression problem, the standard deviation is indicative of the prediction of the fitted regression model.

The mean of audit opinions is 50.33% for the listed companies during the period 2004 to 2008 at a confidence level of 95% with a standard deviation of 15.149. The average weekly share price was found to be Ksh 78.81 with a standard deviation of 49.166. The average closing share price was found to be 3.99 while that of outstanding shares and book value of shares was found to be 1.66E8 and 1.26E10 respectively.

Table 1: Analysis of Descriptive Statistics Results

	Mean	Std. Deviation	N
Audit Opinions	50.33	15.149	265
Weekly Share Average	78.81	49.166	265
Closing Share Price	1.66E8	2.858E8	265
Outstanding shares	1.26E10	3.209E10	265
Book Value of Shares	3.99	.184	265

Source: Research Findings

4.4 Correlation Analysis

Pearson's correlation coefficient determines the strength of linear relationships between two variables. As shown in Table 2 below, the strength of the relationships between audit opinions and weekly average share prices, closing share prices and outstanding shares is weak and negative with coefficients of -0.112 for weekly average share prices and -0.046 and -0.128 for closing share prices and outstanding shares respectively. However, audit opinions and book value of shares have a weak positive relationship. Notably, only the relationships between audit opinions and outstanding shares is statistically significant at 5% significance level with a p-value of $p=0.038<0.05$.

Table 2: Correlations Analysis Results

		Audit Opinions	Weekly Share Average	Closing Share Price	Outstanding shares	Book Value of Shares
Audit Opinions	Pearson Correlation	1	-.112	-.046	-.128*	.045
	Sig. (2-tailed)		.069	.458	.038	.467
	N	265	265	265	265	265
Weekly Share Average	Pearson Correlation	-.112	1	-.016	.346**	.026
	Sig. (2-tailed)	.069		.796	.000	.672
	N	265	265	265	265	265
Closing Share Price	Pearson Correlation	-.046	-.016	1	.623**	.031
	Sig. (2-tailed)	.458	.796		.000	.616
	N	265	265	265	265	265
Outstanding shares	Pearson Correlation	-.128*	.346**	.623**	1	.022
	Sig. (2-tailed)	.038	.000	.000		.717
	N	265	265	265	265	265
Book Value of Shares	Pearson Correlation	.045	.026	.031	.022	1
	Sig. (2-tailed)	.467	.672	.616	.717	
	N	265	265	265	265	265

*. Correlation is significant at the 0.05 level (2-tailed).

**. Correlation is significant at the 0.01 level (2-tailed).

Source: Research Findings

4.5 Analysis of Variance (ANOVA)

The purpose of Analysis of Variance (ANOVA) is to test for significant differences between means. To test for significant differences between means, ANOVA was conducted. F-test is used when comparing statistical models that have been fitted to a data set, in order to identify the model that best fits the population from which the data were sampled. F-test therefore, plays an important role in the Analysis of Variance. Table 3 below shows the results of F test which tests whether the ratio of the variance estimates is significantly greater than 1. The results show an F value of 1.85 between audit opinions and weekly share average; 0.846 between audit opinions and closing share prices; 0.393 between audit opinions and outstanding shares; and 0.232 between audit opinions and book value of equity. This was found to be statistically significant at 5% significance level with a p-value $p = 0.05$. This implies that their means are significantly different from each other.

Table 3: Analysis of Variance (ANOVA) Results

		Sum of Squares	df	Mean Square	F	Sig.
Weekly Share Average * Audit Opinions	Between Groups (Combined)	1469699.287	214	6867.754	1.858	.005
	Within Groups	184845.792	50	3696.916		
	Total	1654545.079	264			
Closing Share Price * Audit Opinions	Between Groups (Combined)	1.689E19	214	7.895E16	.846	.791
	Within Groups	4.666E18	50	9.333E16		
	Total	2.156E19	264			
Outstanding shares * Audit Opinions	Between Groups (Combined)	1.705E23	214	7.968E20	.393	1.000
	Within Groups	1.013E23	50	2.025E21		
	Total	2.718E23	264			
Book Value of Shares * Audit Opinions	Between Groups (Combined)	4.466	214	.021	.232	1.000
	Within Groups	4.500	50	.090		
	Total	8.966	264			

Source: Research Findings

4.6. Regression Analysis

Bi-variate regression analysis was used to test hypotheses. Bi-variate analysis is appropriate as it does not take into consideration other factors whose presence or absence can possibly affect the relationship between dependent and independent variables. From the methodology, a bivariate regression equation was estimated and later fitted from analysis of the data. The model that was estimated in Chapter 3 was as follows;

$$Y = \alpha + \beta_1 X_1 + \varepsilon$$

4.6.1: Audit Opinions and Closing Share Prices

Table 4: Model Summary and Variable Coefficients

Model Summary									
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df 1	df2	Sig. F Change
1	.046[a]	.002	.002	2.860E8	.002	.553	1	263	.458

Coefficients[b]										
Model 1	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95.0% Confidence Interval		Correlations		
	B	Std. Error	Beta			Lower Bound	Upper Bound	Zero order	Partial	Part
(Constant)	2.090E8	61070427.017		3.423	.001	88766518.548	3.293E8			
Audit Opinions	-864274.359	1162041.428	-.046	-.744	.458	-3152362.952	1423814.234	-.046	-.046	-.046

a. Predictors: (Constant), Audit Opinions

b. Dependent Variable: Closing Share Price

Source: Research Findings

The coefficient for audit opinions is negative (Table 4). This implies that there is a negative relationship between closing share prices and audit opinions. This implies that the presence of an adverse audit opinion influences a company's share price negatively. From the fitted regression equation, it can be seen that for every instance of presence of a 'negative' audit opinion, the dependent variable (share price) declines by a factor of 0.046. The coefficients' p-values are given in the parenthesis. The estimated model coefficients, (p-values) indicate the statistical significance of a result, that is, the degree to which the result is true. The estimated model coefficients, the p-value was less than 0.05 (i.e. p = 0.001<0.05) for the constant. On the other hand the coefficient p-value for audit opinions p=0.458>0.05 implying that it is not statistically significant at 5% significance level. The fitted regression model was as follows;

$$Y = \underset{0.001}{2.090E8} - \underset{(0.458)}{0.046X_1} + 2.860E8$$

The fitted model was diagnosed and found not to be statistically significant at 5% significance level (regression p-value=0.458<0.05). This implies that there are many other factors that affect the share price of a firm other than audit opinions. The R-square value is an indicator of how well the model fits the data, hence showing the strength of a model in forecasting. As shown in Table 4, the adjusted R-square=0.002, implying that the independent variables accounted for 0.2% of the dependent variable.

4.6.2 Audit Opinions and Book Value of Shares

Table 5: Model Summary and Variable Coefficients

Model Summary									
Model 1	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df 1	df2	Sig. F Change
	.045[a]	.002	.002	.184	.002	.530	1	263	.467

Coefficients[b]										
Model 1	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95.0% Confidence Interval		Correlations		
	B	Std. Error	Beta			Lower Bound	Upper Bound	Zero order	Partial	Part
(Constant)	3.961	.039		100.580	.000	3.884	4.039			
Audit Opinions	.001	.001	.045	.728	.467	-.001	.002	.045	.045	.045

a. Predictors: (Constant), Audit Opinions

b. Dependent Variable: Book Value of Shares

Source: Research Findings

From the fitted regression equation, it can be seen that for every instance of a negative audit opinion, the dependent variable (book value of shares) declines by a factor of 0.045. The estimated model coefficients, the p-value was less than 0.05 (i.e. p = 0.000<0.05) for the constant implying that the results are statistically significant at 5% significance level. On the other hand the coefficient p-value for audit opinions p=0.467>0.05 implying that it is not statistically significant at 5% significance level. The fitted regression model was as follows;

$$Y = \underset{0.000}{3.961} - \underset{(0.467)}{0.045X_1} + 0.184$$

The fitted model was diagnosed and found not to be statistically significant at 5% significance level (regression p-value=0.467>0.05). Moreover, the adjusted R-square=0.002, implying that the independent variables accounted for 0.2% of the dependent variable.

4.6.3 Audit Opinions and Weekly Average Prices

Table 6: Model Summary and Variable Coefficients

Model Summary									
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df 1	df2	Sig. F Change
1	.112[a]	.013	.009	78.816	.013	3.345	1	263	.069

Coefficients[b]										
Model 1	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95.0% Confidence Interval		Correlations		
	B	Std. Error	Beta			Lower Bound	Upper Bound	Zero order	Partial	Part
(Constant)	108.287	16.829		6.435	.000	75.151	141.423			
Audit Opinions	-.586	.320	-.112	-1.829	.069	-1.216	.045	-.112	-.112	-.112

a. Predictors: (Constant), Audit Opinions

b. Dependent Variable: Weekly Share Average

Source: Research Findings

From the fitted regression equation, it can be seen that for every instance of a negative audit opinion, the dependent variable (Weekly average share price) declines by a factor of 0.112. The estimated model coefficients, the p-value was less than 0.05 (i.e. $p = 0.000<0.05$) for the constant

implying that the results are statistically significant at 5% significance level. On the other hand the coefficient p-value for audit opinions p=0.067>0.05 implying that it is not statistically significant at 5% significance level. The fitted regression model was as follows;

$$Y = \underset{0.000}{108.27} - \underset{(0.067)}{0.112X_1} + 78.81$$

The fitted model was diagnosed and found not to be statistically significant at 5% significance level (regression p-value=0.067>0.05). Moreover, the adjusted R-square=0.009, implying that the independent variables accounted for 0.9% of the dependent variable.

4.6.4 Audit Opinions and Outstanding shares

Table 7: Model Summary, and Variable Coefficients

Model Summary									
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df 1	df2	Sig. F Change
1	.128[a]	.016	.013	3.188E10	.016	4.350	1	263	.038

Coefficients[b]										
Model 1	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95.0% Confidence Interval		Correlations		
	B	Std. Error	Beta			Lower Bound	Upper Bound	Zero order	Partial	Part
(Constant)	2.623E10	6.808E9		3.853	.000	1.282E10	3.963E10			
Audit Opinions	-2.702E8	1.295E8	-.128	-2.086	.038	-5.252E8	-15112911.125	-.128	-.128	-.128

a. Predictors: (Constant), Audit Opinions

b. Dependent Variable: Outstanding shares

Source: Research Findings

From the fitted regression equation, it can be seen that for every instance of a negative audit opinion, the dependent variable (Outstanding shares) declines by a factor of 0.128. The estimated model coefficients, the p-value was less than 0.05 (i.e. p = 0.000<0.05) for the constant implying that the results are statistically significant at 5% significance level. On the other hand the coefficient p-value for audit opinions p=0.038<0.05 implying that it is statistically significant at 5% significance level. The fitted regression model was as follows;

$$Y = \underset{0.000}{2.62} - \underset{(0.038)}{0.128X_1} + 3.188$$

The fitted model was diagnosed and found to be statistically significant at 5% significance level (regression p-value=0.038<0.05). Moreover, the adjusted R-square=0.013, implying that the independent variables accounted for 1.3% of the dependent variable.

CHAPTER FIVE

5.0 SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter summarizes the findings of the study and highlights the conclusions made. It also highlights the recommendations and research gaps identified that will be useful to future students and researchers.

5.2 Summary of the Findings

This study examined the effects of modified audit opinions on share prices for companies quoted at the Nairobi Stock Exchange. It also examined the effects of modified audit opinions on weekly average returns, shares outstanding and book equity.

A regression analysis run to test the hypothesis reveals that there is a negative relationship between audit opinions and closing share prices. The presence of an audit opinion other than the standard unqualified opinion thus influences the company's share price negatively. However, further analysis of the correlation co-efficients reveals that audit opinions accounts for a very small percentage of the change in the share prices (0.2%). This implies that there are many other factors that affect the share price of a firm other than the audit opinions.

A further regression analysis run to test the relationship between audit opinions and weekly average prices, book value of equity and shares outstanding also reveals a negative relationship between audit opinions and the three dependent variables.

ANOVA results point to the fact that there is significant difference between means of audit opinions on the one hand and average weekly share prices, closing share prices, book value of shares and shares outstanding on the other hand. The ANOVA results reveal that the weak relationship between audit opinions and share prices was not significant.

These findings are consistent with those of Baskin (1972) and Mittelstaedt et al. (1992) who argue that the market reacts weakly to the information contained in audit reports and audit

opinions. They conclude that the equity market does not actively respond to audit announcements. Their results imply that an audit opinion announcement is an event that conveys little information.

5.3 Conclusion and Recommendations

This study examined the market reaction to the announcement of audit opinions at the Nairobi Stock Exchange over a five-year period (2004-2008), and provides empirical evidence of the economic impact of auditors' reports in the Kenyan capital market. Without controlling for the effect of changes in accounting earnings and other concurrent announcements, we find that audit opinions are associated with very weak negative market returns and a difference in market reaction between qualified opinion and unqualified opinion with explanatory note(s) is not observed either. Based on the statistical significance of the test results, we conclude that investors have arrived at a convergent interpretation of audit opinions in their investment decisions and, therefore, audit reports have value relevance, and independent auditing as an institution plays an important role in the emerging Kenyan stock market. However, there are many other factors or events that influence share prices concurrently.

This study recommends that ICPAK should strengthen its regulatory role in the audit industry to ensure that the audit reports and financial statements that are released to the public are sound and reliable. This will eliminate any possible collusion between company management and auditors. The study also recommends that companies listed at the Nairobi Stock Exchange should forward their interim (quarterly or semi-annual) audit reports to the Nairobi Stock Exchange and the Capital Markets Authority to enable investors and regulators fully interpret their audit reports and financial statements on a continuous basis. This will assist investors in deciding which stocks to invest in their portfolio based on the regular audit reports examined. A relevant Act of parliament should be passed to facilitate this.

5.4 Limitation of the study

This study was carried out as an event study assuming that audit opinions were the only factors that influenced share prices at the time of audit opinion announcements. There are quite a

number of other micro and macro-economic factors that might have influenced share prices during the period of study.

5.5 Recommendations for further research

1. A study can be done to expand the investment items beyond stocks to investigate the role of audit opinions in influencing investors' decisions on other financial instruments such as corporate bonds.
2. Further studies can be done to establish to what extent audit opinions alone can influence share prices, after controlling for other concurrent announcements and micro and macro-economic factors.

REFERENCES

Abdel-Khalik, A. R., & Wu., A. (1996). The Association between Stock Prices and Accounting Disclosure in the Emerging Chinese Capital Market. Working paper, Taiwan Chenchi University

Alderman, C. W. (1977). The Role of Uncertainty Qualifications: Evidence to Support the Tentative Conclusions of the Cohen Commission. *Journal of Accountancy* (November): pp. 97-100.

Al-Thuneibat, Ali A.; Khamees, Basheer A; Al-Fayoumi and Nedal A (2008). The effect of qualified auditors' opinions on share prices: Evidence from Jordan.

Ameen E.C., Chan K. and Guffey D.M. (1992). Information content of qualified audit opinions for over –the- counter firms

Ball R., & Brown, P. (1968). An Empirical Evaluation of Accounting Income Numbers. *Journal of Accounting Research*, 6, pp. 159 – 178.

Barberis, N. and Thaler R. (2001). A Survey of Behavioral Finance.

Baskin, E. (1972). The Communicative Effectiveness of Consistency Exceptions. *The Accounting Review* 47 (January): pp. 38-51.

Beaver, W. H. (1981). *Financial Reporting: An Accounting Revolution???*, Engelwood Cliffs, NJ: Prentice Hall.

Central Bank of Kenya (CBK) Guidelines, (2005).

Chan, Y. K., & Walter, T. S. (1996). Qualified Audit Reports and Costly Contracting. *Asia Pacific Journal of Management* 13 (January): pp. 37- 63.

Chen K. and Church B., (1996). Going concern opinions and the market's reaction to bankruptcy filings.

Chen J.P., Su X. and Zhao R.(2000). An Emerging Market's Reaction to Initial Modified Audit Opinions: Evidence from the Shanghai Stock Exchange

_____ (2007). Effect of Auditing on Variability of Returns and Trading Volume

Choi, S. K., & Jeter, D. C. (1992). The Effect of Qualified Audit Opinion on Earnings Response Coefficients. *Journal of Accounting and Economics* 14: pp. 229-247.

_____ (2002). The effects of qualified audit opinions on earnings response coefficients.

Chow, C. W., & Rice, S. J. (1982). "Qualified Audit Opinions and Share Prices – An Investigation." *Auditing: A Journal of Practice and Theory* (Winter): pp. 35-53.

Citron, D. B., and R. J. Taffler. (1992). The Audit Report under Going Concern Uncertainties: An Empirical Analysis. *Accounting and Business Research* 2 (88): 337-345.

_____and Uang J. (2001). Do going concern uncertainty disclosures have market price impact?

Davis R.R., (2004), Using Disclaimers in Audit Reports: Discerning Between Shades of Opinion" CPA Journal.

DeFond, M. L., Wong, T. J., & Li, S. (1999). The Impact of Improved Auditor Independence on Audit Market Concentration in China. Paper presented in 1999 AAA Annual Meeting, San Diego, California.

Dodd, P., Dopuch, N., Holthausen, R., & Leftwich, R. (1984). Qualified Audit Opinions and Stock Prices: Information Content, Announcement Dates, and Concurrent Disclosures. *Journal of Accounting and Economics* 6 (April): pp. 3-38.

Dopuch, N., Holthausen, R., & Leftwich, R. (1986). Abnormal Stock Returns Associated with Media Disclosures of 'Subject to' Qualified Audit Opinions. *Journal of Accounting and Economics* 8 (June): pp. 93-118.

Dreman D. and M.A. Berry (1995). *Analyst Forecast Errors and Their Implications for Security Analysis*. *Financial Analysts' Journal*.

Elliott, J, A. (1982). "Subject to" Audit Opinions and Abnormal Security Returns — Outcomes and Ambiguities. *Journal of Accounting Research* 20 (2):617-638

Elliott R.S. and Schaub M., (n.d). Journal of Business & Economics Research Volume 2, Number 5. A Look at Audit Opinion Announcements and The Contagion Or Competitive Effect On Rival Firms

_____, Michael J. Highfield M.J. and Schaub M., (2006). Journal of Real Estate Finance and Economics, Vol. 32, No. 4, 2006. Contagion or Competition: Going Concern Audit Opinions for Real Estate Firms

Epstein, M. J., and M. A. Geiger (1994). Investor's View of Auditor Assurance: Recent Evidence of the "Expectation Gap". *Journal of Accountancy* 177 (1): 60-66.

Fama, Eugene F., (1970), entitled "Efficient Capital Markets: A Review of Theory and Empirical Work. *Journal of Finance* (The Journal of Finance, Vol. 25, No. 2) **25** (2): 383–417.

_____, (1998) Market efficiency, long-term returns, and behavioral finance, *Journal of Financial Economics*.

Fields, L. P., and M.S. Wilkins (1991). The Information Content of Withdrawn Audit Qualifications: New Evidence on the Value of "subject-to" opinions. *Auditing: A journal of Practice and Theory* 10 (2):62-69.

Firth, M. A. (1978). Qualified Audit Reports: Their Impact on Investment Decisions. *The Accounting Review* 53: pp. 642-50.

Fleak, S., and E. Wilson (1994). The Incremental Information Content of the going concern Audit Opinion. *Journal of Accounting Auditing and Finance* 9 (1):149-169.

Frost C.A. (1997). Disclosure policy choices of UK firms receiving modified audit reports

Ghicas D.C., Papadaki A., Siougle G. and Sougiannis T. (2008). The relevance of quantifiable audit qualifications in the valuation of IPOs

Gul F.A., (2009). Qualified audit reports, field dependence cognitive style, and their effects on decision making

Hatherly, D., J. Innes, and T. Brown (1991). The Expanded Audit Report—an Empirical Investigation. *Accounting and Business Research* 21 (4): 311-319.

Holt, G., and P. Moizer (1990). The Meaning of Audit reports. *Accounting and Business Research* 20 (78): 111-120.

Holthausen, R. W., & Verrecchia, R. E. (1988). The Effect of Sequential Information Releases on the Variance of Price Changes in an Intertemporal Multi-Asset Market.*Journal of Accounting Research* 26 (spring): pp. 82-106.

Institute of Certified Public Accountants of Kenya (ICPAK) Self Assessment Reports, (2006/2008).

International Monetary Fund (IMF) Annual Progress Report (2007).

_____/United Nations Conference on Trade and Development Report (2006)

Jones, F. L. (1996). The Information Content of the Auditor's Going Concern Evaluation. *Journal of Accounting and Public Policy* 15:1-27.

Kamau, D.S. (2003) Turn of the Month and January Effects on Stock Prices at the Nairobi Stock Exchange. Unpublished MBA Project University of Nairobi.

Kausar, A., R. J. Taffler, and C. Tan. (2006). Anomalous price and Differential Stockholder response to going-concern audit opinions and withdrawals. Working Paper. University of Manchester, University of Edinburgh and Baruch College.

Kiio, E.K., (2006). An Empirical Investigation into Market Efficiency and the Effects of Cash Dividend Announcements on Share Prices of Companies Listed at the NSE, Unpublished MBA Project University of Nairobi.

Kiweu, J.M, (1991). The Behaviour of Share Prices in the NSE. An Empirical Investigation. Unpublished MBA Project, University of Nairobi.

Lev, B. (1989). On the Usefulness of Earnings and Earnings Research: Lessons and Directions from Two Decades of Empirical Research. *Journal of Accounting Research* 27 (Supplement): pp. 153-92.

_____ & Ohlson, J. (1982). Market-Based Empirical Research in Accounting: A Review, Interpretation, and Extension. *Journal of Accounting Research* 20 (Supplement): pp. 249-329.

Liu, Bo. (1997). An Empirical Analysis of Chinese Security Markets (in Chinese). Shanghai, China: Xue-Lin Press.

Lo, Andrew (2004): "The Adaptive Market Hypothesis; market efficiency from an evolutionary perspective"

_____ (2005): "Reconciling Efficient Markets with Behavioral Finance: The Adaptive Markets Hypothesis

_____ and MacKinlay, Craig (2001). "A Non-random Walk Down Wall St." Princeton Paperbacks.

Loudder, M. L., Khurana, I.K., Sawyers, R.B., Cordery, C., Johnson, C., Lowe, J., & Wunderle, R. (1992). The Information Content of Audit Qualifications, *Auditing: A Journal of Practice & Theory* 11 (January): pp. 69-82.

MacKinlay, A. C.(1997) "Event Studies in Economics and Finance," Journal of Economic Literature *Vol. XXXV, Issue 1 (March, 1997).*

Malkiel B.G. (1987). "efficient market hypothesis," *The New Palgrave: a Dictionary of Economics*, v. 2, pp. 120–23.

_____ (1996). A Random Walk Down Wall Street, W. W. Norton.

McWilliams, A. and Siegel, D. (1997). "Event studies in management research: Theoretical and empirical issues" Academy of Management Journal, Vol. 40, No. 3.

Mednick, R. (1986). The Auditor's Role in Society-the auditor's report and the public expectation: A crisis in Communication. *Journal of Accountancy* 161 (2): 70-74.

Messier, W and C. Emby (2005). Auditing & Assurance Services: A systematic approach. McGraw-Hill Ryerson Limited, 2005.

Mittelstaedt, H. F., P. R. Regier, E. G. Chewning, and K. Pany(1992). Do Consistency Modifications Provide Information to Equity Markets? *Auditing, A Journal of Practice & Theory* 11 (1): 83-98.

Mo S. (2009). The information Content of audit qualification in the Post –Sox era. Case Western University.

Mokua, M.E, (2003). An Empirical Study on the Weekend Effect on the Stocks at the NSE. Unpublished MBA Project University of Nairobi.

Nair, R. D., and L. E. Rittenberg (1987). Messages perceived from Audit, Review and Compilation Reports: Extension to More Diverse Groups. *Auditing: A Journal of Practice and Theory* 7 (1): 15-38.

Nairobi Stock Exchange Website (2010). Listed Companies; Main Investment Market Segment (MIMS) and Alternative Investment Market Segment), July 2010.

Nicholson G., (2007). Role of the external auditor and audit committee within insolvency.

Ojo M. (2006). The Role of External Auditors and International Accounting Bodies in Financial Regulation and Supervision.

Ogneva M. and K.R. Subramanyam K.R (2007). Does the stock market underreact to going concern opinions? Evidence from the US and Australia

Ohlson, J. (1979). On the Financial Disclosure and the Behavior of Security Prices. *Journal of Accounting and Economics* 1: pp. 211-32.

Onyangoh, P.N., (2004). Stock Price Responses to Earnings Announcements: Evidence from NSE. Unpublished MBA Project University of Nairobi.

Rahman M. Z. (2001). Report on the Observance of Standards and Codes (ROSC), Kenya. By World Bank staff team(OPCFM).

Rasugu, C.N., (2005). The Existence of the Holiday Effect in the NSE. Unpublished MBA Project University of Nairobi.

Ryan, S. (1995). A Model of Accrual Measurement with Implications for the Evolution of Book-to-Market Ratio, *Journal of Accounting research*, Spring, pp. 95 –112.sed on the information provided by the Kenyan Authorities

Saibal G, (2007). External Auditing, Managerial Monitoring and Firm Valuation: An Empirical Analysis for India.

Schaub M., (2009). Applied Financial Economics, Volume 16, Issue 16 . Investor overreaction to going concern audit opinion announcements.

_____ and M. J. Highfield (2002). On the Information Content of Going Concern Opinions: the Effect of SAS numbers 58 and 59. *Journal of Asset Management* 4 (1): 22-31.

_____ and M. J. Highfield (2006a). Investor Reaction to Regulated Monopolies Announcing Going Concern Opinions: What Explains Contagion Among Electric Services Companies. *Review of Accounting and Finance* 5 (4): 393-409.

_____ and M. J. Highfield (2006b). Investor Overreaction to going concern audit opinion announcements. *Applied Financial Economics* 16: 1163-1170.

Shen, Y. F. (1996). Disclosure of Accounting Information and Semi-Strong Efficiency: An Empirical Analysis of the Chinese Market. *Accounting Research (Chinese)*, Vol. 1, pp. 14 – 17.

Shefrin, Hersh (2000). *Beyond Greed and Fear : Understanding Behavioral Finance and the Psychology of Investing*.

Shevlin T. and Whittred G., (1984). Australian Journal of Management, Vol. 9, No. 1, 37-52. Audit Qualifications and Share Prices: Further Evidence

Shiller, Robert J. (1998). Human Behavior and the Efficiency of the Financial System

Statement on Auditing Standards (SAS) No. 59: *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, issued by the Auditing Standards Board

Statman, Meir (1999). Behavioral finance: past battles and future engagements, association for investment management and research, financial analyst journal. Volume55, No.6 p 18-27

Sun, Z., Zhang, W. G., & Zhou, Q. Y. (1997). Relationship between Market Efficiency and Accounting Information, *Accounting Research (Chinese)*, Vol. 3, pp. 2- 12.

Swanson J. and Marshall P., Lokey H. and Norley L., Kirkland & Ellis International LLP (2008). A Practitioner's Guide to Company Restructuring, Andrew Miller's Valuation of a Distressed Company page 24.

Taffler, Lu, and Kausar's (2004). In denial? Stock market underreaction to going-concern audit report disclosures. Journal of Accounting and Economics 38, 263–285.

Thaler, Richard H. (1994) (Editor), Advance in Behavioral Finance.

Tuttle B. and Vandervelde S.D. (2009). Does the going concern audit opinion have a stabilizing effect on the overall stock market?

Tversky, A. & Kahneman, D. (1974). Judgment under uncertainty: Heuristics and biases. Science, 185, 1124-1130.

World Bank/International Monetary Fund Financial Sector Assessment Program/Project Appraisal Document (2003/2004).

Wu S.N., & Huang, Z.G. (1997). An Empirical Analysis on Earnings Announcements, Price Changes and Market Efficiency. *Accounting Research (Chinese*), Vol. 4, pp. 12 – 17.

Z. Jun Lin, Qingliang Tang and Jason Xiao (2003). An experimental study of users' responses to qualified audit reports in China.

APPENDICES

Appendix I: INTRODUCTION LETTER TO THE NAIROBI STOCK EXCHANGE

TO WHOM IT MAY CONCERN

Dear Sir/Madam,

RE: REQUEST FOR RESEARCH DATA

I am a postgraduate student at the University of Nairobi pursuing a course leading to the award of a master degree in Business Administration (MBA). To fulfil the requirements for the award of the degree, I am required to undertake a research project.

in this regard, I am undertaking a research project entitled **"The Effects of Modified Audit Opinions on share prices for companies quoted at the Nairobi Stock Exchange''** In order to achieve this objective, data concerning audit reports and audited financial statements, daily bid-ask prices, closing share prices, weekly average share prices, shares outstanding and book equity for the period 2004 to 2008 from your organization will be very useful. I hereby kindly request for the research data from your organization.
Any information that will be obtained from your database will be treated with strict confidentiality and will be used specifically for academic purposes only.

Yours faithfully,

Christopher Tanui	Herick Ondigo
Student	Supervisor

Appendix II: COMPANIES QUOTED AT THE NAIROBI STOCK EXCHANGE FROM 2004 TO 2008

1. East African Breweries Ltd.
2. Unilever Tea Ltd.
3. Kakuzi Ltd.
4. Rea Vipingo Plant.
5. Sasini Tea
6. Car and General
7. CMC Holdings
8. Kenya Airways
9. Marshalls (E. A)
10. Nation Media
11. Standard Group
12. Barclays Bank
13. CFC Bank
14. Diamond Trust
15. Housing Finance
16. Centum Investments
17. K.C.B Bank
18. Jubilee Insurance
19. National Bank
20. NIC Bank
21. Pan African Insurance
22. Standard Bank
23. Athi River Mining
24. Bamburi Cement
25. British American Tobacco Ltd.
26. BOC Kenya
27. Crown-Berger Kenya
28. East African Cables
29. Olympia Capital
30. East African Portland Cement
31. Sameer Africa
32. Kenya Power
33. Total Kenya
34. Unga Group
35. City Trust
36. Eaagards Limited
37. Express Kenya
38. Kapchorua Tea
39. Limuru Tea
40. Williamson Tea
41. Carbacid Investments
42. TPS East Africa Ltd.

43. Kenya oil Company
44. Mumias Sugar
45. Kenol