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The Effect of Auditors' Report on Earnings Persistence: Evidence from Listed Entities of Sri Lanka

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ABSTRACT

In the past literature, inconsistencies of the results were found in relation to the with regard to the impact on auditors' report (AR) and earnings persistence (EP). Similarly, less literature was able to find which examined the significance of the relationship between each type of five main categories of AR on EP and there is a doubt whether the users pay adequate attention to the AR when they are making decisions. Hence, the purpose of this paper is to examine the impact of different types of AR on EP of listed entities in Sri Lanka from 2012 to 2018. The study used descriptive statistics and a multiple panel regression model with the support of the literature. The findings showed significantly less EP with regard to DAR and no significant impacts were found with respect to the other ARs. Overall, this analysis concludes that there is an intrinsic value in the auditors' report and it has an informative value to the investors in Sri Lankan context. Modifications to AR indicate different degrees of concerns in companies which subsequently has an impact on EP. Thus, regulatory bodies and policymakers in Sri Lanka should highlight the importance of using AR. Further individual audit firms must also be more aware of the reputation risk and more effort on delivering appropriate AR to provide a better picture regarding the client organization.

1. INTRODUCTION

External Auditors' Report (AR) is the channel of communication between the external auditor and the users of the financial statements (Al-Thuneibat *et al.*, 2008). It will enhance the assurance level of the audited financial statements which provides the basis for investors to make their investment decisions. Since the management is different from the ownership of public limited companies, shareholders are keen to see whether the financial statements provide actual figures relating to the financial position and performance of the company. In order to facilitate such, AR plays a major role. According to Sri Lanka Auditing Standard 705 (SLAuS 705) auditors modify their opinion when they find problematic issues such as scope limitation, going concern ability, uncertainties, and disagreement in accounting applications. Hence, theoretically, an unmodified auditors 'opinion (UMO) may provide a positive signal to the investors resulting in positive market returns and vice versa (Choi & Jeter, 1992).

Even though the AR is a vital document it is doubtful whether the users pay adequate attention to the AR when they are making decisions. Anulasiri *et al.* (2015) also found that there is less information value in AR to investors in Sri Lankan Context. Similarly, Gwilliam (1987) argued that a number of studies have suggested that the average investor pays little attention to AR. Less attention on AR may be the reason for the recent corporate collapses that happened over the globe. For example, the Freddie Mac scandal in 2003 December, American International Group scandal in 2005 can be seen as global and local failures in the recent past.

Even after several studies, there is still no consensus on whether there is an information value for the AR when making investment decisions. In the Sri Lankan context under different circumstances, investors thoughtlessly invest in entities irrespective of the type of AR received and finally ended up losing the investment also. Hewage and Ediriwikrama (2021) and Anulasiri *et al.* (2015) conclude that there is a less informational value of AR in Sri Lankan context. If the users of the financial statements paid attention to the AR and got the benefit of information value, it is expected to refrain from investing in companies that have modifications in AR as they have fewer earnings persistence. Thus it is suspicious whether users pay satisfactory awareness to the information value of AR in decision-making process.

When analyzing the literature relating to the investigation of informativeness of AR (Dopuch *et al.*, 1986; Loudder *et al.*, 1992), it has been challenging to evaluate the usefulness of modified audit reports to investors. Francis (2004) emphasis in his study on earnings quality that it is difficult to discrete information in AR from other released information. However, in the current study, we are trying to mitigate effects from other released information in the market's reaction study by using EP. Many early studies (i.e. Frost, 1997; Choi & Jeter, 1992; Lam & Mensah2006; Sundgren, 2009; Vichitsarawong & Pornupatham, 2015; Moghaddam *et al.*, 2016) have been conducted with regard to AR and EP. Inconsistencies in the results were found in these studies. Please refer to Annexure 1 for the summary of previous studies.

It is expected that the outcome of the findings will be benefited to the scholars as there is a dearth of literature in Sri Lankan context relevant to AR and EP. Hence, the study attempts to bridge the knowledge and empirical gap in the existing literature by examining the effect of each type of AR on EP in Sri Lankan context. Investors and managers of the companies will have an opportunity to predict the future business performance with the support of information provided by AR as the companies with modified AR may have lower EP and vice versa. Correspondingly, understanding types of AR allows financial statement users to assess the earnings quality of listed companies and make effective economic decisions. Most professional institutions and experts engaged in the continuous reviewing of the activities of the auditors and updating the processes and Auditing Standards concurrently. The Institute of Chartered

Accountants of Sri Lanka (CASL) is the main responsible authority in relation to auditing practices. The results of this study will provide information on the intrinsic value of the AR to assess the importance of auditing to the users of the financial statements. As well as it will help them to strengthen their policy decisions on the auditing process. They can design their future initiatives relating to the revision of accounting and auditing standards by incorporating findings of this research.

2. LITERATURE REVIEW

2.1. Understanding and Defining AR

The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material aspects, in accordance with the applicable financial reporting framework (SLAuS 700). Accordingly, the auditor may provide either an unmodified opinion or a modified opinion in the AR depending on the circumstances.

As per SLAus 700, Auditors may provide UAR when firms' financial statements are presented fairly in accordance with financial reporting standards of the country. Similarly, without modifying the AR, an emphasis of matter will be disclosed which draws users' attention to a matter disclosed in the financials as per SLAuS 706. On the other hand, modification to the audit report was classified into mainly three types (i.e. qualified, adverse, disclaimer) in SLAuS 705 (2016). The auditor may provide QAR when, the auditor has obtained sufficient and appropriate audit evidence, concludes that misstatements, individually or in the aggregate are material, but not pervasive to the financial statements or the auditor is unable to obtain sufficient and appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effect on the undetected misstatements could be material but not pervasive. The auditor shall express an adverse opinion when, the auditor has obtained sufficient and appropriate audit evidence, concludes that misstatements, individually or in the aggregate are both material and pervasive to the financial statements. The auditor may express DAR when the auditor is unable to obtain sufficient and appropriate audit evidence and he concludes that the possible effect on the unobserved misstatements could be both material and pervasive. Further in extremely rare circumstances involving multiple uncertainties also auditor shall express DAR (SLAuS 705)

2.2. Understanding and Defining EP

EP is defined as the continuity and durability of the current earnings. It is affected by the magnitude of the accruals. Considering the effect of EP, it measures the ability of current earnings to explain and predict future earnings (Barth & Hutton, 2004; Jonas & Blanchet, 2000). Knowledge gathered on the earnings reports and the informativeness on the features of a firm's financial performance is highly useful in making economic decisions (Dechow & Schrand, 2010). Higher profits earned by the operating assets indicate the more persistent earnings and more able to maintain the current earnings. The accountability of earnings is to assist the investors to form potentials of firms' future cash flows. Firms with more justifiable earnings and cash flows have more EP. Similarly, Agustina *et al.* (2021) suggested that corporate governance being a vital factor in public organizations also has a positive implication on EP which is moderated by the audit committee.

When considering the audit modification, modified opinions will be received by the firms with concerns such as scope limitation, going concern ability, uncertainties, and disagreement on accounting applications. These issues are likely to reduce earnings quality, which should lower EP. Hence the firms with issues are likely to have unjustifiable earnings and lower earnings quality, which could be observed by lower EP (Vichitsarawong & Pornupatham, 2015).

In the literature, attempts were taken to examine the relationship between EP with audit quality (Ticoalu & Panggabean, 2020), audit fees (Ulupui, 2020), and cash flows (Pirveli, 2020). However limited literature was found in the examination of private information of companies signaled by auditors (Dopuch *et al.*, 1986; Loudder *et al.*, 1992), but it has been difficult to assess the informativeness of modified audit reports. However, those studies were unable to capture the role of AR in reflecting earnings information, without confounding effects from other released information. In the current study, the researcher tries to understand the relationship between each type of AR on EP in order to bridge the gap in the literature.

2.3. Theoretical Background

The signaling theory was originally proposed by Spence (1973) to explain job market behaviour. It helps to explain the behaviour of two parties when they have access to different information. The signaling theory has been widely used in accounting and auditing studies which proposed the management may signal something about the firm through various aspects of financial information disclosures which can be viewed as a signal by investors. At the time the information is announced, the investor will first evaluate or analyse the information as a good signal or a bad signal. These signals can be corporate profits, information on share issues, going concern issues, etc.

Considering the fundamentals of signaling theory, AR also can be viewed as a signal to the investors when they are making investment decisions. Theoretically, a UMO may provide a positive signal to the investors whereas modified AR has the potential to affect market expectations by signaling that earnings generated by the ûrm are noisier or less persistent (or both) than previously assumed by investors (Choi & Jeter, 1992). Further, auditing can be treated as one of the vital mechanisms that are in place to overcome the self-interest motives of managers. AR reflects the acceptance of the financial reporting of a firm and ensures that the financial statements give a true and fair view of the company. Hence any modification to the AR will issue a sign of red flag regarding the financial statements of the company to the stakeholders. Hence theoretically it is assumed that AR with negative opinions may yield comparatively lessor earnings in the future due to the issues of the entities.

2.4. Empirical Evidences on Relationship between AR and EP

Contradictions in the results were found when reviewing the literature on AR and EP. Frost (1997) showed that firms receiving modified AR are financially weaker and exhibit significant reductions in profitability compared to firms with UMO. Hence, audit modifications reflect some problematic accounting issues that have the potential to increase the "noise" or degree of uncertainty in the firm's present and future earnings, resulting in lower earnings quality.

Choi & Jeter (1992) discover that QAR is associated with a smaller earning response coefficient, agreeing with audit qualifications dropping the perception of the market on EP. Diverse degrees of information to the public will be conveyed by different types of audit opinions. Sundgren (2009) discloses that different types of modifications in the AR have positive relations with the possibility of bankruptcy level.

Consistently, Lam and Mensah (2006) found that firms receiving an unmodified opinion with emphasis on the matter were likely to survive afterward while those receiving qualified opinion had more severe financial distress. The conditions for issuing a qualified opinion include noisier or less sustainable earnings than circumstances reported by an unmodified opinion with emphasis on the matter. It concludes that different types of audit opinions do benefit financial statements users because the auditors' reports do have incremental predictive value. Association between audit modification and EP in Thailand was by Vichitsarawong and Pornupatham (2015). It was found that firms receiving modified opinions have lower EP than other firms. Results show that firms receiving a qualified opinion or a disclaimer have lower EP than firms receiving UME emphasizing that investors need to be mindful regarding the AR.

Contradicting the above results, Moghaddam *et al.* (2016) investigated 123 firms listed in the Tehran Stock Exchange from 2009 to 2013 to test the amount of the relationship between QAR and EP. The results showed that there is no significant relationship between QAR and EP.

Further, there are very few recent studies have been carried out to find the impact of AR and EP and resulted in contradictory results. Similarly, investigation of the impact of UMO on EP is a new variable in this study that couldn't be found in the literature. In Sri Lankan context no studies were seemed to be carried out in this respect. However, the results of the previous studies in different countries cannot be generalized to Sri Lankan context due to the unique set of the local context with the accounting system and legal system. For instance, countries like USA, UK have efficient capital markets and legal requirements on audit report publishing dates to shareholders are different across the countries. Hence, the study attempts to bridge the knowledge and empirical gap in the existing literature by examining the effect of each type of AR on EP in Sri Lankan context.

3. RESEARCH METHODOLOGY

UMO is a positive signal to the market as well as it shows that the financial statements of the entity provide a true and fair view, it is assumed to have a positive EP. Since a clean opinion will reflect a clear presentation of the financial statement of an entity, it will have higher earnings quality with less financial distress Therefore, the first alternative hypothesis is provided as:

H1: Firms with UMO have a positive impact on EP

In contrast to unmodified opinion, emphasis of matter and modified opinion may raise concerns about the reliability of the ûrm's ûnancial information which needs the user's attention. Modification is issued based on the materiality and persuasiveness of the issues found by the external auditors. Sundgren (2009) reveals that different types of audit modifications have positive relations with the likelihood of bankruptcy level. Dodd *et al.* (1984) point out that disclaimer opinion has a significant negative impact on stock prices, while audit qualification has no significant impact. Consistently, Lam and Mensah (2006) find that firms receiving a disclaimer have more severe financial distress than those receiving a qualified opinion. This implies that firms with a disclaimer have lower earnings quality than those with a qualification. Therefore, having a modification in the AR theoretically creates higher financial distress to the entity.

Accordingly the rest four alternative hypotheses are provided as:

H2: Firms with Unmodified auditors' reports with an emphasis on matter (UEM) have a negative impact on EP (Lam & Mensah, 2006; Vichitsarawong & Pornupatham, 2015)

H3: Firms with Qualified auditors' report (QAR) have a negative impact on EP (Lam & Mensah, 2006; Vichitsarawong & Pornupatham, 2015)

H4: Firms with Adverse auditors' report (ADAR) have a negative impact on EP (Lam & Mensah, 2006; Vichitsarawong & Pornupatham, 2015)

H5: Firms with Disclaimer auditors' report (DAR) have a negative impact on EP (Lam & Mensah, 2006; Vichitsarawong & Pornupatham, 2015)

3.1. Model Specification

To investigate the impact of the audit reports on EP of the companies, it is decided to use one Multiple Panel Regression Model using the Ordinary Least Square (OLS) method. It will clearly demonstrate the impact of each type of AR (independent variable) with future earnings (dependent variable) (Sloan, 1996; Vichitsarawong & Pornupatham, 2015). In conducting these analyses, the statistical software, 'E views 10' has been used. Therefore, following Sloan (1996) and Vichitsarawong and Pornupatham (2015), the below multiple regression model is used.

Earn it = α + β1Earn it-1 + β2UMO it-1 + β3UEM it-1 + β4QAR it-1 + β5ADAR it-1 + β6DAR it-1 + β7Earn it-1 X UM O it-1 + β8Earn it-1 X

UEM it-1 + β9Earn it-1 X QAR it-1 + β10Earn it-1 X ADAR it-1 + β11Earn it-1 X DAR it-1 + β12 MCAP it-1 + β13 AUD it-1 + β14 DIV it-1 + εit-1 (1)

Where;

Earn it	= Earnings of current year
Earn it -1	= Earnings of previous year
UMOit-1	= Unmodified auditors' report of previous year
UEMit-1	= Unmodified auditors' report with emphasis of matter of previous year
QAR it-1	= Qualified auditors' report of previous year
ADAR it-1	= Adverse auditors' report of previous year
DAR it-1	= Disclaimer auditors' report of previous year
MCAP it-1	= Firm Size of previous year
AUD it-1	= Auditors' Reputation of previous year
DIV it-1	= Dividend Effect of previous year

3.2. Data Collection Sampling

Data and information were collected using several sources. All the audited annual reports except for banking, finance, and insurance sector issued by the companies listed in CSE uploaded in the official websites of the CSE (www.cse.lk) during the period 2012 to 2018 were used in order to examine the type of the AR, auditor's reputation and Return on Capital Employed (ROCE). The rationale for selecting the time period is similar presentation financial statement can be founded from 2012 with the International Financial Reporting Standards (IFRS) adoption. Details of the control variables (dividend effect, market capitalization and, auditors' reputation) were taken from the following sources. The dividend effect and market capitalization of each company were taken from the data library CD of CSE for the period 2012-2018. The name of the auditors which is measured by auditors' reputation was obtained from individual AR.

To investigate the relationship between AR and EP, it was decided to obtain the population excluding the companies listed under the banks, finance, and insurance sector as it has unique characteristics which could not be found in non-finance companies when determining EP. There were 415 observations of the banking, finance, and insurance sector from 61 companies. Additionally, 14 observations falling in the top and bottom (1 of the sample) have been excluded to reduce the effect of outliers. Further, five observations were found with different reporting currencies which were excluded as missing data. Table 1 shows the composition of the sample of the regression analysis.

Table 1
Selection of sample for the Regression Model

Description	*No. of firm-year observations*
Total audited annual reports	1889
Less: Exclusion	
Banks, Finance and Insurance sector companies	415
Extreme Values (Outliers)	14
Missing data	5 (434)
The Final sample	1455

Source: Compiled by Researchers (2021)

3.3. Conceptualization

Auditors issue each type of AR considering the true and fair presentation of the financial reporting of a firm. As per SLAuS 705, modifications are issued looking at the materiality and pervasiveness of the misstatements. Theoretically, the seriousness of AR can be ranked as follows.

Table 2
Types of AR listed with the seriousness

Types of AR	*Seriousness/Risk*
Disclaimer auditors' report (DAR)	Very high risky
Adverse auditors' report (ADAR)	High risky
Qualified auditors' report (QAR)	Risky
Unmodified auditors' report with emphasis of matter (UEM)	Need attention
Unmodified auditors' report (UMO)	Nil

Source: Compiled by Researchers (2021)

When conceptualizing the relationship between AR and EP, theoretically a positive relationship can be seen with respect to UMO and EP. When auditors found challenging issues in the financial statements, they will modify the opinion. In such a situation, except for UMO, for all the other types of ARs, it emphasises that there is a concern with the auditors with regard to the financials of the company, maybe in terms of going concern, application of accounting policies, and scope limitations, etc. Hence, theoretically, there should be a negative relationship between the modified opinions and EP of the company. Empirical studies also supported

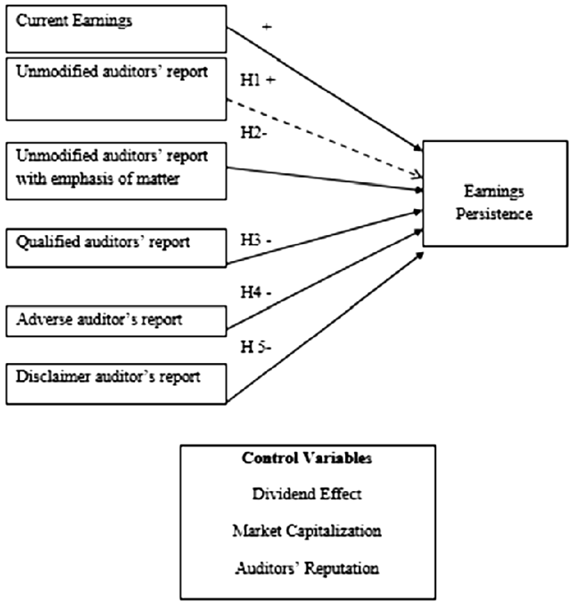

Figure 1: Conceptual Framework for AR and EP

this theoretical relationship where the conceptual framework has been developed based on findings of the literature. UMO is the variable that brings the novelty to the framework that assumes a positive relationship with earnings.

3.4. Operationalization of Variables

The regression model employs three main sets of variables to execute the conceptualized relationships namely; independent, dependent, and controlling. The dependent variable represents the EP which is measured from Return on Capital Employed Ratio (ROCE). Independent variables represent the previous year's earnings and each type of AR. In order to maintain the accurateness, the predicted relationships are controlled by using three main firm characteristics namely; Market Capitalization, Auditors' Reputation, and Dividend Effect. Table 3 shows the operationalization of the variables of the regression model.

4. DISCUSSION OF THE RESULTS

4.1. Descriptive Statistics

Under the descriptive analysis, firstly a descriptive statistic of variables with mean, median, maximum, minimum, standard deviation have been

Table 3
Operationalization of the Variables for the Regression Analysis

Key Concept	*Definition*	*Measure*	*Evidence*
Dependent Variable (DV)			
EP	The ability of current earnings to explain and predict future earnings.	Using regression model specified in equation 01	Barth and Hutton, 2004; Jonas and Blanchet, 2000; Bardia (2008); Vichitsarawong and Pornupatham (2015)
Independent Variables (IV)			
Earnings	The degree to which the firm's activity yields profit.	Return on Capital Employed of pervious year (Operating Income/ Capital Employed).	Bardia (2008)
UMO2	A type of AR where the auditor expresses an opinion that financial statements are presented in accordance with the applicable financial reporting framework.	'1' if the auditor issues UMO '0' otherwise.	SLAuS 700 (Revised)
UEM	A type of unmodified opinion that draws users' attention to a matter disclosed in the financial statements.	'1' if the auditor issues UEM '0' otherwise.	SLAuS 705
QAR	A type of AR issued by the auditor when he is unable to obtain sufficient and appropriate audit evidence or encountered misstatements, which are material, but not pervasive to the financial statements.	'1' if the auditor issues QAR '0' otherwise.	SLAuS 705
ADAR	A type of AR issued by the auditor when he encountered misstatements, which are both material and pervasive to the financial statements.	'1' if the auditor issues an ADAR'0' otherwise.	SLAuS 705
DAR	A type of AR issued by the auditor when he is unable to obtain sufficient and appropriate audit evidence or encountered misstatements, which are both material and pervasive to the financial statements.	'1' if the auditor issues DAR'0' otherwise.	SLAuS 705

Source: Compiled by Researchers (2021) presented in Table 4. This has been presented separately for each type of audit report (Panel A) except for ADAR as it has only one firm with ADAR in the sample. Panel B of Table 4 shows the descriptive statistics of the full sample without segregating the category.

As per Table 4, on average it is noted that firms with clean opinions (UMO) have significantly higher current and previous year's earnings (11.34 and 11.98 respectively) than those with modified opinions. Further, it is observed that firms receiving DAR have the lowest current and previous year's earnings (-14.68 and -8.77 respectively). Similarly, firms receiving DAR are comparatively small in terms of market capitalization (18.04). Overall Table 4, indicates that firms with modified opinions are likely to have problematic issues, resulting in lower earnings and becoming unprofitable, which impairs the ability to generate future earnings. This is consistent with Abolfazl et al (2016), Vichitsarawong and Pornupatham (2015), Lam and Mensah (2006), and Sundgren (2009).

Table 5, presents Pearson correlations of variables in this study. The results of the tables show no multicollinearity problem since there are no very high (more than 0.9) correlations between variables. Accordingly, current earnings are significantly and positively correlated with previous year earnings (0.670, p=0.0000), UMO, firm size, auditor reputation, and dividend, but are negatively correlated with UEM, QAR, ADAR, and DAR. A similar correlation can be seen in the previous year's earnings with the same variables. Therefore, it out can be pointed that future earnings are determined by these variables. Further, it shows UMO and UEM are positively correlated with firm size (0.437 and 0.025) and auditor reputation (0.188 and 0.086). However, UEM, QAR, ADAR, and DAR are negatively correlated with the dividend effect (-0.0158, -0.067, -0.122, and -0.032). It emphasizes that firms with modified opinions are less likely to pay dividends as they are not healthy in terms of earnings. Overall, there is strong significant evidence supporting H1 to H5 from the results of the correlation matrix. These results are agreed with the findings of Abolfazl *et al.*(2016), Vichitsarawong and Pornupatham (2015), Lam and Mensah (2006), Sundgren (2009).

Further, Sector classification is performed to observe the decomposition of each type of AR during the sample period. Table 5 shows sample decomposition by Industry and AR from 2012 to 2018. Sectors have been classified based on the 2018 CSE classification. As per Table 6, firms receiving UEM and modified opinions (QAR, ADAR, and DAR) are mainly from the hotel and travel sector (17%), land and property (14), and manufacturing (14%). Similarly, the hotel and travel sector has a larger

Table 4
Summary Descriptive Statistics of Independent Variables

Panel A

Variable/	*UMO*			*UEM*			*QAR*			*DAR*		
Statistics	$Earn_{it}$	$Earn_{it-1}$	$Mcap_{it-1}$	$Earn_{it}$	$Earn_{it-1}$	$Mcap_{it-1}$	$Earn_{it}$	$Earn_{it-1}$	$Mcap_{it-1}$	$Earn_{it}$	$Earn_{it-1}$	$Mcap_{it-1}$
Mean	11.34	11.98	21.52	-3.09	-2.52	21.18	-7.22	-2.74	20.41	-14.68	-8.77	19.91
Median	10.38	10.78	21.72	0.71	0.14	21.20	-2.51	-0.34	19.82	-14.90	-12.85	19.96
Maximum	368.55	360.40	26.24	84.03	74.37	25.99	27.94	48.00	24.87	0.010	68.08	21.96
Minimum	-145.1	-126.44	15.07	-98.18	-90.12	19.08	-126.40	-64.87	17.82	-37.67	-30.29	18.04
S.D	29.28	28.08	4.50	24.54	24.61	1.15	29.63	22.93	2.15	12.90	24.93	1.26
No. of obs		1300		116				25			14	

Summary Descriptive Statistics of Variables except Dummy Variables

Panel B

Variables	*Mean*	*Median*	*Maximum*	*Minimum*	*SD*	*Skewness*	*Kurtosis*
EARNit	1.5	2.2	6.0	(5.0)	2.0	(0.87)	3.3
EARNit-1	1.5	2.2	5.8	(4.6)	2.0	(0.74)	3.6
MCAPit-1	20.70	21.35	26.2	0	4.5	(3.8)	17.7

Note: No. of observations are 145

Table 5
Pearson Correlations of Variables

Correlation *Probability*	$EARN_{it}$	$EARN_{it-1}$	UMO_{it-1}	UEM_{it-1}	QAR_{it-1}	DAR_{it-1}	$ADAR_{it-1}$	AUD_{it-1}	DIV_{it-1}	$MCAP_{it-1}$
EARN it	1.0000									
	——-									
EARN it-1	0.6709	1.0000								
	(0.0000)	——-								
UMOit-1	0.3341	0.3655	1.0000							
	(0.0000)	(0.0000)	——-							
UEM it-1	-0.2294	-0.2433	-0.7227	1.0000						
	(0.0000)	(0.0000)	(0.0000)	——-						
QAR it-1	-0.1342	-0.1232	-0.3246	-0.0388	1.0000					
	(0.0000)	(0.0000)	(0.0000)	(0.1380)	——-					
DAR it-1	-0.1751	-0.1667	-0.2420	-0.0289	-0.0130	1.0000				
	(0.0000)	(0.0000)	(0.0000)	(0.2689)	(0.6195)	——-				
ADAR it-1	-0.0535	-0.0682	-0.0643	-0.0077	-0.0034	-0.0025	1.0000			
	(0.0412)	(0.0092)	(0.0140)	(0.7687)	(0.8949)	(0.9215)	——-			
AUD it-1	0.1678	0.1855	0.1882	0.0869	-0.0739	-0.0624	0.0124	1.0000		
	(0.0000)	(0.0000)	(0.0000)	(0.0009)	(0.0047)	(0.0172)	(0.6357)	——-		
DIV it-1	0.4490	0.5475	0.3094	-0.1584	-0.0670	-0.1226	-0.0326	0.2373	1.0000	
	(0.0000)	(0.0000)	(0.0000)	(0.0000)	(0.0104)	(0.0000)	(0.2133)	(0.0000)	——-	
MCAP it-1	0.2096	0.2534	0.4379	.0251	-0.0087	-0.0174	-0.0131	0.4313	0.3495	1.0000
	(0.0000)	(0.0000)	(0.0000)	(0.3368)	(0.7380)	(0.5061)	(0.6165)	(0.0000)	(0.0000)	——-

Note: The dependent variable is EARNit which is the Natural logarithm of operating income divided by capital employed of the current year; EARNit-1= Natural logarithm of operating income divided by capital employed of the previous year; UMOit-1 = 1 if the auditor issues UMO in the year t-1 and 0 otherwise;UEMit-1 = 1 if the auditor issues UME in the year t- 1 and 0 otherwise; QARit-1 = 1 if the auditor issues QAR in the year t-1 and 0 otherwise; DARit-1 = 1 if the auditor issues DAR in the year t-1 and 0 otherwise; ADAR it-1 = 1 if the auditor issues ADAR in the year t-1 and 0 otherwise; AUD it-1 = 1 if a firm is audited by one of the big 3 auditors in the year t-1 and 0 otherwise; DIV it-1 = 1 if a firm paid dividend in the year t-1and 0 otherwise; MCAP it-1 = Natural Logarithm of annual market capitalization of the firm in the year t-1;The p-values are provided within parenthes.

Table 6
Sample Composition by Sector and AR

Sector	*Clean Opinion*			*Modified Opinion*			
	UMO		*UME*	*QAR*	*ADAR*		*DAR*
	Firm-year observation	*%*	*%*		*Firm-year*		*observation*
Beverage, Food and Tobacco	149	12	1	4			3
Chemicals and Pharmaceuticals	39	3	8	2			6
Construction and Engineering	21	2	7				4
Diversified Holdings	108	8	16	2			12
Footwear and textiles	7	1					0
Healthcare	46	4	3				2
Investment Trusts	7	1	7				4
Information Technology	14	1					0
Land and Property	97	7	15	2	1	4	14
Hotels and Travel	245	18	26	1			17
Manufacturing	196	15	10	4		8	14
Motors	41	3		1			1
Oil Palms	35	3					0
Plantation	100	8	16			2	12
Power and Energy	52	4	2	2			3
Services	55	4	4	4			5
Stores suppliers	20	2		1			1
Telecommunications	14	1					0
Trading	54	4		2			1
Total	1236	100	116	25	1	14	100

Source: Annual Reports 2012-2018

number of firms receiving clean opinions (18%). Footwear and textiles, Information Technology, Oil Palms, and Telecommunications industries have never received a modified opinion within the period under review.

4.2. Regression Analysis

Table 7
Regression Results for AR and EP

Variable	*Coefficient*	*Std. Error*	*t-statistic*	*Prob.*
C	1.194817	0.299454	3.989981	0.0001**
EARNit-1	0.310470	0.025422	10.514676	0.0005**
UMOit-1	0.133379	0.564679	0.236204	0.8133
UEMit-1	-0.235981	0.593291	-0.397748	0.6909
QARit-1	-0.442680	0.641204	-0.690389	0.4901
ADARit-1	-1.021856	0.875164	-1.167617	0.2432

contd. table 7

Variable	*Coefficient*	*Std. Error*	*t-statistic*	*Prob.*
DARit-1	-2.596579	0.885868	-2.931113	0.0034**
EARN it-1*UMOit-1	-0.194749	0.451128	-0.431693	0.6660
EARN it-1*UEM it-1	-0.116824	0.453417	-0.257653	0.7967
EARN it-1*QAR it-1	-0.084858	0.453145	-0.187265	0.8515
EARN it-1*DAR it-1	-0.633988	0.470566	-1.347288	0.0181**
AUDit-1	0.072778	0.301841	0.241115	0.8095
DIVit-1	0.095873	0.117517	0.815820	0.4148
MCAPit-1	-0.016562	0.021337	-0.776237	0.4378
DUM_1	5.331012	1.490380	3.576947	0.0004
DUM_2	-5.218644	1.464533	-3.563351	0.0004
DUM_3	3.481247	1.486777	2.341472	0.0194
DUM_4	6.547944	1.488686	4.398473	0.0000
Adjusted R Square	0.546			
F Statistic	8.862**			
Durbin Watson Value	2.172			
No. of Observations	1456			

Note: Table 7 presents the panel data OLS regression results. The dependent variable is EP which is measured by ROCE (Operating Income /Capital Employed). C= Constant; EARNit-1= Natural logarithm of operating income divided by capital employed of the previous year; UMOit-1 =1if the auditor issues an unmodified auditors' report in the year t-1 and 0 otherwise;UEMit-1 = 1 if the auditor issues an unmodified auditors' report with emphasis of matter in the year t- 1 and 0 otherwise; QARit-1 = 1 if the auditor issues a qualified auditors' report in the year t-1 and 0 otherwise; DAR it-1 = 1 if the auditor issues a disclaimer auditors' report in the year t-1 and 0 otherwise; ADAR it-1 = 1 if the auditor issues an adverse auditors' report in the year t-1 and 0 otherwise; AUD it-1 = 1 if a firm is audited by one of the big 3 auditors in the year t-1 and 0 otherwise; DIV it-1 = 1 if a firm paid dividend in the year t-1and 0 otherwise; MCAP it-1 = Natural Logarithm of annual market capitalization of the firm in the year t-1; DUM_1 to DUM_4= Dummies. * Significant at 10 level, ** Significant at 5 level, *** Significant at 1 level.

At the time of selecting the sample for the regression analysis in the initial stage, 14 observations falling in the top and bottom (1 of the sample) have been excluded to reduce the effect of outliers. When performing the regression analysis, the main four outliers were noted while screening the Actual, Fitted, Residual graph in E views. In order to eliminate the impact from those outliers, we introduced four dummy variables to the initial regression model as follows.

Earn it = α+ β1Earnit-1 + β2UMOit-1 + β3UEMit-1 + β4QARit-1 + β5ADARit-1 + β6DARit-1 + β7Earnit-1 X UMOit-1 + β8Earnit-1 X UEMit-1 + β9Earnit-1 X QARit-1 + β10Earnit-1 X ADARit-1 + β11Earnit-1 X DARit-1 + β12 MCAPit-1 + β13AUD it-1 + β14 DIVit-1+β15DUM1 + β16DUM2+β17DUM3+β18DUM4+εit-1 (02)

The results of the regression analysis show that EARNit-1 which is the previous year's earnings in the model shows a positive 0.31 coefficient with a p-value of 0.005. Similarly, the constant is also positive 1.194 with a p-value of 0.0000. Hence it shows that without the impact of any other variables firms can have a statistically significant positive impact of 1.194 on future earnings. Considering the ARs, the highest negative significant coefficient among the modified AR can be seen in DAR which is -0.633 with a p-value of 0.018. It can be suggested that firms with disclaimer opinions will have negative EP. It appears that firms with material problematic issues which receive disclaimer opinions have very lower earnings ability in the future due to the risk involved in such companies. Hence there may be a risk of going concern continuity of similar types of firms. However, none of the other types of AR become statistically significant. Vichitsarawong and Pornupatham (2015) also found that the degree of EP in DAR is negative and lower than the QAR which is supported by the findings of this study. Sundgren (2009) also concluded that there is a positive and significant association between the likelihood of bankruptcy level and modified AR. Similarly, consistent results were found by Abolfazl *et al.* (2016) and Lam and Mensah (2006) in their studies relating to earnings. Nevertheless, these results are inconsistent with the outcomes of Rahmani and Talebnia (2013) and Moghaddam *et al.* (2016).

5. SUMMARY AND CONCLUSIONS

The current study examines the association between AR and EP in Sri Lanka. Overall, the researchers find that firms receiving modified opinions have lower EP than other firms. Currently, in Sri Lanka, it was observed that investors do not pay adequate attention to AR when making investment decisions Hewage and Ediriwikrama (2021). The results of the current study emphasize that there is an information value with regard to the EP in AR. Moreover, firms receiving DAR do have a significant negative relationship with EP. Similarly, when analysing the degree of the negative coefficient values of each type of modified AR, it shows that the highest risky AR which is the DAR has the highest negative earning coefficient, the second-highest negative earning coefficient by the ADAR, and UEM has the lowest negative coefficient. That shows the severity of the audit modification is reflected by EP. However, only the coefficient of DAR is significant. Further, it emphasizes that the firm's previous year's earnings also do have a significant impact on future earnings. High risky companies with internal financial reporting issues will receive a DAR which reflects that company has a significantly lower ability to generate future earnings than other firms which receive other modification opinions.

The current study contributes to the literature that the degree of EP inversely affects the degree of severity of audit modifications. The implication of the study is that there is information contained in a certain type of modification in relation to EP. Modified AR provides red flags about insecure companies. Hence it is advisable for investors to look at the AR before making an investment decision in order to get an understanding of the financial stability of the company rather than making unsighted investments. Hence investors need to be mindful when investing in firms mostly with disclaimer opinions. Similarly, managers need to adhere to the recommendation given by the auditors in the "Management Letter" and need to get the corrective actions immediately for the fair presentation of financial reports. Further, policymakers and regulatory bodies should highlight the importance of using auditors' reports. Our study is subject to limitations of the characteristics of a frontier stock market excluding the banking and finance sector due to unique features. The extension of this type of study to other institutional settings may be a direction for future research.

NOTES

1. Trading suspension of Entrust Securities PLC in 2016, Swarnamahal Financial Services PLC in 2018, and PC Pharma PLC in 2018 (CSE,2019) in Sri Lankan context.
2. Each types of AR (i,e., UMO, UEM ,QAR ,ADAR ,DAR) are considered to be dummy variables.

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Annexure 1
Summary of The Empirical Evidences on the relationship between AR and EP

Author(s)	*Context*	*Scope*	*Findings*
Positive Relationship between AR and EP			
Frost (1997)	United Kingdom (UK)	AR modified but not qualified and Qualified Report	Modified AR have a weaker financial situation and a significant reduction in profitability as compared to firms receiving unadjusted (acceptable) audit opinions.
Choi and Jeter (1992)	Korea	Qualified AR	Qualified AR are connected with smaller earning response coefficient, consistent with audit qualifications dropping the market perception in EP.
Lam and Mensah (2006)	Hong Kong	Modified with explanatory paragraph, Qualified Opinion, Disclaimer Opinion	Firms receiving modified opinions with "explanatory paragraph" were likely to survive afterwards whereas QAR had more severe financial distress.
Sundgren (2009)	Finland	Audit Opinions with modifications	Dissimilar types of modifications have positive relations with the possibility of bankruptcy level.
Pornupatham (2015)	Thailand	Unmodified with emphasis of matter and Qualified Opinions	Firms with problematic issues are likely to have unjustifiable earnings and lower earnings quality, which could be observed by lower EP.
Abolfazl et al. (2016)	Iran	Qualified AR	Firms with QAR have less EP as compared to firms with accepted audit opinions.
No Relationship between AR and Stock returns			
Rahmani and Talebnia (2013)	Tehran	Qualified AR	No significant relationship in type of auditor in no industry with earnings management index and there is significant and negative relationship in type of auditor report in the automobile industry, basic metals and materials and pharmaceutical products with earnings management index.
Moghaddam et al. (2016)	Tehran	Qualified AR	No major relationship between Qualified AR and EP was found