

The Impact of Auditing on Stock Prices of Amman Stock Market's Listed Companies

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Abstract

The purpose of current study is to explore the impact of auditing on stock prices of Amman stock market. Study is conducted based on primary data collected from finance managers of listed companies of Amman stock market, about audit and its impact of stock prices. Impact of audit is indicated in terms of audit quality and its effect on financial performance of firm because stock prices are an indicator of financial performance of firms. To find out the relationship among key variables of study, audit quality and stock prices, hypotheses are proposed as well as tested using SPSS and AMOS. Descriptive analysis, factor analysis and structural equation modeling is implemented to find out the results. It is found that audit has a direct impact on stock prices of firms in Amman stock market, while improved audit quality results in improved financial performance of the firm indicated in their stock prices.

Keywords: Audit, Audit Quality, Financial Performance, Finance Managers, Stock Prices, Amman Stock Market.

1. Introduction

Economic development of countries is indicated in terms of investment activities, which are dependent on the financial situation of the company (Anvarkhatibi, Safashur and Mohammadi, 2012). Thus, financial statements are considered as an important tool to make investment decisions, but for this purpose the transparency of information disclosed in financial statements is quite necessary. To make such information transparent and to eliminate ambiguities, audit reports serve as a medium of communication between auditors and investment decision makers (Moradi et al, 2011). Although investigated by many researchers, contradictory findings are reported. At one hand, audit has significant relationship with stock prices (Hoti et al, 2012) while on the other hand having no relationship with the stock prices of companies Al-(Thuneibat, Khamees and Al-Fayoumi, 2007). Due to such contradictory findings, it becomes unclear that whether audit influences stock prices, especially in listed companies of Amman stock exchange. Therefore, there is a need to explore such influence. For this purpose, current study aims and have a motivation to explore the opinions of finance managers of listed companies of Amman stock market that whether audit has an impact on stock prices. Through exploring such impact, current study will contribute

academically in the research about Amman stock market as well as practically for investors by highlighting the impact of audit, so that they would be confident about their investment decisions in Amman stock market.

2. Literature Review

Investment decisions by investors, brokerage firms and dealers are made after certain evaluation of the financial information disclosed by the company, so they mostly rely on audit reports for assuring the fairness of information so that effective decisions can be made. Thus, audit reports are considered as a constructive source of information for investment decisions about company stocks (Anvarkhatibi, Safashur and Mohammadi, 2012). Audit reports are the product of auditing process, thus quality of audit process influences investment decisions, when audit reports are used as major source of information while making investment decisions. Such influences are indicated in the share prices of the listed companies because changes in share prices are the reflection of changes in investment decisions by investors and other stakeholders (Moradi et al, 2011). The advantages of auditing are un-contentious in developed as well as emerging economies as it enhances investors' confidence on organizations by improving their trustworthiness on financial statements. Financial information disclosed in financial statements is ordinary to all investors, thus increased confidence on it reduces discrepancy in investors' appraisal of firm value. Therefore, investors mostly rely on audited information, and it is found that auditing has beneficial influences on trading volume as well as stock returns of the firms (Chen, Srinidhi and Su, 2014).

Hoti et al, (2012) investigated that how audit opinion influences stock prices and found that stock prices fluctuate in reaction of audit opinion provided by auditors. Audit quality as well as auditors' opinion has significant influence on stock prices movements, because investors seek towards auditors' opinion as a source of reliable information about company's financial performance. Hussainey (2009) state that audit quality has an influence on investors' perceptions about firms' financial performance. Audit quality influences their ability to forecast future earnings of the firms and make decisions accordingly that is reflected in stock price movements. Investors feel confident about their investment decisions for firms having audited financial information as compare to unaudited information of firms. Due to such increased confidence in firms' profitability based on the trustworthiness of information, demand for such stocks increases as well as their trading volume enhances, which in turn has significant influence on stock prices (Hussainey, 2009). Investors rely on audit quality of the firm and differentiate among profitable and unprofitable firms, hence making forecasts about their future earnings. Firm specific information is incorporated in its stock prices, which is influenced by foreign ownership, ownership concentration and audit quality. Shareholders mainly focus on auditor's quality as they link it with the quality of information provided by the company. If they feel any uncertainties about auditor's quality, they do not rely on company's financial information rather have negative response about such firms which have any quality issues (Gul, Kim and Qiu, 2010). Goosh and Moon (2005) state that along with audit quality, investors are also concerned about auditors' tenure and associate auditors' tenure with their earnings quality. Extended tenures lead towards enhanced stock rankings with a perception to have quality earnings from the firm. As auditors' tenure increases the influence of past earnings also becomes greater on next year's earnings. Information intermediaries and investors relate auditor's tenure with audit quality having a perception in mind that increased tenure ensures improved audit quality. Chaney and Philipich (2002) audit quality is also associated with the auditor's reputation which in turn has an influence on

investors' behavior towards auditors' clients' stocks. Audit companies having shredded reputation due to audit failures has a negative influence on their clients' stock market activities. Investors show negative market reaction towards companies who are associated with audit firms that fail to perform audit processes fairly. In such cases stock prices show huge fluctuations, hence audit has significant influence on stock prices of firms.

When firms go for external auditors, then reputation of audit firm significantly influences organization's stock prices because investors look for audit firm's reputation and react accordingly. When audit firms have reputational losses, then their clients must suffer great losses on their stock prices as well. Enron is a well-known example of such cases, when Andersen's reputation caused Enron to suffer huge loss in its market value (Asthana, Balsam and Krishnan, 2003). As auditor's reputation negatively influences stock prices of its client firms, firms mostly like to switch from such audit firms. Firms with developed corporate governance tend to switch more quickly as compare to others, because they do not want to suffer losses in their market value in case of declines in their stock prices. Although cost of finding new auditors is also incurred by the firm but it is still cost efficient to switch such auditors, because audit has a significant influence on stock prices which are at risk in such cases. Switching towards new auditor reduces the uncertainty associated with the stock prices in case of investor's reaction towards audit quality of the firm (Asthana, Balsam and Krishnan, 2010). Audit failures by audit firms not only cause harm to the audit firm's reputation but also destroys shareholders' trust and confidence towards client organizations. Shareholders rely on financial information disclosed by organizations for making their efficient investment decisions, while having confidence on information provided after quality audits. Investors' trading activities and their reactions towards company's financial information are reflected in stock prices and their fluctuations. Increased trading volume and improved stock prices indicate investors' positive behavior towards organization and vice versa. When shareholders find any discrepancies about audit process, audit quality or auditor's opinion they have negative reaction towards their investments which is indicated by reduced stock prices. Hence, audit has a significant influence on stock prices of firms (Skinner and Srinivasan, 2012).

Al-Thuneibat et al, (2011) has contradictory findings about impact of auditor tenure on audit quality. It is found that audit firm's relationship with its client as well as organization's size has significant influence on audit quality while increased auditors' tenure adversely affects audit quality. When auditor's tenure is extended, it deteriorates audit quality due to the growth in the extent of discretionary accruals. To enhance audit quality and auditor's independence, organizations should rotate audit firms so that investigations can be made with due care and greater scrutiny. Audit quality improvement is vital for firms to sustain investors' confidence about their financial performance. Improved audit quality will enhance financial reporting quality which in turn has an influence on company's stocks trading volume and stock prices. Al-Thuneibat, Khamees and Al-Fayoumi (2007) investigated the effect of competent audit reports on stock returns and share prices in Jordan and found that qualified auditor's opinion has no significant influence on share prices or stock returns.

Literature review shows contradictory findings about impact of audit on stock prices. But there is no research about the impact of audit in Amman stock market. Therefore, current study aims at exploring facts about audit influence on stock prices of listed companies in Amman stock market, so that researchers as well as investors of Amman stock market may reduce their ambiguities about their research and investments in Amman stock market.

3. Methodology

To examine the impact of audit on stock prices, responses from finance managers of listed companies of Amman stock exchange. Current study is a qualitative research based on primary data collected using a set of a structured questionnaire. A sample of 233 finance managers of listed companies of Amman stock exchange is selected and questionnaires are sent to them. Among those 180 responses were collected which are analysed using SPSS and AMOS.

3.1 Model of Study

Based on the aim of current study and aligning it previous studies, following hypothesis are proposed:

Ho: Audit has significant impact on stock prices of listed companies of Amman stock exchange.

H1: Audit has no significant impact on stock prices of listed companies of Amman stock exchange.

Following previous studies of Hussainey (2009), Gul, Kim and Qiu, (2010) and Chaney and Philipich (2002) impact of audit is measured in terms of its quality, which is further broken down into technical quality, service quality and need for audit quality. While their impact on stock prices are measured in terms of a set of items that indicate the response of finance managers about their impact. Thus, the variables of study are technical quality, service quality and need for quality as independent variables and stock prices as dependent variable. Based on this relationship following model of study is proposed:

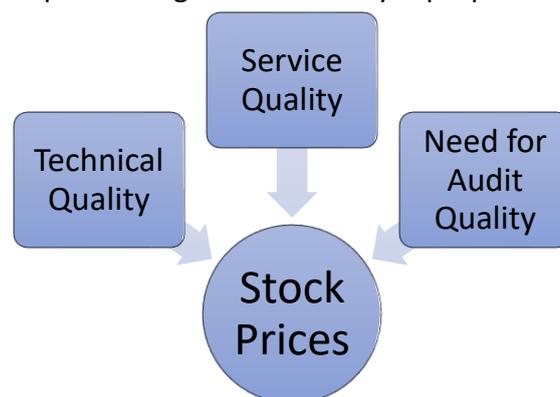


Figure 1: Model of Study

4. Empirical Testing and Results

The data collected through questionnaire is analysed using SPSS and AMOS. Initially the reliability of data is checked through cronbach's alpha. Sekaran (2003) state that cronbach's alpha greater than 0.7 is acceptable, as cronbach's alpha for this study is 0.874, thus it means data is reliable to be analysed.

Table 1: Reliability of Data

Cronbach's Alpha	N of Items
.874	20

4.1 Descriptive Analysis

Descriptive analysis is applied through SPSS to find out frequencies, which shows following results:

Table 2: Gender

		Frequency	Percent
Valid	Male	174	96.7
	female	6	3.3
	Total	180	100.0

Above table indicates that in Amman stock market's listed companies most of the finance managers are male, while having very few numbers of females working as finance managers.

Table 3: Age

		Frequency	Percent
Valid	<35	7	3.9
	35-45	170	94.4
	>45	3	1.7
	Total	180	100.0

Above table indicates that most of the finance managers belong to the age group of 35-45 years.

Table 4: Work Experience

		Frequency	Percent
Valid	1-2years	2	1.1
	2-3years	4	2.2
	3-4years	104	57.8
	4-5years	67	37.2
	>5 years	3	1.7
	Total	180	100.0

Above table indicates that most of the finance managers have 3-5 years of experience while very few managers having less than 3 years or more than 5 years of experience.

Table 5: Audit Committee

		Frequency	Percent
Valid	Yes	180	100.0

Table 6: Quality Assurance

		Frequency	Percent
Valid	Yes	180	100.0

Table 5 and 6 indicate that all the listed companies of Amman stock market are having their audit committees and maintain their quality assurance for audit practices.

Table 7: Auditor Tenure

		Frequency	Percent
Valid	<5years	100	55.6
	5-10years	76	42.2
	>10years	4	2.2
	Total	180	100.0

Above table indicates that most of organizations have less than 5 years of auditor tenure while many having 5-10 years of auditor tenure, very few having more than 10 years of relationship with their auditors.

4.2 Factor Analysis

Factor analysis is applied to extract components using principal component analysis through SPSS.

Table 8: Factor Analysis

Component Matrix

	Component			
	1	2	3	4
Reputation	.366	.536	.236	.219
Capability	-.100	.462	-.089	-.118
Independence	.272	.725	.152	-.044
Expertise	-.026	.263	-.121	.059
Experience	-.200	.569	.022	-.297
Non-Audit Service	.494	-.240	-.366	.075
Empathy	.506	-.139	.074	-.023
Client Service	.698	-.127	-.192	-.058
Robustness	.563	-.213	.421	-.348
Responsiveness	.572	.221	-.133	-.170
Audit_Quality1	.221	.259	.040	.526
Audit_Quality2	-.049	.031	.326	.703
Audit_Quality3	.078	-.144	-.056	.349
Audit_Quality4	.407	-.142	.416	.507
Audit_Quality5	.016	.438	-.316	.536
FP1	.018	-.210	.609	.532
FP2	.507	.046	.631	-.242
FP3	-.359	-.356	.570	.449
FP4	-.513	.434	.642	.156
FP5	-.318	.021	.687	-.240

Extraction Method: Principal Component Analysis.

Above table indicates that factor analysis has divided the items into four components. First five items that fall under component number 2 indicate the technical quality of audit, items 6-10 under component 1 indicate the service quality, items 11-15 under component 4 indicate need for audit quality and last five items under component 3 indicate stock prices fluctuations. Using SPSS these items are transformed into their underlying constructs i.e. technical quality, service quality, need for quality and stock prices, and structural equation modeling is implemented to find out the relationship.

4.3 Structural Equation Modeling

Following model has been proposed and tested through structural equation modeling using AMOS, to find out the relationship between dependent and independent variables of study.

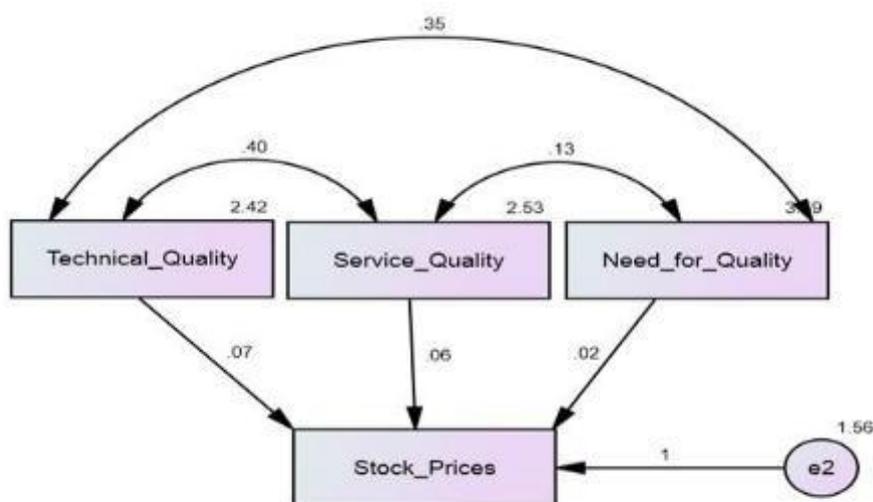


Figure 2: Structural Equation Model of Study

Above model indicates the relationship between dependent and independent variables, which is tested through structural equation modeling applied through AMOS. Chi square test indicates the results of tested relationship, by testing null hypothesis as “model is good fit”; means the proposed relationships depict the true picture. In this case, if null hypothesis is accepted it will indicate that audit; measured through its proxy’s i.e. technical quality, service quality and need for quality has an influence on stock prices. If rejected, then alternate hypothesis that “model is not good fit” is accepted, which means there is no association between these variables of study and independent variables do not influence dependent variable.

Results indicate that chi square for above tested model is 0.045 with p value of 0.73. Hence null hypothesis is not rejected, thus indicating that audit has significant influence on stock prices. Moreover, this relationship is further verified by the results of model fit summary, which are as follows:

Table 9: CMIN

Model	NPAR	CMIN	DF	P	CMIN/DF
Default model	10	.065	0		
Saturated model	10	.000	0		
Independence model	4	9.471	6	.149	1.579

Table 10: RMR, GFI

Model	RMR	GFI	AGFI	PGFI
Default model	.000	1.000		
Saturated model	.000	1.000		
Independence model	.185	.974	.957	.585

Table 11: RMSEA

Model	RMSEA	LO 90	HI 90	PCLOSE
Independence model	.000	.000	.122	.309

Table 12: AIC

Model	AIC	BCC	BIC	CAIC
Default model	20.000	20.575	51.930	61.930
Saturated model	20.000	20.575	51.930	61.930
Independence model	17.471	17.701	30.243	34.243

Above tables indicate the model fit summary of the tested model, which facilitates making decisions based on various criteria like CMIN (smaller value is better; indicates good fit), GFI (good fit at 1, poor fit at 0), RMSEA (good fit at 0, poor fit at 0.1) and AIC (lower value as compare to other criteria like BCC, BIC and CAIC indicates good fit).

Tested model of current study has CMIN 0.065, GFI 1.0, RMSEA 0.00 and AIC having smaller value as compare to other criteria. Thus, based on these results it is indicated that tested model indicates true relationships between variables of study and audit has significant impact on stock prices.

5. Discussions and Findings

Per the results found after empirical analysis, the proposed null model of current study is accepted that audit has significant impact on stock prices of listed companies of Amman stock market. these findings validate the previous findings of Hoti et al (2012), Hussainey (2009), Gul, Kim and Qiu (2010) and Goosh and Moon (2005) arguing that investors consider audit reports and audit opinions as trustable sources of financial information about companies. Audit quality influences investor's behavior towards company's stock which is indicated by the fluctuations in stock prices. Thus, audit has significant influence on stock prices of companies. While these findings are contradicted the findings of Asthana, Balsam and Krishnan (2003, 2010) and Skinner and Srinivasan (2012), that audit has no significant influence on stock prices. Current study found that investors consider audited information as more reliable as compare to unaudited information. Investor's confidence increases for companies that focus on audit quality, while reduced audit quality has negative influence on

stock prices. Thus, it is found that audit has significant impact on stock prices and companies should focus on their audit quality to sustain their investors' trust on them.

6. Conclusion and Recommendations

Financial statements provide information about financial health of company, which is utilized by investors to make investment decisions. But investors seek for the trustworthiness of such information, thus they mostly rely on audited information. Audit quality plays significant role in developing investors' trust over company's information and they react accordingly. Investors' reaction is indicated in stock prices fluctuations. Companies focusing on audit quality have positive trends for their stock prices while those having audit quality issues face negative stock price reactions. Finance managers of listed companies of Amman stock exchange also responded that audit has significant influence on stock prices, which is measured in terms of audit quality; technical quality, service quality and need for audit quality. Firms ensuring audit quality and providing audited financial reports are successful in building and sustaining investors' confidence towards them. Thus, it is recommended that companies should focus on their audit practices and ensure audit quality because audit has significant influence on stock prices.

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Appendix

Questionnaire

Please choose the right option:

1. Gender

1. Male 2. Female

2. Age Group

1. <35 years. 2. 35-45 years. 3. >45 years.

3. Work experience with the firm

1. 1-2 years. 2. 2-3 years 3. 3-4 years. 4. 4-5 years. 5. More than 5 years

4. Existence of an audit committee?

1. Yes 2. No.

5. Possession of a recognized quality assurance standard?

1. Yes 2. No

6. Auditor Tenure

1. <5 years. 2. 5-10 years. 3. >10 years

7. Please mark the right option whereas; 1. Strongly Agree (SA) 2. Agree (A) 3. Neutral (N) 4. Disagree (DA) 5. Strongly Disagree (SDA)

Adopted from: Duff (2004), Topping (2015) and IAASB (2012)