# If Leases are not Capitalized: The Effects of a Qualified Audit Opinion on Investors' Judgments and Decisions

**Botao Chen**
**University of Maryland Eastern Shore**

**Xia Zhang**
**Alabama A&M University**

*FASB's new leases standard ASC 842 requires most leases to capitalize on a balance sheet. If some leases are misclassified and not capitalized, the auditor will issue a qualified audit opinion on financial statements. This study conducts an experiment with 68 MBA students to examine the informative value of a qualified opinion due to lease misclassification. The results reveal that this qualified opinion significantly decreases investors' willingness to invest in the client. Also, when the qualified opinion is issued, as compared to an unqualified opinion, investors perceive information related to company growth and return on common stock less important.*

## INTRODUCTION

The informative value of a qualified audit opinion has always been of vital concern to the public users and regulators. A qualified audit opinion is a relatively unclean opinion and quite common in practice. Auditors issue qualified audit opinions because the financial statements that they audit have material but not pervasive deficiencies. These deficiencies are due to either a departure from Generally Accepted Accounting Principles (GAAP) or a scope limitation (PCAOB, 2007). In terms of judging the fairness of financial statements, a qualified audit opinion falls in between an unqualified audit opinion, which sends a positive signal, and an adverse audit opinion, where financial statements are not presented fairly in accordance with GAAP. To what extent do investors tolerate the misstatements on a qualified audit opinion? Prior research has examined the effects of a qualified audit opinion on investors' judgments and decisions; however, the results of the research have been mixed because audit qualifications are not homogenous (e.g., Firth, 1978; Chow and Rice, 1982; Gul, 1987; Lin, Tang, and Xiao, 2003).

Whether a qualified audit opinion has an informative value depends on investors' perceptions of the various types of audit qualifications. Some types of audit qualifications have a significant effect on investors' decisions while others do not (Firth, 1978). For instance, Chow and Rice (1982) find that "asset realization" qualified audit opinions have more negative impacts on stock prices than "uncertainty" qualifications in the U.S. Gul (1987) indicates that the "except for" qualified audit opinion due to litigation uncertainty negatively affects share prices. However, Lin et al. (2003) find a qualified audit opinion due to inaccessible inventory has no significant effect on Chinese loan officers' credit decisions, although this opinion negatively affects these loan officers' perceptions of the credibility of financial

statements. Because audit qualifications are not homogeneous, it is necessary to examine the effects of a qualified audit opinion on the basis of different audit qualifications.

This study focuses on a qualified audit opinion due to lease misclassification. Because leases compose an important part of a company's finances, investors are very concerned about the leasing information in a company's financial report, and auditors are required to examine the information during their auditing procedures. However, the complexity of classification standards on leases can create auditor-client disputes. For instance, KPMG recently disputed lease accounting with the Commodity Futures Trading Commission (CFTC) and issued a qualified audit opinion due to large lease misstatements (CFTC, 2016). To draw a complete picture of a company's lease activities, The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (ISAB) jointly proposed a standard related to lease classification in 2010 and issued final standards FASB Accounting Standards Codification (ASC) 842 and International Financial Reporting Standards (IFRS) 16 in 2016. Under both standards, most long-term or material leases are required to be classified as capital leases, which are included in the balance sheet. This complicated overhaul may create more auditor-client disputes, which may result in more qualified audit opinions being issued. This issue led us to examine the effect of a qualified audit opinion due to misclassification of leases on investors' judgments and decisions.

Although a number of previous studies examined the informative value of a qualified audit opinion in a U.S. audit report from the 1970s to 1990s (e.g., Chow and Rice, 1982; Ameen, Chan, and Guffey, 1994), these studies need to be re-examined due to the changes in the U.S. audit report format and business environment. In 2002, in response to a series of American business scandals such as WorldCom and Enron, the Sarbanes-Oxley Act (SOX) was enacted and required an opinion on internal control over financial reporting (an internal control opinion) in addition to or integrated with the financial statement audit opinion in an auditor's report. Because an internal control opinion affects a financial statements opinion (Asare, 2012; Goh, Krishnan, and Li, 2013), whether a qualified audit opinion still affects investors' judgments and decisions needs to be examined under the post-SOX environment. Additionally, in terms of the business environment, the 2008 financial crisis may also change investors' attitudes towards a qualified audit opinion. After the 2008 financial crisis, investors' optimism and confidence in financial reporting were shaken. Therefore, investors' attitudes towards a qualified audit opinion may be more conservative than before. However, after SOX, especially after the 2008 financial crisis, little research has been conducted to examine the effects of a qualified audit opinion in an integrated audit report.

The purpose of this study is to examine whether a qualified audit opinion in an integrated audit report still has informative value to investors today. After the 2008 financial crisis, the public may have a lower tolerance to material errors reported in a qualified audit opinion than before. A qualified audit opinion is considered "bad news" and conveys negative information to investors. Based on negative bias theory (Lewicka, Czapinski, and Czapiniski, 1992; Baumeister, Bratslavsky, and Finkenauer, 2001; Rozin and Royzman, 2001), negative information weighs more heavily on users' decisions than positive information. Thus, investors will pay more attention to a qualified audit opinion ("bad news") when they make judgments and decisions. Furthermore, the halo effect of a qualified audit opinion will affect investors' perceptions of the credibility of financial statements as well as their trust in other information in the financial report such as company growth and return on common stock. Halo Effect is a cognitive bias and first described by Edward Thorndike (Thorndike, 1920). Based on Thorndike (1920), halo effect refers to the transfer of perceptions of any one trait of a person or thing to another related or unrelated trait. That is, if an investor does not like a piece of information in a financial report, s/he will have a negative predisposition toward other information in this financial report.

The study employs an experimental approach. The participants are 68 MBA students at a private university in the southern U.S., who are randomly assigned to one of two treatment conditions: an unqualified audit opinion and a qualified audit opinion regarding misclassification of leases. Participants are presented with a case involving a large public retailer's financial statements, company growth facts, and the integrated auditor's report under AS 5 (PCAOB, 2007). This study examines investors' risk

assessments and their decisions as well as their perceptions of the importance of company growth and return on common stock, which are two key indicators of company performance and profitability. The study also conducts supplemental analysis which asks the participants to score the importance on a series of information involving the experimental instrument.

The results indicate that a qualified opinion due to misclassification of leases has an informative value to investors. This qualified audit opinion significantly decreases an investor's willingness to invest in the client. When the qualified audit opinion is issued, as compared to an unqualified audit opinion, investors perceive information related to company growth and return on common stock as less important. The findings suggest that a qualified audit opinion due to lease misclassification reduces the credibility of a financial report and investors have a low tolerance for this misclassification.

This study contributes to the prior literature related to the effects of a qualified audit opinion. Corresponding to the issuance of the new leases standards FASB ASC 842 (2016) and IFRS 16 (2016), this study investigates the effect of a specific type of audit qualification - misclassification of leases. Since investors attach great importance to leasing information, they perceive that this qualified audit opinion conveys "bad news," which affects the credibility of financial reporting via halo effects. When the qualified audit opinion is issued, investors put less trust in other information such as company growth and return on common stock provided in financial reporting and become less willing to invest in this company.

Furthermore, as one of the few research updates after the 2008 financial crisis, this study suggests nonprofessional investors' conservative attitudes towards a qualified audit opinion. The findings confirm the informative value of a qualified audit opinion in an integrated report. In this study, as required by SOX, an audit opinion on financial statements is integrated with an internal control opinion over financial reporting. However, even if an internal control opinion is unqualified, a qualified audit opinion is considered "bad news," which conveys negative information to investors. The results have strong implications to audit researchers and regulators such as the U.S. Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB).

The remainder of this paper is organized as follows. The second section develops the hypotheses based on psychology theory and previous empirical research. The third section describes the research method. The fourth section presents the results. The fifth section concludes with a discussion of the results.

## LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

### Background

To evaluate a company's financial condition and performance, investors analyze the company's financial reporting as well as other available information about the company. Because investors do not possess sufficient information about the business and its financial transactions, they rely on the independent auditor's report on the fairness of financial statements. The PCAOB categorizes audit opinions on financial statements as unqualified, qualified, and adverse opinions (PCAOB, 2007). An unqualified audit opinion provides assurance on the fairness of financial statements; an adverse opinion, in contrast, provides negative information and states that the financial statements are not fairly presented. A qualified audit opinion falls in between these two opinions in that it indicates one or more material but non-pervasive mistakes in the financial statements. Based on PCAOB (2007), the issuance of a qualified audit opinion is due to two types of audit qualifications: departures from GAAP and scope limitations. Lease misclassification is a typical example of a departure from GAAP.

PCAOB (2007) presents an example of a qualified audit opinion due to misclassification of leases. Leasing is a major means of using assets without the risk of owning. In lease accounting, leases are classified as either capital leases or operating leases. Operating leases are rent expenses where the leased asset is not reported on the balance sheet while capital leases are treated as an asset purchase and are recorded on the balance sheet. Accordingly, capital leases reduce the company's return on assets and liability to equity ratios, which can make the company's performance look worse. A company will

structure leases as operating, rather than capital leases, in order to avoid this situation. However, due to the complexity of classification standards, auditors may disagree to management's classification of leases; auditor-client disputes happen, and the audit qualification is disclosed in a qualified audit opinion if not resolved. For many years, lease activities were allowed to be "off the balance sheet," which makes it difficult for investors to accurately evaluate the company's financial health (FASB ASC 840, 2010). FASB and IASB jointly proposed to change the lease accounting standards in 2010 and thus, in 2016 new leases standards FASB ASC 842 (2016) and IFRS 16 (2016) were issued by FASB and ISAB, respectively. Under both new standards, most leases are required to be presented on the balance sheet. Additionally, during the transition period, a retrospective method is required. Therefore, it is meaningful to examine the effects of a qualified audit opinion due to misclassification of leases on investors' judgments and decisions after the standards update.

Finally, the audit report model changed in 2002. In early 2000, American business scandals such as WorldCom and Enron shook public users' confidence in auditors' reports. To restore users' confidence, Congress passed SOX in 2002. SOX requires that auditors examine and report on internal controls over financial reporting. PCAOB states that the audit of internal control over financial reporting is an integral part of the audit of the financial statements (PCAOB, 2007). In fact, auditing a company's leases is a necessary procedure. Therefore, the effects of a qualified audit opinion due to lease misclassification in an integrated audit report on investors' judgements and decisions should be reexamined.

**Prior Literature**

There are two streams of prior research examining the effect of a qualified audit opinion. The first focuses on the effects of specific types of audit qualification. Firth (1978) uses questionnaires to find that certain types of qualifications such as the going concern and asset valuation affect bankers or credit analysts' decisions. Chow and Rice (1982) find that "asset realization" qualified audit opinions have negative impacts on stock prices compared with "uncertainty" qualifications in the U.S. Gul (1987) uses the experimental approach to discover that the "except for" qualified reports due to litigation uncertainty negatively affects the share prices. However, Bessell, Anandarajan, and Umar (2003) use an experimental study with Australian data to indicate that the qualified report with an "Emphasis of matter," and "Except for report" has no information value even if the company is in a state of financial crisis. Lin et al. (2003) also use an experimental study to find that a qualified audit opinion due to inaccessible inventory has no significant difference on Chinese loan officers' credit decisions, although the qualified audit opinion negatively affects Chinese credit and loan officers' perceptions of the credibility of financial statements.

The second stream reveals that the informative value of a qualified audit opinion has changed as economic development has changed because economic development influences investors' attitudes towards a qualified audit opinion. During the period from the 1970s to early 2000s, most studies suggest that qualified audit opinions negatively affect public users' decisions or stock prices. For instance, Ameen et al. (1994) use an event study to find a negative market reaction in the U.S. prior to the release of the qualified audit opinions, but no market reaction during the event period. Soltanis (2000) demonstrates the significant negative effects of a large sample of qualified audit opinions on abnormal returns in French markets. In 2002, SOX changed the audit report format and required that an opinion on internal control over financial reporting be integrated with an audit opinion on financial statements. Under the post-SOX environment before the 2008 financial crisis, investors' attitudes towards a qualified audit opinion were optimistic (e.g., Martinez, Martinez, and Benau, 2004; Al-Thuneibat, Khamees, and Al-Fayoumi, 2008). The rapid economic growth further boosted investors' optimism, and qualified audit opinions did not elicit much of a negative reaction from investors. Although little research has been conducted on American markets, most of the international studies deny the informative value of qualified audit opinions. For instance, Martinez et al. (2004) use an event study to find that there is no relationship between stock prices and qualified audit opinions in the Spanish capital market. Al-Thuneibat et al. (2008) use a market-based study to find that there are no significant effects of a qualified audit opinion on share prices and returns in Jordan market during the period of 2000-2005.

Investors' optimistic attitudes towards a qualified audit opinion were affected by the 2008 financial crisis. Investors' attitudes took a more conservative turn than before, as seen in Stunda and Pacini (2013), the most recent archival study in the U.S. They find that from 2005 to 2010, investors show significant negative share price responses to qualified audit opinions in the post-SOX environment (with or without auditor change). Abad, Sanchex-Ballesta, and Yague (2015) document that Spanish firms with audit qualifications show higher information asymmetry levels than those with unqualified audit opinions. Vichitsarawong and Pornupatham (2015) find that Thailand firms receiving modified opinions (qualified and disclaimer) have lower earnings persistence than firms receiving unqualified audit opinions.

Because the new leases standard FASB ASC 842 (2016) cause large changes on the balance sheet, we expect more auditor-client disputes, which may result in more qualified audit opinions due to lease misclassification. In addition, except for Stunda and Pacini (2013), scant literature in the U.S. examines the effects of qualified audit opinions after the 2008 financial crisis. Although Stunda and Pacini (2013) examine the effects of qualified audit opinions issued during 2005-2010, they do not consider the homogeneity of the types of internal control opinions. In fact, internal control opinions affect audit opinions on financial statements (Asare 2012; Goh et al. 2013). Taken together, it is necessary to examine whether a qualified audit opinion due to misclassification of leases has negative effects on investors' perceptions and decisions when it is integrated with an internal control opinion in an audit report.

**Risk Assessments and Investment Decisions**

In accordance with investors' conservative attitudes towards an audit qualification with regard to the misclassification of leases and the findings of Stunda and Pacini (2013), Abad et al. (2015), and Vichitsarawong and Pornupatham (2015), this study hypothesizes that a qualified audit opinion due to misclassification of leases has an informative value to American investors after the 2008 financial crisis because a qualified audit opinion conveys seriously negative information. Based on the negativity bias theory (Lewicka, et al., 1992; Baumeister, et al., 2001; Rozin and Royzman, 2001), negative information weighs more heavily on users' decisions than positive information. Therefore, when investors make their judgments and decisions, they consider a qualified audit opinion primary information and other information such as the unqualified internal control opinion secondary information. Additionally, the halo effect of the negative information causes a decline in investors' perceptions of the credibility of the financial statements. Investors perceive the investment risk as higher, and therefore, they are not willing to take this risk. The following hypotheses are tested in the study:

H1a: Investors' risk assessments are higher in the presence of a qualified audit opinion as compared to an unqualified audit opinion.

H1b: Investors are less likely to invest in the company in the presence of a qualified audit opinion as compared to an unqualified audit opinion.

**Perceived Importance of Company Growth and Return on Common Stock**

When investors make their decisions, they mainly evaluate a company's operations and its profitability. To help investors review management performance and profitability, a company uses many financial indictors to analyze its financial statements in the management discussion and analysis section of its annual report. Among these indicators, company growth including sales growth and market shares has been widely used as a key measure of financial performance; while return on common stock is regarded as a very popular metric of a company's profitability. In terms of company growth, as compared to profitability, sales growth is more useful to measure the company's performance, especially in dynamic environments (Singh and Mitchell, 2005; Eisenhardt and Martin, 2000). As an outcome variable, market share reflects a company's size related to the industry and its competitors (Rupinder, Sarangee, Echambadi, and Lee, 2016; Gázquez-Abad and Martínez-López, 2016). Return on common stock is more important to investors than return on investment (ROI) because it directly tells investors how well a company uses their investments to generate benefits.

Although company growth and return on common stock are important factors for investors to make their decisions, a qualified audit opinion will likely influence investors' responses to the information. A

qualified audit opinion conveys negative information about financial statements. The halo effect of this negative information leads to investors' distrust in financial indicators such as company growth and return on common stock. Therefore, the information related to sales growth, market shares, and return on common stock becomes less important for investors' decisions. Accordingly, this study predicts the following hypotheses:

H2a: The information about company growth becomes less important to investors in the presence of a qualified audit opinion as compared to an unqualified audit opinion.

H2b: The information about return on common stock becomes less important to investors in the presence of a qualified audit opinion as compared to an unqualified audit opinion.

## METHODOLOGY

An experimental study is conducted to examine the effect of a qualified audit opinion in an integrated audit report on the individual investors' judgments and decisions. Many previous studies use archival approaches to investigate capital market reactions to qualified audit opinions, traditionally by using abnormal accruals. However, this approach has its shortcomings. The measurement is "noisy" and potentially performance-biased and thus the result provides indirect evidence (DeFond and Francis, 2005). The potential confounding factors ("noises") such as concurrent information disclosure, firm-specific characteristics (Schneider and Church, 2008), and simultaneous news releases (Lopez, Vandervelde, and Wu, 2009) may influence the relationship between a qualified audit opinion and stock prices. An experimental study compliments the limitations in an archival study by controlling the information given to the participants and thus, sufficiently isolates the effect of a qualified audit opinion from the effects of other potential factors.

### Participants

The participants in this study are 71 MBA students from two evening classes in a private university in the southern U.S. Experimental cases were randomly assigned to these students. Discussions among the students were not allowed. The statistical analysis indicates that participants from these two classes have no significant difference in responses and thus are pooled for the research analysis in this study. A total of 71 responses were received. Three were removed for being incomplete. Therefore, 68 responses were retained in this study.

This study uses MBA students as participants, which is common in prior accounting research on public users' investment and lending decisions. Several recent studies use MBA students to examine the effects of an audit report on public users' decisions (e.g., Lin, et al., 2003; Al-Thuneibat, et al., 2008; Lopez, et al., 2009; Schneider, 2009). Furthermore, a large number of prior studies use MBA students to test the relationship between financial reporting and public users' decisions (e.g., Hodge, 2001; Maines and McDaniel, 2000; Frederickson and Miller, 2004; Elliott, 2006; Elliott, Hodge, Kennedy, and Pronk, 2007; Clor-Proell, Proell, and Warfield, 2014). MBA students are eligible to be a proxy for nonprofessional investors when these students analyze an experimental task within low integrative complexity (Elliott, et al., 2007). In other words, the MBA participants draw relatively simple connections between distinct characteristics of the information set and participants' judgments and decisions. If these students have completed a financial statement analysis course, they are a reasonable surrogate even facing a task within high integrative complexity.

The MBA students in this study satisfy the criteria of Elliott et al. (2007) and are eligible to serve as a proxy because they have completed some key prerequisite accounting and finance courses related to financial statement analysis such as survey of financial accounting, business finance and investment before they entered the MBA program. Furthermore, similar to Elliott et al. (2007), the participants make relatively low connections between distinct characteristics of the information set in this experimental case and subsequent investors' judgments and decisions. Thus, the selected MBA students in this study are considered an appropriate proxy for qualified nonprofessional investors.

### Experimental Design and Tasks

This is an experimental study to examine the effect of a qualified audit opinion in an integrated audit report on individual investors' decisions. The type of a financial statement audit opinion (unqualified or qualified) is manipulated. Regardless of the type of a financial statement audit opinion, the internal control opinion over financial reporting in the integrated audit report is always set to be unqualified. Participants are randomly assigned to one of the two experimental scenarios of an integrated audit report. The first scenario is an unqualified financial statement audit opinion integrated with an unqualified internal control opinion (control group, Group 1); whereas the second scenario includes a qualified financial statement audit opinion integrated with an unqualified internal control opinion (manipulate group, Group 2).The participants in this study are requested to complete several tasks. This study first asks the participants to assess the risks associated with investment and whether they are likely to invest in the company, and then the participants are asked to rate the importance of all information involved in the experimental instrument.

### Experiment Instrument

This study employs a paper questionnaire in booklet form to collect the data. The questionnaire booklet is randomly assigned. Each booklet involves a short case of a hypothetical corporation based on a real grocery store's annual reports in the United States. Every participant receives the same background information of the hypothetical corporation: brief introductory information, balance sheet, income statement, statement of cash flows, company growth, and return on common stock. Also, each participant receives the experimental materials with one type of audit opinions (unqualified or qualified) on financial statements in an integrated audit report. Group 1 receives a standard unqualified financial statement audit opinion integrated with an unqualified internal control opinion over financial reporting, whereas Group 2 receives a qualified financial statement audit opinion integrated with an unqualified internal control opinion over financial reporting. This study develops the case in which the qualified audit opinion is issued due to misclassification of leases. Based on the example of a qualified audit opinion listed in PCAOB (PCAOB, 2007), this study assumes that the hypothetical corporation misstates certain lease obligations, which should be capitalized in order to conform to generally accepted accounting principles in the U.S.

After reading the case information and audit opinion, the participants are asked to evaluate investment risks and make their investment decisions. In terms of *risk assessment associated with investment*, the participants are asked to make their judgments on a 10-point Likert scale from one to ten, with one being "Very low risk" and ten being "Very high risk." The participants' *intent to invest* is measured on a 100-point scale from zero percent to one hundred percent, with zero percent being "Definitely would not invest" and one hundred percent being "Definitely would invest." According to Schneider and Church (2008), the ideal average responses should be near the scale midpoints instead of being clustered at either end. The collected data in this study is in conformity with the criteria (4.71 for risk assessments and 51% for intent to invest).

Upon completion of the task the participants are asked to rate the importance of all factors presented in the booklet. These factors include income statement, balance sheet, statement of cash flows, company growth, return on common stock, Big Four CPA firm audit (vs. non-Big Four CPA firm), auditor's opinion on financial statements, and auditor's opinion on internal control over financial reporting. Finally, in order to investigate the characteristics of participants, demographic information on gender, type of job, work experience, investment experience, understanding of the auditor's opinion, use of audit reports, and use of financial statements is collected.

## RESULTS

Table 1 presents descriptive statistics of participants' demographic information. Among 68 participants, 38 participants are males (55.9 percent), 23 are managers, loan officers or investors (33.9 percent), 29 have over 5 years of working experience (42.7 percent), 16 have over 5 years of investment

experience (23.6 percent), and 16 often use ("frequently" and "average") audit reports (23.5 percent). Although the above statistics indicates that the participants are unsophisticated, most are familiar with financial reports. 76.5 percent of participants generally understand ("fully" and "average") the audit reports and 55 percent often use ("frequently" and "average") financial statements. Accordingly, they are qualified to take part in the experiment.

**TABLE 1**
**DEMOGRAPHIC INFORMATION ON PARTICIPANTS**

| | **Group 1** *Unqualified* | **Group 2** *Qualified* | **Total** | **Percentage** |
|---|---|---|---|---|
| Group Size | 30 | 38 | 68 | 100% |
| Gender | | | | |
| Male | 56.7% | 55.3% | 38 | 55.9% |
| Female | 43.3% | 44.7% | 30 | 44.1% |
| | 100% | 100% | 68 | 100% |
| Type of job | | | | |
| Business Manager | 13.3% | 28.9% | 15 | 22.1% |
| Loan Officer | 3.3% | 5.3% | 3 | 4.4% |
| Investor | 3.3% | 10.5% | 5 | 7.4% |
| Other | 80.0% | 55.3% | 45 | 66.2% |
| | 100% | 100% | 68 | 100% |
| Work experience | | | | |
| Less than 5 years | 66.7% | 50.0% | 39 | 57.4% |
| 5-10 years | 13.3% | 18.4% | 11 | 16.2% |
| More than 10 years | 20.0% | 31.6% | 18 | 26.5% |
| | 100% | 100% | 68 | 100% |
| Investment experience | | | | |
| Less than 5 years | 83.3% | 71.1% | 52 | 76.5% |
| 5-10 years | 6.7% | 7.9% | 5 | 7.4% |
| More than 10 years | 10.0% | 21.1% | 11 | 16.2% |
| | 100% | 100% | 68 | 100% |
| Your understanding of the auditor's opinion | | | | |
| Limited | 30.0% | 18.4% | 16 | 23.5% |
| Average | 60.0% | 68.4% | 44 | 64.7% |
| Full | 10.0% | 13.2% | 8 | 11.8% |
| | 100% | 100% | 68 | 100% |
| Your use of audit reports | | | | |
| Rarely use | 93.3% | 63.2% | 52 | 76.5% |
| Average use | 6.7% | 31.6% | 14 | 20.6% |
| Frequently use | 0% | 5.3% | 2 | 2.9% |
| | 100% | 100% | 68 | 100% |
| Your use of financial statements | | | | |
| Rarely use | 53.3% | 39.5% | 31 | 45.6% |
| Average use | 30.0% | 42.1% | 25 | 36.8% |
| Frequently use | 16.7% | 18.4% | 12 | 17.6% |
| | 100% | 100% | 68 | 100% |

* This study employs Chi-square analysis to compare the differences of the above factors between groups and finds that only "Your use of audit reports" is significantly different. However, because this factor does not substantially affect the results of later analysis, it is not considered a covariate in the hypothesis tests.

**Test of Hypotheses H1a and H1b – Risk Assessments and Investment Decisions**

Table 2 provides the comparison results of investors' risk assessments and their decisions when a qualified or unqualified audit opinion is issued. The results indicate that the effect of a qualified audit opionion on investors' risk assessments is not significant (p = 0.117, one-tailed). H1a is not supported. Although the effect is not significant, a qualified audit opinion slightly increases investors' risk assessments (mean = 4.43, SD = 1.716 for unqualified vs. mean = 4.92, SD = 1.617 for qualified). In the presence of a qualified audit opinion, compared to an unqualified audit opinion, investors are less likely to invest in the company (mean = 56%, SD = 16.5% for unqualified vs. mean = 46%, SD = 20.1% for qualified), the effect is statistically significant (p = 0.014, one-tailed). H1b is supported. The significant effect of a qualified audit opinion on investors' decisions implies that the qualified audit opinion does provide informative value in helping investors make their decisions.

**TABLE 2**
**DESCRIPTIVE STATISTICS (MEAN (STANDARD DEVIATIONS)) OF INVESTORS' RISK ASSESSMENTS[a] AND LIKELY TO INVEST[b]**

| | Overall | Group 1 Unqualified | Group 2 Qualified | t-Statistic | p-Value (One-tailed) |
|---|---|---|---|---|---|
| | (n = 68) | (n = 30) | (n=38) | | |
| Risk Assessment | 4.71 (1.667) | 4.43 (1.716) | 4.92 (1.617) | -1.202 | 0.117 |
| Likely to Invest | 51% (19.2%) | 56% (16.5%) | 46% (20.1%) | 2.265 | 0.014 |

[a] Risk assessment is measured on a 10-point Likert scale anchored at 1 (very low risk) and 10 (very high risk).
[b] Likely to invest is measured on a percentage-based scale anchored at 0% (definitely would not invest) and 100% (definitely would invest).

**Test of Hypotheses H2a and H2b – Perceived Importance of Company Growth and Return on Common Stock**

Table 3 reports the importance scores on the perceived importance of company growth and return on common stock. The results reveal when an auditor issues a qualified audit opinion on financial statements, compared to an unqualified audit opinion, the information about company growth and return on common stock becomes less important for investors when making their decisions (company growth, mean = 8.10, SD = 1.517 for unqualified vs. mean = 7.39, SD = 2.021 for qualified; return on common stock, mean = 8.43, SD = 1.357 for unqualified vs. mean = 7.50, SD = 2.165 for qualified). Both the effects of a qualified audit opinion are significant (for company growth, p = 0.059, one-tailed; for return on common stock, p = 0.022, one-tailed). Thus, both H2a and H2b are supported.

This implies that a qualified audit opinion provides informative content to investors. When a qualified audit opinion is issued, investors decrease their trust in the information about company growth and return on common stock. Therefore, they rely less on this information when making their decisions.

**Supplemental Analysis**

Similar to Schneider and Church (2008), participants are requested to rate the importance of all factors addressed in the experimental instrument. These factors include (1) income statement, (2) balance sheet, (3) statement of cash flows, (4) company growth, (5) return on common stock, (6) Big Four CPA firm audit (vs. non-Big Four CPA firm), (7) auditor's opinion on financial statements, and (8) auditor's opinion on internal control. The importance scores for the above factors are measured on a 10-point Likert scale anchored at 1 (no influence) and 10 (strongest influence). The measurement result are displayed as follows: (from high to low)

Return on common stock (Mean = 7.91);
Company growth (Mean = 7.71);
Income statement (Mean = 7.19);
Auditor's opinion on financial statements (Mean = 7.13);
Balance sheet (Mean = 6.94);
Auditor's opinion on internal control (Mean = 6.93);
Statement of cash flows (Mean = 6.90);
Big Four CPA firm audit (vs. non-Big Four CPA firm) (Mean = 5.96).

The results suggest that nonprofessional investors care about not only financial statements but also information about return on common stock, company growth, and auditor's opinion when they make decisions. These findings corroborate the primary tests of this study.

**TABLE 3**
**DESCRIPTIVE STATISTICS (MEAN (STANDARD DEVIATIONS)) OF IMPORTANCE SCORES FOR PERCEIVED IMPORTANCE OF COMPANY GROWTH AND RETURN ON COMMON STOCK[a]**

| Factor | Overall | Group 1 Unqualified | Group 2 Qualified | t-Statistic | p-Value (One-tailed) |
|---|---|---|---|---|---|
| | (n = 68) | (n = 30) | (n=38) | | |
| Company Growth | 7.71 (1.837) | 8.10 (1.517) | 7.39 (2.021) | 1.590 | 0.059 |
| Return on Common Stock | 7.91 (1.898) | 8.43 (1.357) | 7.50 (2.165) | 2.061 | 0.022 |

[a] Importance scores for the perceived importance of *Company Growth* and *Return on common stock* are measured on a 10-point Likert scale anchored at 1 (no influence) and 10 (strongest influence), respectively.

## CONCLUSION AND AREAS FOR FUTURE RESEARCH

This study provides the results of an experiment that examines whether a qualified audit opinion due to misclassification of leases on financial statements has an informative value to investors after the 2008 financial crisis. This study is motivated by the importance of audit qualification with regard to misclassification of leases. Because new leases standard FASB ASC 842 (2016) will bring an overhaul of financial statements, we expect more issuance of this type of audit qualification in the future. This study is also driven by the lack of current research on the effect of a qualified audit opinion in the U.S. The result provides direct evidence that a qualified audit opinion due to misclassification of leases affects investors' confidence about financial reporting and their decision making. When a qualified audit opinion is issued, investors consider it "bad news" and thus a decrease in the credibility of financial reporting due to halo effects. They perceive the value-related information about company growth and return on common stock less important to their decision. Therefore, they are less likely to invest in the company. In conclusion, since investors attach great importance to a qualified audit opinion due to misclassification of leases, the qualified audit opinion provides relevant information to investors.

This study is one of the few studies to examine a specific type of qualified audit opinion due to misstatement of leases. New leases standard FASB ASC 842 was issued in 2016 and most leases will be classified as capital leases and presented on the balance sheet. Based on FASB ASC 840 (2010), the purpose of this new standard is to provide investors a complete and understandable picture of a company's leasing activities. Thus, this change is expected to cause an increase in the disputes between auditors and clients. This study confirms the effects of the audit qualification regarding misclassification of leases. The second contribution of this study is to extend prior research on the effects of qualified

opinion on individual users' judgments and decisions after the 2008 financial crisis. In this study, an audit opinion on financial statements, as required under the post-SOX environment, is integrated with an opinion on internal control over financial reporting. The findings are consistent with previous literature regarding the effects of a qualified audit opinion prior to SOX but inconsistent with the research results since issuance of SOX until the 2008 financial crisis. For regulators and audit researchers, these findings imply investors' attitudes are more conservative towards financial reporting than before. Even if an internal control opinion is unqualified, a qualified audit opinion is considered to be "bad news", which conveys negative information to investors. Furthermore, the halo effect of this "bad news" results in investors putting less trust in the company, viewing company growth and return on common stock as unreliable, and decreasing willingness to invest in this company.

This study is subject to several limitations and provides some avenues for future research. For instance, the participants are MBA students representing nonprofessional investors rather than professional investors. Whether these findings can be generalized to sophisticated professional investors is one direction of future research. Also, future studies can examine other audit qualifications such as inventory misstatements or scope limitations.

## REFERENCE


Abad, D., Sanchex-Ballesta, J. & Yague, J. (2015). Audit opinions and information asymmetry in the stock market. *Accounting and Finance*, 57, (2), 565-595.

Al-Thuneibat, A. A., Khamees, B. A. & Al-Fayoumi, N. A. (2008). The Effect of Qualified Auditors Opinions on Share Prices: Evidence from Jordan. *Managerial Auditing Journal*, 23, (1), 84-101.

Ameen, E., Chan, K. & Guffey, D. (1994). Information Content of Qualified Audit Opinions for Over-The-Counter Firms. *Journal of Business Finance and Accounting*, 21, (7), 997-1011.

Asare, S. & Wright, A. (2012). The effects of type of internal control report on users' confidence in the accompanying financial statement audit report. *Contemporary Accounting Research*, 29, (1), 152-175.

Baumeister, R., Bratslavsky, E. & Finkenauer, C. (2001). Bad Is Stronger Than Good. *Review of General Psychology*, 5, (4), 323-370.

Bessell, M., Anandarajan, A. & Umar, A. (2003). Information content, audit reports and going-concern: an Australian study. *Accounting and Finance*, 43, (3), 261-282.

Chow, C. W. & Rice, S. J. (1982). Qualified Audit Opinions and Share Prices - An Investigation. *Auditing: A Journal of Practice and Theory*, 1, (2), 35-53.

Clor-Proell, S. M., Proell, C. A. & Warfield, T. D. (2014). The effects of presentation salience and measurement subjectivity on nonprofessional investors' fair value judgments. *Contemporary Accounting Research*, 31, (1), 45-66.

Commodity Futures Trading Commission (CFTC). March 31, 2016 Report - CFTC. Retrieved from http://www.cftc.gov/idc/groups/public/@aboutcftc/documents/file/oig_reporttocongress033116.pdf.

DeFond, M. L. & Francis, J. R. (2005). Audit Research after Sarbanes-Oxley. *Auditing: A Journal of Practice and Theory*, Supplement, 24, (s-1), 5-30.

Eisenhardt, K. M. & Martin, J. A. (2000). Dynamic capabilities: What are they? *Strategic Management Journal*, 21, 1105-1121.

Elliott, W. B. (2006). Are investors influenced by pro forma emphasis and reconciliations in earnings announcements? *The Accounting Review*, 81, (1), 113-133.

Elliott, W. B., Hodge, F. D., Kennedy, J. J. & Pronk, M. (2007). Are M.B.A. Students a Good Proxy for Nonprofessional Investors? *The Accounting Review*, 82, (1), 139-168.

FASB Accounting Standards Codification (ASC). (2010). Topic 840 - Leases. Retrieved from http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175823559205&blobheader=application/pdf.

FASB Accounting Standards Codification (ASC). (2016). Topic 842 - Leases. Retrieved from http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176167901010&acceptedDisclaimer=true.
Firth, M. (1978). Qualified Audit Reports: Their Impact on Investment Decisions. *The Accounting Review*, 53, (3), 642-650.
Frederickson, J. & Miller, J. (2004). The effects of pro forma earnings disclosures on analysts' and nonprofessional investors' equity valuation judgments. *The Accounting Review*, 79, (7), 667-686.
Gázquez-Abad, J. C. & Martínez-López, F. J. (2016). Increasing a brand's competitive clout: the role of market share, consumer preference, and price sensitivity. *Journal of Marketing Management*, 32, (1-2), 71-99.
Goh, B. W., Krishnan, J. & Li, D. (2013). Auditor Reporting under Section 404: The Association between the Internal Control and Going Concern Audit Opinions. *Contemporary Accounting Research*, 30, (3), 970-995.
Gul, F. (1987). The Effects of Uncertainty Reporting on Lending Officers' Perceptions of Risk and Additional Information Required. *Abacus*, 23, (2), 172-179.
Hodge, F. (2001). Hyperlinking unaudited information to audited financial statements: Effects on investor judgments. *The Accounting Review*, 76, (10), 675-691.
IASB International Financial Reporting Standards (IFRS). (2016). IFRS 16 - leases. Retrieved from http://www.ifrs.org/issued-standards/list-of-standards/ifrs-16-leases/.
Lewicka, M. A., Czapinski, J. & Czapiniski, J. (1992). Positive-negative asymmetry or 'When the heart needs a reason'. *European Journal of Sociology*, 22, 425-434.
Lin, Z. J., Tang, Q. & Xiao, J. (2003). An Experimental Study of Users" Responses to Qualified Audit Reports in China. *Journal of International Accounting, Auditing and Taxation*, 12, (1), 1-22.
Lopez, T. J., Vandervelde, S. D. & Wu, Y. (2009). Investor perceptions of an auditor's adverse internal control opinion. *Journal of Accounting and Public Policy*, 28, (3), 231-250.
Maines, L. & McDaniel, L. (2000). Effects of comprehensive income characteristics on nonprofessional investors' judgments: The role of financial statement presentation format. *The Accounting Review*, 75, (4), 179-207.
Martinez, M. C. P., Martinez, A. V. & Benau, M. A. G. (2004). Reactions of the Spanish Capital Market to Qualified Audit Reports. *European Accounting Review*, 13, (4), 689-711.
Public Company Accounting Oversight Board (PCAOB). (2007). Auditing Standard No. 5 - An audit of internal control over financial reporting that is integrated with an audit of financial statements and related independence rule and conforming amendments. Retrieved from https://pcaobus.org/Rulemaking/Docket%20021/2007-06-12_Release_No_2007-005A.pdf.
Rozin, P. & Royzman, E. B. (2001). Negativity bias, negativity dominance, and contagion. *Personality and Social Psychology Review*, 5, 296-320.
Rupinder, P. J., Sarangee, K. R., Echambadi, R. & Lee, S. (2016). Designed to Succeed: Dimensions of Product Design and Their Impact on Market Share. *Journal of Marketing*, 80, (4), 72-89.
Schneider, A. (2009). Auditors' internal control opinions: Do they influence judgments about investments? *Managerial Auditing Journal*, 24, (8), 709-723.
Schneider, A., & Church, B. K. (2008). The effect of auditors' internal control opinions on loan decisions. *Journal of Accounting and Public Policy*, 27, (1), 1-18.
Singh, K. & Mitchell, W. (2005). Growth dynamics: The bidirectional relationship between interfirm collaboration and business sales in entrant and incumbent alliances. *Strategic Management Journal*, 26, 497-521.
Soltanis, B. (2000). Some Empirical Evidence to Support the Relationship between Audit Reports and Stock Prices - The French Case. *International Journal of Auditing*, 4, (3), 269-291.
Stunda, R. & Pacini, C. (2013). Shareholder wealth effects of auditor changes and auditor opinions: Does a difference exist in a pre-SOX versus post-SOX environment. *Academy of Accounting and Financial Studies Journal*, 17, (4 ), 29-40.

Tahinakis, P., Mylonakis, J. & Daskalopoulou, E. (2010). An Appraisal of the Impact of Audit Qualifications on Firms' Stock Exchange Price Fluctuations. *Enterprise Risk Management*, 1, (1), E5.

Thorndike, E. L. (1920). A constant error in psychological ratings. *Journal of Applied Psychology*, 4, (1), 25-29.

Vichitsarawong, T. & Pornupatham, S. (2015). Do audit opinions reflect earnings persistence? *Managerial Auditing Journal*, 30, (3), 244 -276.