

**MODIFIED AUDIT OPINION AND MONITORING MECHANISMS:
EMPIRICAL EVIDENCE FROM MALAYSIAN PUBLIC LISTED COMPANIES**

By

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ABSTRACT

Based on the agency theoretical background, the effectiveness of internal corporate monitoring mechanisms enhances the reliability of financial reporting and contributes to protect the interests of all shareholders. This study provides an answer to the following main question of “What are the factors that affect the prospect of receiving a modified audit opinion among Malaysian public listed companies?” to provide an insight-into the issue of internal corporate monitoring mechanisms and modified audit opinion. To date, little is known about this issue, especially in the Malaysian-setting. Accordingly, twelve hypotheses are developed to examine the association between the effectiveness of the board of directors’ characteristics, audit committee characteristics and internal audit function with a modified audit opinion (a proxy for the quality of financial-reporting) in the Malaysian context by using individual and aggregated tests. To examine these hypotheses, logistic regression is used to analyse the data of 136 firm-year observations of seven sectors from the main-market and ACE-market listed on Bursa-Malaysia over the period 2009-2011. Several important findings emerged that are consistent with the hypotheses that Malaysian public listed companies with a large audit committee, audit committee members with greater expertise in accounting and auditing process, outsourcing internal audit function and the investment in the internal audit function are less likely to receive a modified audit opinion. Furthermore, the results confirm the argument that the combined-scores of the board of directors’ characteristics and the audit committee characteristics contribute to their effectiveness in reducing the prospect of receiving a modified audit opinion. Importantly, this study provides evidence that corporate governance reforms in Malaysia can enhance the effectiveness of monitoring mechanisms in order to avoid the Malaysian public listed companies from obtaining a modified audit opinion. Therefore, the results of this study consistent with agency theory and might-be of interest to Malaysian-regulators and policymakers as well as market-participants and researchers.

Keywords: modified audit opinion, corporate monitoring mechanisms, Malaysia

ABSTRAK

Berdasarkan latar belakang agensi teori, keberkesanan mekanisme pemantauan dalaman korporat dapat meningkatkan tahap kebolehppercayaan sesuatu laporan kewangan dan ini juga menyumbang kepada perlindungan kepentingan semua pemegang saham. Kajian ini memberi jawapan kepada soalan utama yang berikut "Apakah faktor-faktor yang memberi kesan kepada prospek menerima pendapat audit diubahsuai kalangan syarikat tersenarai awam Malaysia?" untuk memberikan pemahaman tentang ke dalam isu mekanisme pemantauan dalaman korporat dan pendapat audit diubahsuai. Ini kerana, sehingga kini, sedikit yang diketahui tentang isu ini, terutamanya dalam persekitaran Malaysia. Sehubungan dengan itu, sebanyak dua belas hipotesis dibangunkan untuk memeriksa hubungan antara keberkesanan lembaga pengarah ciri-ciri, ciri-ciri jawatankuasa audit dan fungsi audit dalaman dengan kemungkinan menerima pendapat audit diubahsuai (proksi kepada kualiti laporan kewangan) dalam konteks Malaysia dengan yang menggunakan ujian individu dan agregat. Untuk memeriksa hipotesis ini, regresi logistik digunakan untuk menganalisis data daripada 136 firma-tahun pemerhatian tujuh sektor daripada pasaran utama dan pasaran ACE disenaraikan di Bursa Malaysia dalam tempoh yang 2009-2011. Beberapa penemuan penting muncul yang konsisten dengan hipotesis-hipotesis bahawa syarikat tersenarai awam Malaysia yang mempunyai jawatankuasa audit yang lebih, ahli-ahli jawatankuasa audit yang lebih pakar dalam bidang perakaunan dan proses pengauditan, penyumberan luar fungsi audit dalaman dan pelaburan dalam fungsi audit dalaman adalah kurang berkemungkinan untuk menerima pendapat audit yang diubahsuai. Tambahan pula, hasil-hasil kajian ini telah menyokong dan mengesahkan hujah bahawa gabungan skor lembaga ciri ciri dan gabungan skor ciri ciri jawatankuasa audit menyumbang kepada keberkesanan mereka dalam mengurangkan prospek menerima pendapat audit diubahsuai. Yang penting, kajian ini telah membekalkan bukti yang menunjukkan bahawa pentadbiran korporat yang mengalami pembaharuan di Malaysia boleh meningkatkan keberkesanan mekanisme pemantauan supaya bagi mengelakkan syarikat-syarikat awam Malaysia yang tersenarai daripada mendapatkan suatu pendapat audit diubahsuai. Oleh itu, hasil kajian ini konsisten dengan teori agensi dan mungkin berfaedah dengan pengawal selia Malaysia dan pembuat dasar dan peserta pasaran dan penyelidik.

Kata kunci: pendapat audit diubah suai, mekanisme pemantauan korporat, Malaysia

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TABLE OF CONTENTS

TITLE PAGE	i
CERTIFICATION OF THESIS WORK	ii
PERMISSION TO USE	iv
ABSTRACT	v
ABSTRAK	vi
ACKNOWLEDGEMENTS	vii
TABLE OF CONTENTS	ix
LIST OF TABLES	xii
LIST OF FIGURES	xiii
LIST OF ABBREVIATIONS	xiv

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study	1
1.1.1 Scandals in Corporate Governance and Audit Opinion	4
1.1.2 Board of Directors' Characteristics and Audit Opinion	9
1.1.3 Audit Committee Characteristics and Audit Opinion	12
1.1.4 Internal Audit Function and Audit Opinion	15
1.2 Problem Statement	18
1.3 Research Questions	23
1.4 Research Objectives	24
1.5 Significance of the Study	25
1.6 Scope of the Study	32
1.7 Structure of this Study	33
1.8 Chapter Summary	34

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction	35
2.2 Modified Audit Opinion	36
2.3 Corporate Governance Mechanisms	41
2.3.1 Board of Directors' Characteristics	44
2.3.1.1 Board Independent Non-executive Directors	47
2.3.1.2 Board of Directors' Size	51
2.3.1.3 Board of Directors' Meetings	54
2.3.1.4 Board of Directors' Financial Expertise	57
2.3.1.5 Board of Directors' Effectiveness Score	60
2.3.2 Audit Committee Characteristics	62
2.3.2.1 Audit Committee Independence	66
2.3.2.2 Audit Committee size	70
2.3.2.3 Audit Committee Meetings	73
2.3.2.4 Audit Committee Financial Expertise	78
2.3.2.5 Audit Committee Effectiveness Score	84
2.3.3 Internal Audit Function	87

2.3.3.1 Internal Audit Sourcing Arrangements.....	91
2.3.3.2 Investment in Internal Audit Function.....	97
2.4 Underpinning Theory.....	102
2.4.1 Agency Theory.....	103
2.5 Chapter Summary	115

CHAPTER THREE: RESEARCH FRAMEWORK AND DEVELOPMENT OF HYPOTHESES

3.1 Introduction.....	116
3.2 Research Framework	116
3.3 Hypotheses Development	118
3.3.1 Board of Directors' Characteristics.....	118
3.3.1.1 Board Independent Non-executive Directors	119
3.3.1.2 Board of Directors' Size.....	121
3.3.1.3 Board of Directors' Meetings.....	123
3.3.1.4 Board of Directors' Financial expertise.....	125
3.3.1.5 Board of Directors' Effectiveness Score	127
3.3.2 Audit Committee Characteristics	130
3.3.2.1 Audit Committee Independence	131
3.3.2.2 Audit Committee size	133
3.3.2.3 Audit Committee Meetings	135
3.3.2.4 Audit Committee Financial Expertise	137
3.3.2.5 Audit Committee Effectiveness Score.....	140
3.3.3 Internal Audit Function	142
3.3.3.1 Internal Audit Sourcing Arrangements.....	144
3.3.3.2 Investment in Internal Audit Function.....	147
3.4 Chapter Summary	149

CHAPTER FOUR: RESEARCH METHODOLOGY

4.1 Introduction.....	150
4.2 Research Philosophy	150
4.3 The Population of Sampling Frame	153
4.4 Sample Selection	153
4.5 Data Collection	157
4.6 Research Models and Measurement of Variables.....	160
4.6.1 Research Models.....	160
4.6.2 Research Measurement of Variables	161
4.6.2.1 Measurement of Dependent Variable.....	161
4.6.2.2 Measurement of Independent Variables.....	161
4.6.2.2.1 Board of Directors' Characteristics	161
4.6.2.2.2 Audit Committee Characteristics.....	166
4.6.2.2.3 Internal Audit Function Variables	170
4.6.2.3 Control Variables.....	171
4.7 Statistical Analysis Procedures (Methods)	179
4.7.1. Diagnostic Tests.....	180
4.7.2 Statistics and Univariate Analysis	181

4.7.3 Multivariate Analysis.....	182
4.8 Chapter Summary	182

CHAPTER FIVE: DESCRIPTIVE RESULTS OF MODIFIED AUDIT OPINION FRAMEWROK

5.1 Introduction.....	183
5.2 Sample Selection and Sample Description	183
5.3 Descriptive Statistics and Univariate Analyses	187
5.4 Diagnostic Tests.....	200
5.4.1 Sample Size Assumption	200
5.4.2 Tests of Detecting Outliers	200
5.4.3 Tests of Multicollinearity.....	202
5.4.4 Model Specification Test.....	206
5.5 Chapter Summary	208

CHAPTER SIX: RESULTS AND DISCUSSION OF MODIFIED AUDIT OPINION FRAMEWORK

6.1 Introduction.....	210
6.2 Logistic Regression Results Model 1	210
6.2.1 Multivariate Logistic Regression Results	210
6.2.2 Corporate Governance Monitoring Mechanisms	217
6.2.2.1 Board of Directors' Characteristics	217
6.2.2.2 Audit Committee Characteristics.....	233
6.2.2.3 Internal Audit Function Variables	245
6.2.3 Control Variables.....	250
6.3 Logistic Regression Results Model 2	257
6.3.1 Multivariate Logistic Regression Results	257
6.3.2 Corporate Governance Monitoring Mechanisms	263
6.3.2.1 Board of Directors' Effectiveness Score	263
6.3.2.2 Audit Committee Effectiveness Score.....	265
6.3.2.3 Internal Audit Function	267
6.3.3 Control Variables	267
6.4 Alternative Analyses.....	267
6.5 Chapter Summary and Conclusion	276

CHAPTER SEVEN: SUMMARY AND CONCLUSION

7.1 Introduction.....	281
7.2 Overview of the Study	281
7.3 Implication of the Study.....	292
7.4 Limitations of this Study.....	302
7.5 Suggestions for Future Study.....	305
7.6 Chapter Conclusion.....	309
REFERENCES.....	312

LIST OF TABLES

TABLE	DESCRIPTION	PAGE
Table 1.1	Study Outline	33
Table 4.1	Measurement of Variables	176
Table 5.1	Type of Audit Opinion	184
Table 5.2	Reasons Cause Modified Audit Opinions	185
Table 5.3	Sample Industry Description	186
Table 5.4	Description the Percentage of Criterion of Control Sample Group	187
Table 5.5	Descriptive Statistics and Univariate Test Results of Continuous Variables Classified by Modified audit Opinion/Unmodified audit Opinion	197
Table 5.6	Descriptive Statistics (percentage) and Univariate Test Results for Dummy Variables for Modified Audit Opinion/Unmodified Audit Opinion	199
Table 5.7	Residual Statistics – After Test of Multivariate Outliers	201
Table 5.8	Residual Statistics – After Test of Multivariate Outliers	202
Table 5.9	Correlation Matrix of Independent Variables for Model 1	204
Table 5.10	Correlation Matrix of Independent Variables for Model 2	205
Table 5.11	Multicollinearity Statistics of Assessing VIF and Tolerance Values for Model 1	205
Table 5.12	Multicollinearity Statistics of Assessing VIF and Tolerance Values for Model 2	206
Table 6.1	Logistic Analysis Results Audit Opinion (Model 1)	225
Table 6.2	Logistic Analysis Results Audit Opinion (Model 2)	265
Table 6.3	Alternative Analyses	269
Table 6.4	Alternative Analyses	271
Table 6.5	Alternative Analyses	275
Table 6.6	The Summary of Hypotheses Testing	280

LIST OF FIGURES

FIGURE	DESCRIPTION	PAGE
Figure 3.1	Modified Audit Opinion and Monitoring Mechanism Research Framework	117

LIST OF ABBREVIATIONS

ABB	FULL LIST
ACEScoreM	Audit Committee Effectiveness Score
AICPA	American Institute of Certified Public Accountants
AOB	Audit Oversight Board
BDEScoreM	Board of Directors' Effectiveness Score
BRC	Blue Ribbon Committee
FASB	Financial Accounting Standard Board
GAAP	Generally Accepted Accounting Principles
IAF	Internal Audit Function
IIA	Institute of Internal Auditors
IIAM	Institute of Internal Auditors Malaysia
ISA	International Standards on Auditing
MAO	Modified Audit Opinion
MCCG	Malaysian Code on Corporate Governance
MIA	Malaysian Institute of Accountants
NACD	National Association of Corporate Directors
NYSE	New York Stock Exchange
SEC	Securities and Exchange Commission
SOX	Sarbanes-Oxley Act of 2002

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Accounting can be described as an information system upon which the real economic situation of a particular body is enumerated. According to Ball (2008), financial reporting performs a principal role in the economic activities. The quality of financial reporting highlights the extent of how the financial statement information reveals the actual economic situation of the entity (Watkins et al., 2004). Similarly, according to Beest et al. (2009), the main aim behind financial reporting is to provide an overview of the high quality financial information regarding an entity's economic picture in financial terms and its contribution to economic decision-making (FASB, 1999). In order to efficiently allocate capital, high quality financial reporting is imperative (Healy et al., 2001). Therefore, it can be stated that the financial reporting quality is invaluable to users of such reports including potential investors, creditors, etc., as they base their decisions upon such reports.

However, accounting information of low quality may mislead recipients into making the wrong decisions concerning investment or financing, which will eventually lead to the inefficient allocation of economic resources. Importantly, the absence of audit quality could result in a less efficient capital market, costly capital (higher interest rates for new loans or a change in debt covenant for existing loans), and, ultimately, might reduce the standard of living (Elliot, 1995; Saul, 1996; Wallman, 1995, 1996) due to inefficient

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