THE RELATIONSHIP BETWEEN RISK MANAGEMENT COMMITTEE CHARACTERISTICS AND MODIFIED AUDIT OPINION IN MALAYSIA

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ABSTRACT

The existence of a separate risk management committee (RMC) in non-banking and non-financial companies is seen as very important. It serves as a crucial element in risk management process and as a corporate governance mechanism. This study investigates the relationship between the existence and characteristics of a RMC and modified audit opinion issued by the auditors for the non-banking and non-financial companies listed on Bursa Malaysia. Data is collected from the annual reports of 300 companies for the period of 2004 until 2009. Both descriptive and multivariate analyses are employed to address the research objectives. The results indicate that a separate RMC is negatively related to acceptance of modified audit opinion. Meanwhile, RMC's members with accounting and financial background also reduce the acceptance of modified audit opinion. For RMC's members sitting on more than one board committee, the probability of the company receiving modified audit opinion is higher. Further, companies experiencing modified audit opinion and losses during prior accounting years as well as higher leverage are positively associated with the acceptance of modified audit opinion. Lastly, companies with more than one business segment reduce the acceptance of modified audit opinion. The findings provide empirical evidence on the development and importance of the existence and characteristics of a RMC for the quality of companies' financial reporting. The existence of a separate RMC in non-banking and non-financial companies can reduce the acceptance of modified audit opinion due to risk reasons. Thus, regulators and policy makers need to note the importance of the existence of a separate RMC in non-banking and non-financial companies as well as some characteristics of the committee that contribute to its success.

Keywords: risk management committee; risk; modified audit opinion; Malaysia

ABSTRAK

Kewujudan jawatankuasa pengurusan risiko (RMC) berasingan di dalam syarikat-syarikat bukan perbankan dan bukan kewangan adalah dilihat sebagai sangat penting. Ia merupakan sebagai satu element yang sangat penting di dalam proses pengurusan risiko dan sebagai satu mekanisma tadbir urus korporat. Kajian ini menguji hubungan antara kewujudan dan ciri-ciri RMC dan laporan audit tidak baik yang dikeluarkan oleh juruaudit-juruaudit bagi syarikat-syarikat bukan perbankan dan bukan kewangan yang tersenarai di Bursa Malaysia. Data dikumpulkan daripada laporan tahunan syarikat-syarikat sebanyak 300 sampel bagi tempoh 2004 sehingga 2009. Kedua-dua analisa *descriptive* dan *multivariate* digunakan untuk mencapai objektf-objektif kajian. Hasilnya menunjukan jawatankuasa pengurusan risiko secara berasingan mempunyai kesan secara negatif dengan penerimaan laporan audit tidak baik. Selain itu, ahli-ahli jawatankuasa pengurusan risiko yang mempunyai latarbelakang perakaunan dan kewangan juga berkemungkinan mengurangkan penerimaan laporan audit tidak baik. Bagi ahli-ahli jawatankuasa pengurusan risiko yang berstatus lebih daripada satu ahli jawatankuasa lembaga pengarah, kemungkinan untuk syarikat menerima laporan audit tidak baik adalah lebih tinggi. Seterusnya, syarikat yang berpengalaman menerima laporan audit tidak baik dan kerugian bagi tahun-tahun perakaunan sebelum ini dan juga hutang yang tinggi mempunyai hubungan secara positif dengan penerimaan laporan audit tidak baik. Akhir sekali, syarikat yang mempunyai segmen perniagaan yang lebih daripada satu berkemungkinan akan mengurangkan penerimaan laporan audit tidak baik. Hasil kajian menyediakan bukti ilmiah ke atas perkembangan dan kepentingan kewujudan dan ciri-ciri jawatankuasa pengurusan risiko untuk kualiti laporan kewangan syarikat-syarikat. Kewujudan RMC berasingan di dalam syarikat-syarikat bukan perbankan dan bukan kewangan dapat mengurangkan penerimaan laporan audit tidak baik yang di sebabkan oleh risiko-risiko. Oleh itu, pihak berkuasa dan pembuat polisi perlu mengambil kira berkenaan kewujudan RMC berasingan di dalam syarikat-syarikat bukan perbankan dan bukan kewangan dan juga beberapa ciri jawatankuasa tersebut yang menyumbang kepada kejayaannya.

Kata kunci: jawatankuasa pengurusan risiko; risiko; laporan audit tidak baik; Malaysia

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LIST OF ABBREVIATIONS

RMC	Risk Management Committee
BM	Bursa Malaysia
SC	Security Commission of Malaysia
BOD	Board of Director
ASX	Australian Securities Exchange
ACCA	The Association of Chartered Certified Accountants
COSO	Committee of Sponsoring Organizations of the Treadway Commission
ERM	Enterprise Risk Management
MCCG	Malaysian Code on Corporate Governance
KLSE	Kuala Lumpur Stock Exchange
AC	Audit Committee
GAAP	Generally Acceptable Accounting Principles
MIA	Malaysian Institute of Accountants
MASA	Malaysian Approved Standards on Auditing
AASB	Auditing and Assurance Standards Board
IAPC	International Auditing Practice Committee
IFAC	International Federation of Accountants
MSA	Malaysian Standards on Auditing
ISA 240	International Standard on Auditing: The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
ISA 315	International Standard on Auditing: Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
ISA 330	International Standard on Auditing: The Auditor's Responses to Assessed Risks
ISA 570	International Standard on Auditing: Going Concern
ISA 700	International Standard on Auditing: Forming an Opinion and Reporting on Financial Statements

ISA 705	International Standard on Auditing: Modifications to the Opinion in the Independent Auditor's Report
ISA 706	International Standard on Auditing: Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
PCAOB	Public Company Accounting Oversight Board
AICPA	Americans Institute of Certified Public Accountants
MSWG	Minority Shareholders Watchdog Group
SAS	Statement on auditing standards: Americans Institute of Certified Public Accountants
FRC	Financial Reporting Council
IIA	Institute of Internal Auditors UK and Ireland
PKFZ	Port Klang Free Zone
MAS	Malaysia Airlines System
ROA	Return on Assets
PLC	Public Listed Companies

CHAPTER ONE

INTRODUCTION

1.1 Background and Motivation of the Study

The objective of the study is to examine the relationship between the risk management committee's characteristics and modified audit opinion issued by the auditors in Malaysia. At the Corporate Governance Week 2010 and 2011 which was jointly hosted by the Securities Commission (SC) of Malaysia and Bursa Malaysia (BM), both chairmen of these regulatory bodies stressed on the risk management process and awareness of board of directors (BODs) on those processes as key elements in the corporate governance practices of a company. The remark was directed to the BODs as key persons for establishing and implementing good risk management processes in the company. The remark was also a signal to the BODs to pay more attention to the company's risk management profile and the establishment of a committee at the board level that concentrates on the risk management profile of the company.

For a company to ensure that the board or board committee that is responsible for the risk management profile is operating well, the committee must possess strong attributes or characteristics. In this study, the researcher has chosen the risk management committee (RMC) as the main variable that formulates the study's framework. Some indicators are used to measure the effectiveness of that committee, such as professional audit opinion issued by the auditor as well as some other indicators. Based on the observation and data gathering, there are more than 150 companies with modified audit opinion due to risk reasons from years 2004 until 2009. This figure shows the importance of risk management and modified audit opinion issues.

According to the International Standards on Auditing (ISA 240, ISA 315 and ISA 330), the auditor has the responsibility to assess the risks of material misstatement, whether they come from fraud or error, client's internal control system and client's business environment. Besides, the auditor also has to assess the viability of client's business operations in future (ISA 570) before he or she can issue professional audit opinion (ISA 700 and ISA 705). For example, in the independent auditor's report for United Malayan Land Berhad and Genetic Technology Berhad, the auditors stated about their risk assessment of the companies' financial statements during the audit process. It shows the importance of risk appraisal during audit planning and also audit findings to auditors.

However, in this study, the researcher defines and classifies modified audit opinion as unqualified with explanatory paragraph (modified wording), qualified, adverse and disclaimer audit report received by a company. Only the reasons of risk that contributed to the modified audit opinion are chosen for this study, such as the reason of going-concern issues and fraud; while the other reasons for the modified audit opinion, such as limited scope of audit by the auditors and inadequate disclosure are not chosen in this study. Hence, in this study, only modified audit opinion due to reasons of risk are selected.

The study on the association between RMC's characteristics and modified audit opinion is scarce and limited. There are however several studies on the relationship between board's characteristics and audit committee composition and audit opinion (see Carcello & Neal, 2000; Farinha & Viana, 2009; Masyitoh & Adhariani, 2010; Wenyao & Qin, 2007; Pucheta-Martinez & Fuentes, 2007). The above studies relate several board and audit committee's characteristics to the audit opinion issued by the auditors. The RMC is a sub-committee of the BODs and it is the same as the other board committees, such as Audit Committee, Nomination Committee and Remuneration Committee. The main purpose for establishing the RMC is to manage risks or solely to focus on risk management (Yatim, 2009).

The financial crisis in 2007 and 2008 has highlighted the importance of risk management in companies. Many investors, BODs and corporate governance observers have questioned the effectiveness of audit committees in overseeing the risk management function in the company. The public and investors also question the effectiveness of the corporate governance mechanisms; and one of those mechanisms is audit function (Bota-Avram, 2012). The audit function is strongly criticised, particularly on risk issues. This situation creates a new phenomenon about who is actually responsible for risk; whether it is the internal or external auditors,, the BODs, management or others. Hence, more studies are needed on the connection between audit function, corporate governance and risk management (Porter, 2009; Yatim, 2010). In the United States of America (USA), Senators Charles Schumer and Maria Cantwell stressed on the establishment of a stand-alone board level risk committee of independent directors that should be responsible for establishing and evaluating a company's risk management practices (Bates & Leclerc, 2009). The RMC is viewed as the team to oversee the risk management profile as a whole. Hence, its status as a board committee is more credible to the stakeholders, especially the shareholders.

Risk management is a culture, process and structure and should be designed to identify, assess, monitor and manage risk (ASX) (Amendment) (2010); while Keizer (2010) identified the RMC as a 'team sport' and recognised the team as the board's risk oversight committee. If the RMC is recognised as the board's risk oversight committee, hence establishing the RMC is seen as a good initiative for managing the company's risk profile. Risk is a concept used to express future uncertainty for the events and/or outcomes that contain material effect on the goals of the organisation (Selim& McNamee, 1999). However, Hespenheide, Pundmann and Corcoran (2007) identified a risk intelligent approach which accepts risk as necessary for doing business and proactively addressing it. A company, however, may evaluate the type and level of a risk before it is adopted as a necessary condition in business operations.

The RMC's scope of work includes the risk intelligent approach that informs the board and management of the key risks associated with the company's business. The approach, including strategic and tactical actions, if practiced well in the company, can be successful in creating value for the company (Bugalla, Hackett, Kallman and Narvaez, 2010). Risk management not only adds value to the company or organisation, but it also creates economic growth by decreasing the cost of capital and activities related to commercial uncertainty (Nourbakhshian, Rajabinasr, Hooman & Seyedabrishami, 2013).

The Association of Chartered Certified Accountants (ACCA), at its international round-table discussions over 12 months which ended September 2010, agreed that the auditors consider incorporating into the standard audit report a clear statement on companies' risk management and corporate governance arrangements. Such decision by the ACCA indicates the significance of risk management arrangements in a company. The emergence of a standard risk management framework in a company and how risk is reported is becoming increasingly important. The global economic downturn has exposed poor risk management practices of many companies and organisations (Baker, 2011). In 2004, the Committee of Sponsoring Organisations of the Treadway Commission (COSO) (2004) introduced an integrated framework for risk management known as the Enterprise Risk Management (ERM). ERM is defined as:

> *a process, affected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity's objectives.* (COSO, 2004, p. 2).

In 2009, the Geneva-Based International Organisation for Standardisation (2009) published a new standard known as ISO 31000: Risk Management - Principles and Guideline. The standard provides a set of core principles and characteristics. It also suggests a structured and ongoing internal communication best practice approach to risk management. Baker (2011) supported that the ISO 31000 is a framework that aims to provide a foundation for effective risk management within an organisation. However, the ISO 31000 is relatively new and even unheard of at the local scene.

Again, in January 2012, COSO (2012) introduced the Thought Leadership in ERM known as guideline for Understanding and Communicating Risk Appetite. This new guideline stresses the role of management and board oversight function in risk appetite activities for organisations; and the effectiveness of board oversight function is crucial. The Federation of European Accountants, Institute of Chartered Accountants Australia and the Centre for Audit Quality (2013) jointly sponsored the roundtable discussion in New York City, Brussels and Hong Kong, where it was agreed that specific aspects of risk oversight responsibility should be allocated to a specific board committee, such as a RMC. The participants in that discussion also suggested for the establishment of a separate RMC that could focus on the consideration and identification of 'unknown risks, since the existing audit committee may be only familiar with the 'known risks'.

In Malaysia, the Malaysian Code on Corporate Governance (MCCG, 2000; 2007; 2012) best practices clearly state the board has principle responsibility for "*identifying principal risks and ensuring the implementation of appropriate systems to manage these risks*". This is an indicator of the importance of risk management and the oversight function of the BODs, even though there is no mandatory requirement for the establishment of the RMC. The MCCG 2007 (Part 2, BB VII, p 16), states the head of internal audit has responsibility to review and/or appraise risk management, internal control and governance process. This is an indicator that the risk management function is very important. Although the responsibility for regular review and/appraisal of the effectiveness of the risk management is borne by the head of internal audit, when a RMC exists in a company, the full responsibility can fall on this new committee.

A board level RMC is a common practice by banking and financial institutions but is rare in other industry sectors. However, some multi-national companies have already adopted this board committee in their companies, such as JPMorgan, General Motors and General Electric (Bugalla, Kallman, Mandel & Narvaez, 2012); to date, companies with board RMC remain a minority in the USA. Bugalla *et al.* (2012) posited that companies with board level RMC or stand-alone RMC view risk management as a strategic function and progress towards risk management best practices.

Malaysia, and most other countries, still view the RMC as voluntary except for the banking and financial institutions which have a separate RMC. This is because this type of industry has its own special requirements for setting up a RMC. The RMC (principal) as a board committee, is seen as having the ability to perform its oversight function over the management (agent) for specific risks. This is consistent with the agency theory whereby the principal should monitor the activities performed by the agent to safeguard the shareholders' assets and investments. Some companies have their own approach, structure and process for managing risks (Subramaniam, McManus & Zhang, 2009). Yatim (2009) reported that risk management has become a more focused area by the board; the RMC is genaerally seen as the team for managing risks, instead of the audit committee, which is normally seen as being responsible for a company's accounting profile. In addition, the audit committee spends a lot of time focusing on risk management (Demidenko & McNutt, 2010). Fom the review of related literature, there are very limited published studies on the characteristics of the RMC and audit modification. This gap creates several motivations for the researcher to undertake this study.

For this study, the researcher aims to study the relationship between the RMC's characteristics (RMC Size, RMC Diligence RMC Independence, RMC Training, RMC Qualification, RMC Overlap and RMC Interlocking) and modified audit opinion in the context of the Malaysian environment. The BODs has the responsibility for setting the strategies and creating the environment for an effective risk management system in a company and the existence of a RMC is a good step (Yatim, 2010). To be an effective committee, the RMC as a board committee, should have strong attributes, whether in terms of its composition (board size and type of directors), board process (frequency of meetings) and board characteristics (knowledge, skill, experiences, academic qualification, relevant training and multiple directorships).

The strong composition of RMC, its processes and characteristics are parallel to the arguments in the RDT. This theory, as proposed by Preffer and Salancik (1978), argues that the board (RMC), as a crucial resource to the organisation, also acts as the bridge between the organisation and external links. External links are important to the organisation as it is provides other crucial resources to the organisation.

For company performance, Singh and Davidson (2003); and Mak and Li (2001) found that a smaller board is more effective than a larger board. Board size has been prominently used in corporate governance studies (Dalton, Daily, Johnson & Ellstrand, 1999) and viewed as an important element of a company's governance quality (Musteen, Datta & Kemmerer, 2010). For the risk issues, the smaller board is expected to gain better oversight function due to fewer differences in ideas and approaches. Ong and Wan (2008) argued that larger boards may have conflicts in executing and maintaining the board's oversight function. They may have conflicting views among them for monitoring and decision-making. However, for the company's business and industry risk oversight function, the vast knowledge and experiences of board members are needed (Dalton *et al.*, 1999); knowledgeable and experienced independent non-executive directors who are not involved with the company's functions and duties can provide this.

For the director's type, the non-executive directors or independent directors play an important role in ensuring that the company is running an effective internal control system (Kamardin & Haron, 2011). In other words, independent directors from outside bring a diversity of skills and expertise (Abdullah, 2004). Siagian and Tresnaningsih (2011) studied the impact of independent directors on earnings quality for Indonesian companies and the result showed that the level of earnings management is reduced after the appointment of independent directors. The composition of independent or outside directors in the RMC may help the RMC to be a more effective committee without influence from top management who sometimes are members of the RMC (Yatim, 2010). Outside directors with external sources of information and knowledge in the RMC can perfrom better monitoring and give advice to the top management (Marlin & Geiger, 2011; Roy, 2011). In terms of audit quality, the composition of BODs is also an indicator for the issuance of good audit quality (Zaman, Hudaib & Haniffa, 2011).

The knowledge and experiences gained through multiple directorships or interlocking directors (Marlin & Geiger, 2011) can be an asset. Musteen *et al.* (2010) advised that the exposure of board members to multiple industries can help the companies to address the challenges and risks. According to the Malaysian environment, and according to the KLSE (2009) Listing Requirements, (Chapter 15.06), BODs are allowed to have a maximum of ten directorships in the public listed companies (PLCs) and 15 directorships in non-listed companies. Importantly, interlocking or multiple directorships can facilitate the diffusion of information among the directors and enhance awareness of the external risks and challenges (Shropshire, 2010). Companies can also learn how the other companies practice risk oversight functions to be adopted in their own companies. Stuart and Yim (2010); and Hashim and Abdul Rahman (2011) stressed that interlocking directors with vast experiences, knowledge, skills and expertise can improve the quality of financial reporting. As board members in several companies, they must have gained a lot of training which can contribute to their knowledge, skills and expertise.

As members of the BODs or the RMC, they have to update their knowledge and information in administrative, business and industry issues. Relevant training is one of the initiatives to enhance and update directors' knowledge (Coulson-Thomas, 2008). Basically, members of the BODs or the RMC should understand their core responsibilities as board members to the shareholders and not to the chief executive officer (CEO) (Stomierowski, 2009). For directors holding the risk management portfolio, Barton, Shenkir and Walker (2011) advocated that directors attend seminars, conferences, listen to talks by risk consultants and go on board retreats. They added that as directors, they should assess their knowledge relating to risk management and decide to attend relevant training in order to perform effective oversight function. Such knowledge is important to them as a tool to assess the risk information of the companies. Barton *et al.* (2011) stressed that an effective risk oversight function is acheived by directors' possesing diverse skills and experiences gained by attending training and education programmes. Directors with accounting or financial academic background have greater understanding on financial, accounting and risk issues and tend to engage more in risk management activities (Yatim, 2009).

According to the Kuala Lumpur Stock Exchange (KLSE, 2009) Listing Requirements (Chapter 15.08), directors must attend training programmes as prescribed and the BODs must state the reasons for non-attendance by directors at those training programmes. BODs with more training, knowledge and information tend to share with other board members. BODs or RMC meetings indicate the diligence exercised by the board members (Zaman *et al.*, 2011; Gana & Lajmi, 2011); board meeting has been adopted as a proxy for diligence by Krishnan and Visvanathan (2009). When the board meeting is held frequently, more company' issues, including risk profile issues, can be discussed in detail and decisions made (Abbott, Parker, Peters & Raghunandan, 2003). Conger, Finegold and Lawler (1998) indicated that frequent board meetings is likely to improve board functions. Yatim (2010) found some evidences that more diligence among RMC members is likely to increase the level of oversight activities, especially risk management activities, besides improving communication amongst themselves.

1.2 Problem Statement

Due to economic instability and corporate challenges, risk management has gained substantial prominence and is explicitly on the agenda of BODs meetings (Subramaniam, Collier, Phang & Burke, 2011). In June 2010, the chairman of the SC at its Corporate Governance Week 2010 together with BM, mentioned about the importance of proper risk management in a company. Tan Sri Zarinah Anwar reminded that poor risk management is a symptom of poor corporate governance practices. The chairman cautioned the BODs to fully and deeply understand the risks associated with the business operations, products and the market. The statement of the chairman of SC is in line with MCCG's best preactices (2000; 2007; 2012), i.e., the BODs should identify principle risks and ensure the implementation of an appropriate system to manage these risks. The main issue is whether the RMC can focus on the risks profile and manage the risks well or otherwise. When the risks are managed properly, risks can be reduced as well as the issuance of modified audit opinion due to those risks by the auditors.

At the Corporate Governance Week 2011 as well, the chairman of the SC highlighted the responsibility of the BODs in risk management processes. Tan Sri Zarinah Anwar expressed concern over the failure of the BODs to establish appropriate measures for the risk management process in the company. The RMC is seen as the best initiative for risk management of the company. At the end 2011, the SC introduced the 2nd Capital Market Masterplan (CMP2) and Corporate Governance (CG) Blueprint to be implemented starting in 2012 over a five-year period. The introduction of CMP2 is to expand the role of the capital market in driving growth and innovation; while the CG

Blueprint complements the stakeholder participation in the governance process. The aim of the CG Blueprint is to promote a culture of good governance through a deepening relationship among companies, stakeholders and regulators.

According to the ISA 240, ISA 315 and ISA 330, the auditor has the responsibility to assess the risks of material misstatement, whether they come from fraud or error, client's internal control system and client's business environment. Besides, the auditor also has to assess the viability of the client's business operations in future (ISA 570) before he or she can issue the professional audit opinion (ISA 700 and ISA 705). There are several types of risks faced by the companies that are considered by auditors, like the client's business risk, going-concern risk as well as audit risk (inherent, control and detection risk) which are related to the client's internal control system.

There are several specific types of risks that come from the client's business risks, such as competition risk, product risk, market risk and political risk that affect the business' sustainability. The companies must also be aware of internal risks, such as operational risk, compliance risk and financing risk, besides the external risks. With the existence of a separate RMC that is responsible only for the risk profile of the companies, including the internal and external risks, all these type of risks can be managed and controlled well by this board committee. For the companies that have a separate RMC, such as Patimas Computers Berhad and Crimson Land Berhad, their risk management frameworks clearly state that the RMC is responsible for internal and external risks faced by the companies. At the same time, and as mentioned in the earlier paragraph, the external auditor is responsible for risk issues faced by the client company before he or she can issue a professional opinion. As guided by ISA 700 and ISA 705, modified audit opinion is issued by the auditor if there are material misstatement that come from the issues of client's internal control, including fraud, client's business operations and its environment. This phenomena creates a link between the RMC and auditor's professional opinion, especially for modified audit opinion, specifically due to reason of risks.

Can the existence of a RMC with strong characteristics combat significant risks and influence a company to receive modified audit opinion? This question is an issue for the researcher to explore the existence of RMC and its characteristics that affect the risk management profile of a company, consequently leading to the auditor issuing a modified audit report. Based on the data in BM's website between 2004 to 2009, there are more than 150 companies which have received modified audit opinion due to risk issues. The figure shows the importance of risk issues to the companies. Further, Yatim (2009) and Subramaniam *et al.* (2009) suggested for future research to study the role and function of RMC, as well as its interaction in corporate governance mechanism. Yatim (2010) is convinced that the formation of RMC is a commitment of the company to improve the internal control environment and reduce the operational, financial and reputational risks. This area is still unexplored and the finding might contribute to new knowledge.

Subramaniam and Carey (2011) recommended for empirical research on the relationship among risk management, audit committee, internal and external audit.

Liew, Mat Zain and Jaffar (2012) supported that future research is needed to measure the effectiveness of RMC for the board to assess how much a RMC has benefited the company. Hassan, Mohd Saleh, Yatim and Che Abdul Rahman (2012) also suggested that more research on the composition of RMC, its process and roles of its members is still needed.

The main purpose of the RMC, together with its strong characteristics, is to focus on the risk profile of the company and ensure the ongoing process of risk management runs smoothly. The audit committees and the internal auditors will have to concentrate on their functions without extra duties on risk profile. In cases where the independent auditors refer to the audit committee and head of internal audit for the risk profile before issuance of auditor's opinion, the RMC can become the reference point. Being a board committee, any suggestion by the RMC becomes the board's function and responsibility.

1.3 Research Questions

This study is conducted to answer the following questions:

1. Does the existence of a separate RMC influence the company to receive modified audit opinion?
2. What are the RMC's characteristics that influence the company to receive modified audit opinion?

1.4 Objectives of the Study

The purposes of the study are two-fold as follows:

1. To examine whether the existence of a separate RMC influences the company to receive modified audit opinion.
2. To examine the characteristics of the RMC that influences the company to receive modified audit opinion.

1.5 Significance and Contribution of the Study

This study examines the Malaysian PLCs, excluding banking and financial companies. The findings can give better understanding and benefits to various parties, such as regulators, policy-makers, researchers, BODs, management and shareholders regarding the association between the RMC and modified audit opinion.

Significance and contribution of the study are discussed in terms of theoretical (including contribution to knowledge), practical and methodological contributions.

1.5.1 Knowledge and Theoretical Contribution

This study provides empirical findings on the relationship between the existence of a separate or stand-alone and combined RMC and characteristics of the RMC and modified audit opinion for Malaysian PLCs, excluding financial and banking companies. The findings contribute fresh knowledge to the existing literature and are useful to researchers and fellow academicians to further their studies on this issue. Previous studies (Subramaniam *et al.*, 2009;

Yatim, 2009) only focused on the establishment of the RMC instead of the characteristics of the committee; while Yatim's (2010) study is related to the board structure's characteristics and the establishment of RMC.

The findings give meaningful insight into the theoretical and knowledge aspects on the relationship between RMC and modified audit opinion. The RMC, which is responsible for the risk profile of the company, must give full commitment. The impact of the future business operations must be studied and examined systematically and regularly by this committee. The RMC must address the issue of risks which can cause the company to receive modified audit opinion. This relationship contributes to theory and new knowledge. Previous studies done by Farinha and Viana (2009); Pucheta-Martinez and Fuentes (2007); Carcello and Neal (2000); and Wenyao and Qin (2007) only examined the relationship between BODs and audit committee's characteristics and audit qualification and modification. There are very limited published studies on the relationship between the RMC and modified audit opinion, especially in Malaysian PLCs.

1.5.2 Practical Contribution

Since the setting up of a separate RMC is still voluntary, especially in non-financial companies, the findings show the significance of this new board oversight committee to the regulators and policy-makers. In terms of financial reporting, the association between the RMC's characteristics and audit opinion indicates how the composition and uniqueness of this committee can influence the issuance of audit opinion. Audit opinion is one of the important indicators to regulators, government authorities as well as policy-makers to measure the stability, compliance and competitive advantage of a company. The emergence of separate and strong RMC as a new element in the corporate governance mechanism can add value to the practice itself. For the future, regulators, such as the SC and BM, may amend the requirements for the companies to have a separate RMC if the existence of a separate RMC and its characteristics have significant impact on the auditors issuing modified audit opinion.

Nowadays, the MCCG (2007; 2012) has placed the responsibility of risk management onto the shoulders of the BODs, and the board often delegates this duty to the audit committee. This situation creates a burden on the audit committee which has a lot of other accounting and internal control functions. The existence of a separate RMC can focus on the risk profile of the company and external elements that bind the company's business environment, compared to the audit committee which generally ensures adherence of Generally Accepted Accounting Principles (GAAP).

The BODs and top management are the parties responsible for the company's strategic planning. The findings of this study might be able to influence them on the mid- and long-term company's strategic planning process as well as the organisation structure. They might be able to set up a separate RMC with strong characteristics to manage the risks efficiently. Lastly, every potential shareholder and investor always seeks stability and a company with good future prospects before they spend a lot of money on an investment portfolio. Audit report and the issuance of a modified audit opinion are vital for them to make investment decisions. Since this study relates to the risks faced by the companies and audit opinion issued, the result of this study provides some suggestion for the Malaysian government that a good auditing environment will provide better protection for users of financial reporting, such as investors and credit providers. Ismail and Abdul Rahim (2011) are convinced that the institutional investors in Malaysia, such as the Minority Shareholders Watchdog Group (MSWG), have a significant relationship with the risk management disclosure by the companies. The disclosure of risk process as well as risk profile of the companies is crucial to them as the investors.

The results of the PricewaterhouseCoopers Corporate Governance Survey 2002, with regards to Malaysian corporate governance practices, showed positive development. The survey indicates that the annual report remains the most effective communication channel in communicating the company's profile, financial results and corporate developments, including risk management strategy.

1.5.3 Methodological Contribution

This study uses data from 2004 to 2009. This study provides meaningful insight to the Malaysian PLCs on the risk management profile. The existence of the RMC and its characteristics is studied and the relationship to audit opinion is explored. This study also examines the existence of a separate RMC and its characteristics as the variables. Previously, studies only focused on the characteristics of board and audit committee as the variables (see Farinha & Viana, 2009; Pucheta-Martinez & Fuentes, 2007; Carcello & Neal, 2000; Wenyao & Qin, 2007).

1.6 Scope and Limitations of the Study

This study examines the relationship between separate RMC and RMC's characteristics and modified audit opinion issued by the auditor. The population frame for this study is all the PLCs, excluding banking and financial institutions, listed on BM's website, from the period of financial year ended 2004 until 2009. Banking and financial institutions are omitted from the sample as the nature and regulations of these firms are significantly different from the non-financial companies. Secondary data is used for this study. The companies' annual reports published in BM's website were downloaded accordingly.

The separate or stand-alone and combined RMC is examined in this study. Some companies delegate the functions of risk to the audit committee (combined RMC), such as Oilcorp Berhad and Scomi Group Berhad; some companies delegate the duty of risks to the board committee that is responsible only for the risk profile (separate RMC), such as Patimas Computers Berhad and Crimson Land Berhad. In terms of the RMC's characteristics, the variables that are tested are RMC Size, RMC Diligence, RMC Independence, RMC Training, RMC Qualification, RMC Overlap and RMC

Interlocking. Other variables tested are Prior Audit Report, Loss, Big4, Leverage, Auditor Tenure, Client Size, Asset Profitability and Business Segment. Modified audit opinion is the dependent variable in this study.

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Problem Statement
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Conclusion

↓

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Figure 1.1
Organisation of the Study

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Figure 1.1 (Continued)

1.7 Conclusion

This chapter provides the background and motivation of the study, followed by the problem statement. Then, the research questions and objectives are generated. Next, significances and contributions of the study are discussed. Lastly, the scope and limitations of the study are highlighted. The organisation of the study (thesis) is also included at the end of this chapter.

CHAPTER TWO

LITERATURE REVIEW

2.1 Audit Opinion in Malaysia

There are very limited published studies on RMC, especially on its effectiveness. This study is assumed to be a pioneer study on RMC and its relationship to modified audit opinion. This chapter focuses on relevant auditing standards relating to audit opinion, risk issues, related previous studies and regulatory codes on corporate governance and risk management.

In Malaysia, the standards governing the auditing profession, including the professional opinion issued by the external auditors, are issued by the Malaysian Institute of Accountants (MIA) and are known as Malaysian Approved Standards on Auditing (MASA). The Auditing and Assurance Standards Board (AASB), as an independent standard-setting body (operating under the MIA), is responsible for considering new or revised International Auditing and Assurance Standards, as well as setting up local standards. The MASA consists of two categories: the first category is adopted from the ISA issued by the International Auditing Practice Committee (IAPC) of the International Federation of Accountants (IFAC); and the second category is the standards issued by MIA to augment the ISA, known as the Malaysian Standards on Auditing (MSA). These standards are issued to cover topics not dealt with in the ISA where particular features of Malaysian environment need local standards to address them.

According to ISA 700, paragraph 6, the objectives of the auditor are to form an opinion in a written report on the financial statement based on the audit evidence obtained and also describe the basis for issuance of that opinion. For auditors, they have to consider whether the financial statements are prepared in all material respects and obtain reasonable assurance whether financial statements as a whole are free from material misstatement due to fraud or error (ISA 700, paragraph 10 and 11). Such requirements of the auditors are consistent with ISA 240, paragraph 10, whereby the auditors have to identify and assess the risks of material misstatement of the financial statement due to fraud. Material misstatement in preparing the financial statement is an important aspect to be studied by the auditors before they form a professional opinion.

In terms of risks of material misstatement, the auditors have to understand the entity and its environment, including the entity's internal control system (ISA 315, paragraph 3). From the same standard at paragraph 4, the auditors have to consider the entity's business risks which affect its ability to achieve its objectives and execute its strategies. Further, according to paragraphs 15, 16, 17 and 26 of ISA 315, the auditors have the responsibility to understand the entity's process for managing risks, including identifying and estimating the actions to address those risks by the entity. For control activities, the auditors must obtain an understanding of the entity's internal control system that is relevant to the audit and that likely relates to financial reporting (ISA 315, paragraph, 12). The auditors have to respond to the risks that they are realized. They have to obtain sufficient and appropriate audit evidence through designing and implementing appropriate response to those risks (ISA 330, paragraph

3). For that purpose, the auditors have to implement some tests, such as test of control and substantive test (analytical procedures and test of details).

A modified audit opinion will be issued by the auditors if the financial statement is materially misstated; there is inability to obtain sufficiently appropriate audit evidence; or the auditors' judgments about pervasiveness or significant matters that affect the financial statements (ISA 705, paragraph, 2) are found. If there are material risks, whether emerging from the action of fraud or error and which affect the financial statements, modified audit opinion will be issued by the auditors. Likewise, if there are material risks coming from the client's internal control system's weaknesses or client's business operations and environment, the auditors must issue modified opinion (ISA 705, paragraph 7 to 10).

Besides, the auditors have to consider the entity's going-concern assumption before they issue an audit opinion. Modified audit opinion or going-concern opinion will be issued by the auditors if there are material uncertainty or risks about the client's business operations in future (ISA 570, paragraph A20 to A24). The risks or material uncertainty for the client's business operations in future might emerge from the loss of markets or customers, failure to make loan repayments or non-compliance of the legal provisions or statutory requirements (ISA 570, paragraph A2).

2.2 Risk and Auditor Opinion

The nature of audit has become more challenging with contemporary corporate development, such as ERM (Fraser & Pong, 2009). There is a new scope for the external auditor's work, i.e., engaging with the client's business risks. The independent auditors are required to identify and assess the risks of material misstatement of the financial statement due to fraud or error by understanding the entity and its environment, including the entity's internal control (PCAOB, 2004; AICPA, 2002; ISA 240, ISA 315 and ISA 330). Auditors are also required to issue opinions based on the audit evidence obtained during the audit process (ISA 700 and ISA 705). For this kind of situation, the Taskforce on Internal Control, with support from and endorsement by BM Securities Berhad (2000) has launched the 'Statement on Internal Control: Guidance for Directors of Public Listed Companies' which is clearly concerned with the companies having an identifiable and effective risk management framework and policy to assess the adequacy and integrity of the companies' risk and internal control process. Based on the above two statements, the researcher is motivated to study the existence of a strong RMC and relate it to financial reporting quality (audit opinion).

Client-related risk can be classified into audit risk and client's business risk. Audit risk is the risk when the auditor fails to draw attention to a material misstatement, deficiency, abuse or other unacceptable matters in an audit, leading to the issuance of an incorrect audit opinion (Elder, Zhang, Zhou & Zhou, 2009); whereas client's business risk is "the risk that the client's economic conditions will deteriorate in either the short- or long-terms" (Johnstone, 2000). For client's business risk, there are several types of risks faced by the companies, such as market risk, competition risk and political risk that affect the companies' operations and external environment as well as product risks. Audit risk can be divided into three components: inherent risk, control risk and detection risk (Martinis, Fukukawa & Mock, 2011). Inherent risk is the perceived level of risk that a material misstatement may occur in a client's financial statement in the absence of internal control procedures. Control risk is the perceived level of risk that a material misstatement in the client's financial statement will not be detected and corrected by internal control procedures. Detection risk is the perceived level of risk that a material misstatement in the client's financial statement will not be detected by the auditor (SAS No. 107, AICPA, 2006). Inherent risks and control risks lie within the company while detection risk lies with the auditors (Law, 2008).

The above mentioned risks show that there are internal and external risks related to client companies. These two main types of risks are faced by the companies. The audit committee focuses more on accounting transactions, and at its meetings, mentions about risk issues but this is an additional burden for audit committees. It is time consuming to look beyond its principle accounting functions. It may look for internal risks, such as internal control issues, but may not be well-versed on external risks, such as market, product and competition risks. The existence of a separate RMC is the best initiative by the BODs that can assure the shareholders that the company's risk profile is managed, monitored and controlled well. This initiative also puts the issue of risks at the highest rank in the company's hierarchy, i.e., at board level. At the same time, the external auditor has the responsibility for risk issues of the client's company. As guided by ISA 240, ISA 315 and ISA 330, the auditor has responsibility on risks from fraud, client's internal control and its business environment, including the external environment. They have to issue modified audit opinion if there are material misstatements relating to those risks (ISA 700 and ISA 705). This situation or phenomena creates a link between the task of the RMC and external audit opinion, especially for modified audit opinion, specifically due to reason of risks. This link forms a concrete framework between the RMC and modified audit opinion.

The external auditor is required to issue a report on internal control over financial reporting, which includes both opinion on management's assertion and opinion on the effectiveness of the company's internal control over financial reporting (Shelton & Whittington, 2008; ISA 700); failing to detect or not investigating fraud is a liability on the auditor (Reffett, 2010). In recent years, auditors have been required to issue opinion not only on financial statements, but also on the effectiveness of internal control over financial reporting (Akresh, 2010). Norman, Rose and Rose (2010) supported that external auditors must detect fraud during the audit examination period before the issuance of professional opinion. Elder *et al.* (2009) studied the relationship between internal control weaknesses (inherent risk and control risk) and client's business risks and audit opinion. They found that the higher the internal control weaknesses, the higher the tendency of auditors to issue modified audit opinion. The concern on good internal control emerges due to it being an important factor in achieving good quality financial reporting (Krishnan, 2005). In other view, Shelton and Whittington (2008) reported in their study, that auditor's report on internal control's effectiveness provides information on investment risk. They also found that adverse audit opinion lowers the strength of the internal control system and increases assessment of investment risk. As a conclusion, when modified audit report is issued by the external auditor, it indicates that the company's internal control system has problems and the company needs more awareness on this issue. The setting up of a separate RMC responsible for risk issues, including internal control risk, is a good measure to reduce the risks of the internal control system.

Haskins and Williams (1990) and Citron and Taffler (1992) reported that financial distress is the reason for auditors to issue modified audit opinion; while Lennox (2000) found that the highly leveraged companies with risk of bankruptcy are likely to receive modified opinion. Ting, Yen and Chiu (2008) said that audit opinion can provide useful information to investors on the companies' default risk. Auditors will issue modified opinion when the probability of client's business failure is higher (Geiger, Raghunandan& Rama, 2005); and such opinion negatively signals that the companies have higher default risk (Ting *et al.*, 2008). For higher litigation and bankruptcy risks, auditors are more likely to issue modified or going-concern opinion (Blacconiere & DeFond, 1997; Krishnan & Krishnan, 1996). Bankruptcy and litigation risks are the elements of going-concern. The company cannot survive in future due to its liabilities and failure to repay loans. Professional auditors will issue going-concern audit report to companies that have this type of risks and going-concern opinion is one of the modified audit opinions in this study.

A new audit approach has been applied by the big accounting firms and it is known as 'business risk auditing' (BRA), to gain knowledge and understanding of client's business and related business risks (Bruynseels, Knechel, & Willekens, 2011; Knechel, Salterio& Ballou, 2007). This BRA approach has led to effective and efficient audit work and some authors have applied this approach in their study (Kopp

& O'Donnell 2005; Choy & King 2005). Under this approach, auditors assess the client's strategy to achieve a sustainable competitive advantage; the business risks that threaten the strategy; and the client's response to these risks before the audit opinion is issued (Bruynseels *et al.*, 2011). The non-financial information from the internal and external client's business environment is helpful for auditors to evaluate the going-concern risk of a client (Knechel *et al.*, 2007). In a previous study, Bruynseels *et al.* (2011) documented that the auditors who use the BRA approach are less likely to issue qualified or going-concern opinion to a client that subsequently goes bankrupt if the client has undertaken operating initiatives, such as cost-cutting. This new approach has many advantages for both the client company and auditor.

The auditor obtains the non-financial information from the client, such as the business strategy, financial security initiative and client's response to risks, and this can help the company to receive less going-concern audit opinion. All these information can be easily obtained by the auditor if a separate RMC responsible for risk issues is established in the company. The auditor can liaise with this board committee as it will have a lot of information relating to the company's risk profile. According to ISA 570, the auditor has the responsibility to issue qualified audit opinion (going-concern opinion) for companies when there are risks of material uncertainty about those companies' future business operations. Some studies have examined the relationship between risks and going-concern audit opinion (Masyitoh & Adhariani, 2010; Carcello & Neal, 2000). Masyitoh and Adhariani (2010) found a positive effect between the solvency risk (debt risk) and going-concern opinion. The result is consistent with the finding by Davis (2009) that negative cash flow and current ratio affect the issuance of going-concern report by auditors, and in general, this type of audit opinion is useful to investors as it is a negative signal about the company's viability (O'Reilly, 2010).

The auditing profession has been critisised for not issuing the going-concern opinion as a warning signal for the impending bankruptcy of companies (Raghunandan & Rama, 1995). Young and Wang (2010) tested the five-level class of risks for likelihood of companies' failure with the probability of receiving going-concern opinion. Loan default risk and loan covenant violation risk are the factors for bankruptcy and all these risks are captured in the going-concern audit report (Foster, Ward & Woodroof, 1998). Based on the literature discussed above, there is a need to form a strong committee, known as RMC, at board level to focus on the company's risk profile. Board committees, such as the RMC, can influence the quality of financial reporting (Iyengar *et al.*, 2010). A separate RMC that is only responsible for the risk profile of the company can perform its function well since it focuses on its risk tasks only. This can reduce the degree of risks of the company and the job of auditors relating to risk issues. The audit findings relating to risk issues can be reduced as well as the issuance of modified audit opinion due to reasons of risks.

2.3 The Establishment and Importance of Risk Management Committee (RMC)

The RMC is a sub-committee of the BODs. The etablsihment of this committee is still voluntary in most countries, especially for non-financial companies (Subramaniam *et al.*, 2009). The role of the RMC in risk management is relatively unexplored and the published literature on this field is limited and scant. Tufano (1996) added the lack of research on RMC is due to the lack of meaningful data on risk management practices. Subramniam and Carey (2011) reported that the establishment of a formalised system of risk management in organisations is a more recent development. Setting up a RMC is important as the MCCG (2000; 2007 and 2012) and BM Listing Requirements require all listed companies to disclose corporate governance practices, including risk management practices in their annual report in a clear and transparent manner.

At the Corporate Governance Week 2011, the SC's chairman expressed concern about the BOD's failure to establish an appropriate measure for risk management. A strong RMC is a good initiative for risk management. According to Harrison (1987), there are two types of board committees. One type is involved in strategic role and major business decisions, such as strategic planning. The second type undertakes the function of monitoring or oversight, such as audit committee, remuneration committee and nomination committee.

The establishment of the RMC is seen as a complement to the oversight function of the BODs and might be able to reduce the burden on the audit committee. Zaman (2001) suggested it is impossible to expect the audit committee members to implement more than a high level review given their lack of expertise and time. De Lacy (2005), in her study, recommended for separation between audit committee and RMC, especially for complex business industries, where the committee should comprise various levels of people, experiences and qualifications. The complexity of risks associated with complex businesses expose them to failure (Jarvis, 2005). There are additional responsibilities for the audit committee imposed by various codes and legislative requirements, such as Combined Code, FRC (2006), MCCG (2007), Sarbanes-Oxley Act (2002) and Malaysian Companies Act (1965). Further, the Institute of Internal Auditors UK and Ireland (IIA) (2004) emphasises the separation of internal audit from risk management process, and the requirements for the internal auditors to give feedback on the appropriateness of risk management has led the internal auditors to have a new portfolio of duty.

The Audit Committee, as a board committee, and the internal auditor must ensure an organisation or a company adheres to the GAAP and the implementation of internal control effectively (Keizer, 2010). Audit committees and internal auditors have a burden if the risk management profile is included in their portfolio. COSO (2004), MCCG (2007) and ISO 31000 state the job of risk management is given to the audit committee and internal auditor as there is no legal requirement or provision for the establihment of a separate RMC. In this case, the BODs rely on the job of the internal auditor (Fadzil, Haron & Jantan, 2005).

The existence of a separate RMC is crucial for effective and transparent oversight function. The establishment of a separate RMC alone is not enough; the RMC members must have proper qualifications, experiences and commitment. The main aim for setting up a separate RMC is to reduce the burden on the audit committee and to ensure the risk profile of the company is identified, managed, controlled and monitored well. Hence, besides the members' composition in the RMC, its term of reference includes its meeting frequency and job framework (coordination between audit committee to reduce the overlapping tasks). All these refer to the characteristics and quality of the RMC. A good RMC should be established to ensure its effectiveness.

Risk management is a complex process of identifying, managing, monitoring and mitigating business risks (Subramniam & Carey, 2011); they also reported that risk management is commonly perceived as the process of addressing the risks associated with the organisations' activities in pursuit of organisational goals and across the portfolio of their activities. The formation of a separate RMC will allow the committee members to focus only on the complexity of risk faced by the company and provide better quality of internal monitoring rather than having a committee combined with other committees, such as audit committee (Alles, Datar & Friedland, 2005). COSO (2004); Hermanson (2003); and Selim and McNamee (1999) reported that a firm with a separate RMC demonstrates greater awareness of the significance of risk management and control. A strong RMC can perform better oversight function, especially on risk activities. A strong RMC can also help auditors in assessing material risks that are resulting in the issuance of audit opinion. Such risks are due to fraud or error, at the financial statement and assertion level, including the client's internal control system. It is the responsibility of the auditor to assess the materiality of those risks before the issuance of audit opinion (ISA 240, ISA 315, ISA 330 and ISA 705). If the risks are managed and monitored well by a separate RMC, the tendency for the auditor to raise risk issues is less and the issuance of modified audit opinion due to risk reasons can be reduced.

In Malaysia, Yatim (2009; 2010) studied only the factors contributing to the setting up of a separate RMC by companies listed on BM. She related some audit committee's characteristics and board's characteristics to the establishment of the RMC. The data gathered for that study was in 2003, i.e., before the amendment of MCCG (2007). The amendment of MCCG (2007) is important due to some improvements on the role and responsibility of the BODs and audit committee. Similarly, Liew *et al.* (2012) studied the characteristics of BODst related to the establishment of a separate RMC. Both studies did not test the effectiveness of the RMC, including the quality of financial reporting. The lack of studies on the effectiveness of the RMC is due to the setting up of the RMC still being voluntary and not mandatory in most countries. In this study, the relationship between RMC and modified audit opinion is examined. The effectiveness of this board committee is tested to see whether the existence of a separate RMC and its characteristics are related or associated with audit opinion, particularly modified audit opinion due to reasons of risks.

2.4 Corporate Governance and Risk Management

The collapse of corporate companies, such as Enron, highlighted the need to make directors and management of public companies more accountable and promote higher standards of corporate governance. In the USA, the Sarbanes-Oxley Act 2002 was regulated to address the issue of corporate companies and ethics of financial staff. In the United Kingdom (UK), the Department of Trade and Industry has coordinated a Company Law Review, while Italy, France and Spain have established the Corporate Governance Commission (Commission for European Companies, 2005). In the UK, all public companies listed on the London Stock Exchange are subject to the Combined Code on Corporate Governance issued by the FRC.

In Malaysia, the Finance Committee on Corporate Governance (FCCG, 1999) recommended the establishment of a governance code leading to the first MCCG in 2000; and amended in 2007, to make some improvements to suit the current corporate environment; and again in 2012. Brown *et al.* (2009) suggested that the governance structure should have a separate RMC, i.e., the separation of risks and risks under the control of the audit committee to be monitored by this new committee. The risks under the audit committee are related to accounting transactions, including the internal control system.

The risks under the RMC involve a broader scope, including operational or technical risks for the company and the company's external business environmental risks. Recent corporate governance scandals in Malaysia (PKFZ, MAS, PROTON, Sime Darby, and Perwaja Steel) have significantly increased expectation about roles of corporate governance participants including the BODs, regulators and local and international investors. This expectation also relates to the risk management activities implemented by the company (Yatim, 2009). Baker (2011) added the global economic downturn has exposed the poor risk management practices of many companies. Although risks cannot be eliminated all together, the RMC can manage and mitigate the risks (Girotra & Netessine, 2011).

Risk management is a new and important element in the corporate governance mechanism,as an effort to improve the internal control environment (Yatim, 2010).

The governance structure should consider the risk and risk management agendas for corporate decision-making processes as the risk management philosophy advocates communications across the whole organisation. It includes the BODs, senior and middle management as well as ordinary employees, where compensation and budgeting normally are in the scope of this work. . For the company's corporate governance framework, Brown *et al.* (2009) emphasised on the involvement of risk management in the framework in order to successfully implement governance in the actual business environment. Hence, the establishment of a separate RMC that focuses only on the risk profile of the company is one the initiatives to strengthen the corporate governance profile of the company.

Subramaniam and Carey (2011) argued that corporate governance is an interplay of people, structures and processes; and the quality of interaction and communication among these various elements has direct implications for the overall corporate governance effectiveness and efficiency. An earlier study by Mock & Wright (1993) posited that risk management practice is a relatively new addition to the best practices in corporate governance. They added that risk management emerged as an important element in the audit process during the early part of the twentieth century. Risk management, as an element in corporate governance, has links to management accountants on matters of cost control and budgeting (Abdul-Rasid, Abdul-Rahman &Wan-Ismail, 2011). In Malaysia, the study done by Amran, Rosliand Mohd-Hassan (2009) reported that risk management disclosure is still at infancy stage even though risk management is an important element in corporate governance.

Kamardin and Haron (2011) said that recent developments in corporate governance literature signal the significant role played by the BODs and other board committees, including the RMC. In Malaysia, the BM in 2010 issued a statement on internal control as a guide for directors of PLCs to comply with the recommendation of the MCCG on internal control and risk management disclosure in companies' annual report. Yatim (2009) added this guideline emphasises the need for proper risk management function by PLCs and that the risk management function is a critical element of a sound system of internal control. Hence, a sound internal system affects the risk management profile of the company as a whole. The internal control and external environmental risks making up the company's risk profile, come under the function of the RMC. Therefore, the requirement for the disclosure of internal control and risk management statement in company's annual report is one of the initiatives issued by the regulators on risk management issues.

The BODs plays an importance role in initiating the risk management approach in a company. The culture and approach is disseminated to top and middle management as well as all the employees in the company. Deutsch (2012) reported that many companies have concluded that they should focus on risk management at board level; while Sobel and Reding (2004) reported that the board provides the direction, authority and oversight across the company. The internal and external auditors provide independent assurance regarding appropriateness and effectiveness of risk management, internal control and its process. The BODs also plays an important role in the effectiveness of a company's corporate governance system (Younas, Siddiqi, Saeed & Mehmood, 2011); risk management is actually the core of corporate governance tasks and can create value for the company (Kaen, 2002). An informal review done by ermINSIGHTS, an ERM consulting firm, and reported by Bugalla *et al.* (2010), said that of 30 companies comprising the Dow Jones Industrials selected as the samples, 25 companies issued proxy statements; while, 76 percent included a section addressing the board's role in risk oversight; 64 percent mentioned "ERM as an enterprise's approach to risk; and 20 percent said that they had a chief risk officer in place.

Sarens and Christopher (2010) found that the Belgian corporate governance guideline places less emphasis on establishing a sound risk management and internal control system. Therefore, the focus on risk management and internal control system in Belgium is lacking and limited. It is in contrast to the Australian corporate governance guideline, whereby the companies are required to clearly define and communicate about the risk management and internal control system, as well as have a formal system to asses risks on a regular basis and formalise their policies and procedures on risk management. This shows that the implementation of a sound risk management and internal control system is different among the countries in the world.

In terms of firm value, some studies have related risk management practices and firm value. Allayannis and Weston (2001) found a positive association between risk management and firm value. Other studies were undertaken by Bartram, Brown and Conrad (2009); and Graham and Rogers (2002). They also found a positive association between risk management practices by the company and firm value. The above result shows that risk management has a positive impact on firm value.

However, studies on the effectiveness of ERM, which is a synonym for risk management practices, are still rare. The reason for this situation is the difficultly in developing a valid and reliable measure for ERM constructs (McShane, Nair & Rustambekov, (2011). However, McShane *et al.* (2011) studied the effectiveness of ERM towards firm value. They used a modern risk management framework (ERM) instead of a traditional risk management (TRM) practice as independent variable in their study. They also applied Standard and Poor's rating to rate the risk management practices in the company. Tobin's Q has been used to measure the company's value in risk management studies and it is most commonly applied by the researchers in this area of study (Smithson & Simkins, 2005).

The result of this study revealed that there is a positive relationship between TRM practice and company's value but no additional increase in value for companies achieving a higher ERM rating. However, this result is inconsistent with the argument by Brezeanu, Ai Essawi, Poanta and Badea (2011) that risk management tools represent the maximisation of company's value and are essential for capital market integration. McShane *et al.'s* (2011) study is on insurance companies where special regulations must be fulfilled by the companies. It cannot be compared to the non-financial companies since the level of practice of risk management and approach are very different. The term 'risk management' is quite new to the non-financial companies, but it is very common for financial institutions or financial companies. In financial institutions or financial companies, they are involved in financial businesses with higher exposure to risks, such as credit risk. But for non-financial companies, the term 'risk management' is new; they are more familiar with the term 'corporate governance'. Risk management is now a new element in corporate governance mechanism (Frigo & Anderson, 2011; Subramaniam & Carey, 2011). The risk management practice for banking and financial companies is different from non-banking and non-financial companies. In Malaysia, as stipulated in the Basel requirement, banking and financial companies must have separate RMC but this requirement is not applicable to non-banking and non-financial companies.

According to McShane *et al.* (2011), TRM is only related to financial risks, such as interest rate, credit, market and exchange rate risk. They argued that ERM is a modern risk management practice or framework that includes corporate governance, auditing, supply chains, information technology and human resources risk as well as everything that has a negative impact on the company's objectives and goals. Stulz (1996) proposed that the aim of risk management is not to reduce the total risks but to allocate risks to play on the company's strengths. Barney (1991) and Schrand and Unal (1998) agreed that corporate managers should coordinate risk management activities by investing in efficient markets and increasing exposure to core-business activities. The concentration on core-business activities may reduce new and unexpected risks. The reason for the economic crisis is risk management failure due to the complexity of the business environment (Bota-Avram, 2011). Hence, the establishment of a RMC is a good step to have a sound risk management profile. The setting up of this board committee will foster the risk management culture in the company because it starts from the top of the company's organisation structure.

The financial crisis that started in 2007 to 2008 is commonly related to the failure of corporate strategies, whether of corporate governance, BODs or risk management.

These three corporate terms are synonyms in the world of corporate companies, and actually these terms are within the context of corporate governance mechanism. The BODs and risk management are elements in corporate governance. They cannot be separated when discussing corporate governance. The availability of risk related information to the BODs and decision-making process is discussed here. The greater the uncertainty, the greater the amount of information needed by decision makers in order to achieve the given level of performance (Galbraith, 1974). This argument is appropriate for BODs to gain sufficient information for risky projects or matters before making corporate decisions. Jones, Hesterly and Borgatti (1997) reported that governance network can improve information processing, especially in the dynamic environment of a company.

Nohria (1995), in an earlier study, documented that the board does not function well because it is not supported by information, including network structure. In the case of Lehman Brothers, Valukas (2010) reported that several critical information pieces were not passed to the Board. The Board was not informed about the limit of risk appetite in the company and the risk management strategies. More serious occurrences in Lehman included accounting irregularities that were never reported directly to the BODs by senior managers (Bernanke, 2009). Pirson and Turbull (2011) highlighted the reasons for poor risk management before and during the financial crisis. Using an information processing perspective, they identified two main reasons for the board failing to manage risks well during the financial crisis. First, is the board did not have access to relevant information pertaining to risk management profile of the company because they did not have control over the information supply. Second, board members were unable to process the available risk-related information and lacked the power to influence managerial decision-making. The findings of their study had a great impact on the importance of risk-related information to BODs before they can make decisions.

Some implications can be seen in the study, particularly on the implementation of risk management approaches, whether or not the whole concept of ERM is applied well; or the BODs itself is ready to execute the risk management process at oversight level. In summary, the board should have full access to any important company information. Hence, the establishment of a RMC as a board committee, is seen as a good initiative for the board to gain crucial information since this board committee has full responsibility for the risk profile of the company.

Shareholders of the companies are always alert on the investment activities by the companies. They themselves are the investors in the companies and that is why they pay more attention to the companies' investment portfolios and ensure their assets are safeguarded. This situation creates a relationship between managers and shareholders as the owners of assets (Jensen & Meckling, 1976). Bauguess *et al.* (2010) added that besides considering internal monitoring and incentives for the board and executives when there is conflict between manager and owner, the external monitors, such as active shareholders, should be alerted.

As discussed in the earlier paragraph, effective risk management and corporate governance, as well as communication with investors can help increase corporate efficiency and shareholders' value. The BODs are the representatives of the shareholders and investors. They act on behalf of the shareholders who are the investors in the company. The establishment of a strong RMC can help investors in ensuring their investment portfolio is on the right track and safe. Hence, the existence of a separate RMC with strong characteristics is the best action by the BODs that can represent the investors as a whole.

Most academic studies have focused on the structure of corporate governance, either board structure, process or its composition and the effect on company performance (Noonan & Watson, 2007; Denis, 2001; Forbes & Milliken, 1999; Raja & Kumar, 2007; Brennan, 2006). Studies on risk management in corporate governance mechanism are still rare and limited (Brown *et al.,* 2009; Subramaniam *et al.,* 2009).The level of risk is different between industries (Gritta, Chow & Freed, 2003; Smith & Markland, 1981). Brown *et al.* (2009) highlighted and recommended for better corporate governance structure when considering risk management in high complex businesses, like the biotechnology industry. Besides considering financial risks, the audit committee must be formed with members having the necessary skills and experience to understand the non-financial risks faced by this type of industry.

Technical skill is very crucial for audit committee members. The creation of a risk management sub-committee of the audit committee can be considered, but the members of the audit committee must have adequate skills, competencies and experience, since this sub-committee reports to the audit committee. Brown *et al.* (2009) also suggested for the creation of a separate board level RMC to concentrate on the broader scope of risks, especially non-financial risks. The members of this committee must come from various departments, including marketing, production, human resources, finance, research and regulatory departments, and representative/s from the audit committee itself. The authors prefer the existence of a separate board level RMC in the biotechnology company due to the complexity of this type of industry and various risks associated with such a company. It is very important to educate all employees on ERM because of ERM is a risk management framework suitable for a company to implement an effective risk management profile.

When analysing the issues and problems in corporate governance, the internal and external auditor is normally bound to respond to the situation. The external auditor, with his or her professional judgment, will issue an opinion at a reasonable level of assurance regarding the system of corporate governance being implemented in the company (Sikka, Filling & Liew, 2009). The internal auditor should understand all the components in corporate governance system by improving skills and being involved in activities relating to the company's corporate governance (Leung, 2003). Paape, Scheffe and Snoep (2003) added that internal audit should become an integral part of a company's corporate governance mechanism; this statement is also supported by Allen (2008) that internal audit must play a more active role in managing businesses.

Besides the internal audit being viewed as important in the corporate governance system, the audit committee is also an important element in corporate governance mechanism, particularly for the financial reporting process (Porter, 2009). The role of this board committee is strongly related to a successful corporate governance process.

This statement is supported by DeZoort, Hermanson, Archambeault and Reed (2002) that the interaction between internal audit, external audit and audit committee is most important in ensuring strong corporate governance. Bishop, Hermanson, Lapides and Rittenberg (2000); and McElveen (2002) agreed that the combination of internal audit, external audit and audit committee, is considered as a key element for good corporate governance. The effectiveness of audit committee in corporate governance is seen as contributing to the issuance of quality financial reporting (Wolnizer, 1995). DeZoort (1997) found that audit committee members should have sufficient expertise in areas relating to accounting, auditing and law in implementing the new expanded responsibility. This finding is also agreed to by Collier and Gregory (1999) that the presence of executive directors in audit committee and dual function of chairman and chief executive have a negative impact on the effectiveness of audit committee and corporate governance system.

Pomeranz (1997) emphasised on the new structure for audit committee including upgrading the audit committee members' qualification and composition of independent members on the audit committee. Although the internal audit and audit committee are important elements in corporate governance practices of the company, including risk management process, they have other crucial tasks that need to be performed well. They have to ensure the accounting transactions adhere to GAAP and this can be a burden on them. Hence, the existence of a separate RMC that focuses on risk profile of the company as a whole can reduce the tasks of internal auditors and audit committee. Technical experts can be hired to be members of the RMC depending on the company's business operations and environment. Strong membership in a RMC together with other characteristics, such as committee's terms of reference, can reduce the exposure to risks, including internal and external risks.

2.5 Factors Influencing Modified Audit Opinion

There are various reasons for auditors to issue modified audit opinion. Basically, there are three main reasons or categories that contribute to the issuance of modified audit opinion (Lam & Mensah, 2006). The first category concerns the decision of the auditor whether or not to issue a modified opinion; followed by the second category which investigates capital market relevance of the modified audit opinion; and lastly, the third category emphasises on the modified opinion impacting the decision by financial reporting users.

For the purpose of this study, the concern is on the first category which focuses on the decision by auditor whether or not to issue modified audit opinion. There are several previous studies that have examined the decision by auditors to issue qualified or modified audit opinion. These include Masyitoh and Adhariani (2010); Wenyao and Qin (2007); Carcello and Neal (2000); Farinha andViana (2009); Martinez and Fuentes (2007); and Ballesta and Garcia-Meca (2005). Other studies also include Anderson (2011); Dopuch, Holthausen and Leftwich (1987); Farrugia and Baldacchino (2005); and Ireland (2003).

Some studies have examined the corporate governance variables in the likelihood that the company will receive an audit qualification. Ballesta and Garcia-Meca (2005) only tested the share ownership, board size and family members on the board variables in their study. A match pair design sampling technique was adopted to gather the samples from Spanish listed firms during the period of study (1999 until 2002). For multivariate instrument, the logistic regression analysis was applied to test the model and they found that a firm having family members on the board is more likely to receive audit qualification. They argued that the presence of family members on the board can result in higher liquidity and allow them to undertake more marginally acceptable investments, lower their average profitability and increase the likelihood of receiving audit qualification. From a different view, the presence of family members on the board can result in good governance in a company because of their higher awareness on the company's performance. Masyitoh and Adhariani (2010) claimed that profitability has no direct impact on qualified audit opinion. A decrease in profitability has a very low weightage for auditors to issue a qualified audit opinion comapred to a company reporting a loss for the current or prior year. However, the factors of profitability and loss can be tested simultaneously in order to see which one is significantly related to modified or qualified audit opinion.

Farinha and Viana (2009) investigated the relationship between board structure and modified audit opinion for Portuguese listed companies. Five board structure variables and some control variables were used to form a model. The researchers collected the accounting and financial data from published financial documents available in the exchange regulator's website. However, banking and financial companies were excluded because of their special regulatory requirements. As a result, 171 firms as samples were gathered for the period of 2002 until 2005. For the multivariate analysis, the logistic regression technique was used to test the regression of the model that they had developed.

The researchers developed two models: model 1 depicting modified audit opinion as a dependent variable; while model 2 was redefined by assigning qualified audit opinion as the dependent variable. Based on statistical analysis, board size seems to have no influence or is insignificant for both models. Generally, the study evidenced that firms with more board diligence and more board independence are less likely to receive modified audit opinion. The existence of some other monetary factors, such as dividend payments, financial health, performance and growth opportunities, are additional elements associated with the likelihood of modified audit opinion. However, information on composition of board members for this study is unclear due to the non-mandatory disclosure of such information by Portuguese's companies.

An earlier study completed by Wenyao and Qin (2007) correlated between board composition, the existence of audit committee and audit opinion. For board composition, the independent board and board size variables were examined; while return on assets was tested as a control variable. For dependent variable, the researchers regarded the qualified, adverse and disclaimer opinion as modified opinion and a dummy variable was used accordingly. A match-pair sampling procedure was applied to gather 94 samples from Chinese firms for the financial year ended December 2005. The result by logistic regression analysis revealed that there is insignificant difference between modified and clean audit opinion. This may imply that the role of the audit committee in monitoring the financial reporting process is not effective in Chinese listed firms. It is the same for the independent directors with no association between this variable and audit opinion. This may indicate that effective board function is not supported by inclusion of independent board members. However, return on assets and board size have significant impact on audit opinion issued which stipulates that firm performance has direct effect on the auditor's judgment; and the number of board members impact the quality of financial reporting. The result also revealed that the type of board member is not a factor affecting audit opinion compared to size of board that impacts audit opinion in Chinese firms.

Carcello and Neal (2000) tested the composition of financially distressed firms' audit committees and the likelihood of receiving going-concern report. A total of 223 samples were collected for year 1994 after deducting some samples with unintended features like foreign companies, subsidiary companies and prior audit report not being available. The researchers developed logistic regression model to examine the variables. This study evidenced that affiliated directors have a significantly negative relationship with the receipt of a going-concern report, indicating that more gray and inside directors in the audit committee can result in better financial reporting quality and reduce going-concern audit opinion. Further, this study successfully showed the relationship between corporate governance mechanism (audit committee composition) and auditor's going-concern reporting behaviour.

Another study on going-concern audit report was done by Masyitoh and Adhariani (2010). They developed logistic regression analysis model comprising several variables, such as liquidity, solvability, profitability, cash flow, audit committee and size of audit firm. The researchers applied the probability method of sampling to gather the data from companies in the manufacturing sector registered on the Jakarta Stock Exchange in 2004 until 2005. A total of 114 samples were collected during that research period. From the statistical result, audit committee was seen to have no effect on going-concern audit opinion. It meant the audit committee variable in the company has no effect on decision-making by the auditor to issue going-concern audit opinion. The same result was obtained for the size of audit firm variable. There was no relationship between audit firm size and going-concern audit report. The rest of the control variables, such as liquidity, solvability, profitability and cash flow variables also reported the same result. They recorded insignificant relationship with going-concern opinion.

Pucheta-Martinez and Fuentes (2007) studied the impact of audit committee characteristics on the enhancement of the quality of financial reporting. The samples were employed from companies listed on the Spanish Stock Exchange for the of 1999 until 2001 period. The purpose was to study the effectiveness of the audit committee in the companies. Hence, only the companies with complete information or audit committee characteristics were selected. The dependent variable was audit reports containing qualifications concerning errors and non-compliance as in Model 1; while Model 2 considered the uncertainties and scope limitations. Logistic regression analysis was used to examine these models. The result from the statistical test showed a difference, whereby the presence of audit committee did not reduce the occurrence of error and non-compliance audit qualification. It was reported to be statistically insignificant between the presence of audit committee and audit qualification concerning error and non-compliance. The existence of audit committee and its composition were also not factors associated with the receipt of audit reports containing uncertainties or scope limitation as tested in Model 2. This means that audit committee and its composition could not reduce the occurrence of qualified audit report concerning uncertainties and scope limitation. However, independent audit committee members, company size, losses in previous years, receiving the same qualified audit opinion and ownership concentration affect the likelihood of receiving error and non-compliance qualifications.

Many previous studies have investigated the relationship between corporate governance structure, board structure, audit committee structure and audit qualification or modified audit opinion. There are limited published studies on the relationship between RMC's characteristics and modified or qualified opinion. Audit committee which has the oversight function for the preparation of financial statement can reduce the risks of non-compliance with GAAP (McMullen, 1996), thereby reducing the likelihood of the company receiving modified audit opinion. However, Pucheta-Martinez and Fuentes (2007) posited that the existence of audit committee does not reduce the occurrence of error and non-compliance or there is no significant effect on the company receiving modified audit opinion. Other reasons contribute to the issuance of modified opinion by the auditor, like uncertainties or going-concern issues and scope of limitation in the audit process. According to Ireland (2003), there are two main reasons for the modified audit opinion issued by the auditor, namely uncertainty reasons (going-concern issue) and non-going-concern issues, including disagreement and limitation on scope of audit. Ireland (2003) concluded that there are internal and external risks that contribute to the issuance of modified audit opinion, i.e., the going-concern issue related to external risk and non going-concern issue related to internal risk.

2.6 Audit Function and the Significance of Audit Opinion

Audit is an important element in financial reporting because audit can enhance accountability and credibility of financial information provided (Sloan, 2001; Francis, Khurana & Pereira, 2003). Audit function can be divided into two groups: internal audit and external audit or independent audit. The objective and function of internal auditors are mutually important. Leung, Cooper and Perera (2011) highlighted a good correlation between the tasks performed by the internal auditors and objectives towards governing activities. They also added that in terms of the corporate governance process and the issue of risk management, internal control is the key factor for internal audit to make a worthwhile contribution. Mitra and Hossain (2011) supported that corporate governance is a mechanism that helps to improve the reliability of reported accounting information; investors are interested in obtaining this information which shows the impact of corporate activities (Quick & Wiemann, 2011). This argument is supported by Cohen, Gaynor, Krishnamoorthy and Wright (2007) that corporate governance is an important element for internal audit evaluation by the external auditor.

The internal audit function is important even if there is a separate RMC because internal audit function employees have expertise on accounting transactions and responsibility for the company's internal control system as a whole. A separate RMC has to take advantage of this by cooperating with internal audit. Risk of fraud can be detected because of the expertise of the internal audit staff on accounting transactions. Risk management plays an important role in a company. Subramaniam *et al.* (2009) reported that the management of risks is an integral part of good business practice. The RMC can manage those types of risks associated with the company effectively (Sullivan, 2001). The main function of the RMC is to tackle every single risk that the company will face. A strong RMC can ensure a company will survive in the future. Blay, Geiger and North (2011) argued that modified audit opinion issued by the auditor evidences that there is a substantial amount of doubt about the future viability of the company. Demirkan and Platt (2009) suggested that the quality of the board's committees plays a significant role in the quality of financial reporting. The characteristics of the RMC which is also a board's committee has implications and can influence the quality of financial reporting (Iyengar, Land & Zampelli, 2010). The type of modified audit report is a red alert of the failure of the company (Masyitoh & Adhariani, 2010).

MIA revised its Recommended Practice Guide (RPG 5, Revised 2013) that provides guidance for auditors to engage with clients on risk management and internal control statements included in the annual report. Paragraph 44 of this revised practice guide clearly states that auditors need to issue qualified, adverse or disclaimer opinion if there are insufficient or appropriate evidences relating to clients' risk management and internal control practices; or there are circumstances that are material to the inconsistency or non-disclosure of information relating to clients' risk management and internal control practices.

The internal audit function can add value to the companies' operations, and at the same time, support the function of the audit committee. This is supported by Soh and Martinov-Bennie (2011) that audit committee and internal audit function have good interaction between them, consistent with studies in the USA by Beasley, Carcello, Hermanson and Neal (2009); and Cohen, Hayes, Krishnamoorthy, Monroe and Wright (2009). Besides, internal auditing has become increasingly important in recent years as a useful monitoring mechanism in corporate governance (Sarens & Abdolmohammadi, 2011). In terms of risk management, Sarens and De Beelde (2006a, 2006b) found a significant relationship between level of risk and control awareness and role of internal audit function. More people from the corporate community are looking to the internal audit function to help in the problem of corporate reporting and internal control (Bailey,Gramling & Ramamoorti, 2003). Gramling, Maletta, Schneider and Church (2004) argued that in case of corporate reporting failure or scandals, one should not blame only the internal audit function.

The whole system of corporate governance should have responsibility for corporate failures or scandals, starting from the BODs, i.e., whether their monitoring function is enough to implement best practices of corporate governance, including risk management. The senior management also has responsibility for how they run the company and practice good governance. The interaction among BODs, internal audit and audit committee is important as each of them has different functions and different responsibilities. The BODs, through its RMC, is responsible for the risk profile of the company, especially on the external risk issues, whereby the internal audit is responsible for the company's internal control, including accounting transactions. All these efforts can ensure the effectiveness of risk management and corporate governance practices in the company.

In the USA, Sections 302 and 404 of the Sarbanes Oxley Act 2002, require management to document, evaluate and report on the effectiveness of a company's internal control over financial reporting; the Act also requires the external auditor to opine on management's assessment on internal control. The PCAOB (2007) has adopted the Auditing Standard No 5, "An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements". This standard requires the external auditor to increase reliance on internal audit work when performing integrated audit and internal control assessment on a client's company.

In Malaysia, the Taskforce on Internal Control with support and endorsement by BM Securities Berhad (2000) has introduced the 'Statement on Internal Control: Guidance for Directors of Public Listed Companies'. This guideline requires the company's BODs to evaluate and report on the effectiveness of the company's internal control system in the annual report. Desai, Roberts and Srivastava (2010) studied internal audit function and developed a comprehensive internal audit model that incorporates the featurea of 'competence', 'work performance' and 'objectivity'. The model interrelates these features; the external auditor uses all these features to measure the strength of the internal audit function. The result of this study reveals that the three features of 'competence', 'work performance' and 'objectivity' have a perfect or strong relationship with the strength of internal audit function. This study also provides the steps to help the external auditor to evaluate the internal audit function.

Desai and Desai (2011) suggested for future research on this model by testing the assumptions of the model empirically in the real audit world among external auditors. However, the result of the study by Desai *et al.* (2010) contradicts the prior model developed by Krishnamoorthy (2002) in that there are no relationships among the three features as the factors for the external auditor to assess the function of internal audit.

The study done by Sarens and Abdolmohammadi (2011) related the internal audit function and other control mechanisms, such as independent board members and audit committee, to see whether the independent board members and audit committee affect the size of internal audit function. The finding from the study reports that independent board members have negative association with size of internal audit function, meaning that independent board members act as the alternative control mechanism to internal audit function. The status of independent members of the board plays an important role in the company's audit function. In other words, by having small internal audit function, the communication between independent board members and internal audit staff can be enhanced and the information discussed is more crucial. However, in the study, no significant relationship between audit committee and size of internal audit function was found. The authors also omitted other important variables or factors, such as the previous auditor's professional opinion on the size of internal audit function. The modified audit opinion received in previous years needs better governance in the current financial year, whether in terms of internal control or other accounting or auditing (Shelton & Whittington, 2008). It is different from the external audit function whereby the report is issued by the external auditor or independent auditor.

The professional opinion of the external auditor is very important. Users, such as investors, may have more trust on the information provided by the company after being audited. The type of audit report issued depends on the audit work performed by the independent auditor, including reliance on the internal auditor's and audit committee's work. The external auditor also relies on professional opinions from computer specialists, lawyers or experts in certain areas of the industry (Brown, 1983). The external auditor needs this professional opinion due to the limited competency, skill or knowledge possessed by the auditor or his or her team members. ISA - *External Confirmations* (ISA 505) has documented the guidelines for auditors in using professional opinions in their audit work. The same applies to a separate RMC, whereby some experts should sit as committee members depending on the company's business operations and environment. This is important to understand the company's business transactions well before decisions are made.

Milton (1979) highlighted some factors that could be considered by external auditors when relying on the internal audit function. The result of the study indicates that independence and previous years' audit work are factors used by the external auditor regardless of audit firm affiliation and year of experience. This study by Milton (1979) is supported by the findings of a study by Brown (1983) that the independence of internal audit function and previous audit work are significantly related to external audit work. The external auditor has the responsibility on the work of the internal audit and previous audit work before a professional audit opinion can be issued.

In the USA, the practice of using the internal audit function's employees as management trainees before they are transferred to the management team outside the internal audit function team is becoming common (Messier, Reynolds, Simon & Wood, 2011). External auditing standards, such as the PCAOB (2007), encourage the external auditors to reduce the work done by internal auditors. The standard also requires the external auditors to act as evaluators to evaluate the competence and objectivity of internal auditors. Sometimes, external auditors perceive that internal auditors working as management trainees are biased in their work so as to look good to management (Messier *et al.,* 2011). Basically, there are two main approaches where the internal audit function employees become management trainees. First, the new graduates will be hired as employees in internal audit function with the promise they will be transferred to management shortly (Oxner & Kusel, 1996). The second approach is the existing employees work in internal audit function for a specified period of time before they are sent back to management with higher positions than before (Chadwick, 1995).

Some previous studies agree that both approaches have positive impact on the auditing job; managers can be trained to be versatile on the job and they are given exposure to all work areas of the company (Pickett, 1997; Reeve, 1990; Sawyer, 1996). Besides, these approaches also give time for management to evaluate the effectiveness of the internal control system, and at the same time, increase the understanding of internal control by managers (Ridley, 1997; Galloway, 1995). For risk management issues, internal auditors also influence the company's risk assessments and internal control evaluation (Asare, Davidson & Gramling, 2008; Lin, Pizzini, Vargus & Bardhan, 2011). The study by Messier *et al.* (2011) examined how using the internal audit function employees as management trainees can impact a client's external audit fees and external auditors' evaluation of the internal audit function. Firstly, the result of study reveals that external audit fees are significantly higher for companies that use internal audit function as a management training ground.

The findings indicate that the external audit fees could be higher because the external auditors perceive that internal audit function employees as management trainees will be less objective and more auditing jobs must be performed by external auditors instead of relying on the internal auditors' jobs. Secondly, this study also suggested that BODs and audit committees should consider whether the practice of using the internal audit function as corporate governance tool limits the potential of internal audit function to serve as an effective corporate governance mechanism. In addition, external auditors could consider the use of internal audit function as a management training ground in their assessment of internal audit quality.

Generally, investors perceive a company having a going-concern modified opinion negatively (Menon & Williams, 2010). Of late, the high involvement of internal auditors in the ERM process has impacted on the external auditor's reliance on the work of internal auditors (Zwaan, Stewart & Subramaniam, 2011). The involvement of internal auditor in ERM process in a consulting role and the nature of internal audit itself as a provider of assurance services, is becoming a challenge to the internal audit profession, management and BODs.

Audit reporting is a communication tool to inform financial reporting users about their audits (Habib, 2013). Even though the issuance rate of modified audit opinion is low in most countries, but the risks and effect of providing this type of audit opinion is large (Habib, 2013). During the global financial crisis and economic downturn, the percentage of issuance of going-concern opinion and modified audit opinion rose drastically. Xu, Carson, Fargher and Jiang (2010) reported the increase in modified audit opinion rate from the period 2005-2007 (11.5-13.5 percent) to the period 2008-2009 (19.5-20.8 percent). This figure reveals that the issue of modified audit opinion also occurs globally.

The study done by Baber *et al.* (2012) tested the governance characteristics and quality of financial reporting during the period 1997 to 2005. They combined the internal and external governance characteristics, such as independent board members, management, employees and shareholders on the occurrence of accounting restatements. The interaction between internal and external governance characteristics were statistically significant with probability of accounting restatements only when both of them were considered as main effects and interacted with each other. The finding had an impact on the cooperation between internal and external governance, such as shareholders, managers and BODs as the determinant of financial reporting quality. Many countries have improved the audit quality though laws, rules, amendments on accounting and auditing standards as well as enhanced the independence of auditors. Some researchers have also argued that audit quality actually can be measured by risk reduction (Brian, Cox & Roden, 2007). However, Knechel (2000); Watkins, Hillison and Morecroft (2004); Herrbach (2001); and Lowensohn, Johnson, Elder and Davies (2007) claimed that the quality of audit is measured by the independence of the auditor. A different opinion was provided by Francis (2004) that audit quality cannot be measured and it is very subjective in nature. However, the quality of audit can be viewed from the aspect of how much information in audited financing reporting helped and benefitted financial reporting users, such as investors, regulators, researchers and the public.

Another important aspect that must be alerted by the external auditor is fraud in the financial reporting. The Statement on Auditing Standards No 99: *Consideration of fraud in a financial statement audit* of the American Institute of Certified Public Accountants (AICPA, 2007) provides guidance on how the auditors should plan and perform the audit work in order to obtain reasonable assurance whether the financial statements are free from material misstatements due to error or fraud. The standard has also introduced a new audit procedure for audit team members to discuss how items in financial statements might be susceptible to material misstatement due to fraud. Every member in the audit team must be alert on the probability of occurrence of fraud or error in every item in the financial statement. Auditing Standard No. 5: A*n audit of internal control over financial reporting that is integrated with an audit of financial statements* of Public Company Accounting Oversight Board (PCAOB, 2007) is also concerned with the role of auditors in detecting fraud. This standard requires the auditors to extend the audit procedures in order to address the identified risks of material misstatement due to fraud. Some changes in this standard include obtaining evidence that is more reliable, the timing of doing the substantive tests and procedures must reflect the assessment of risk of material misstatement due to fraud. Auditors must think about the likelihood of occurrence of fraud in financial statement, especially fraud that is considered material.

More importantly, ISA 240: *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* provides guidance to auditors to identify and assess the risks of material misstatement of the financial statement due to fraud and obtain sufficient and appropriate audit evidence regarding the assessed risks of material misstatement due to fraud. This international standard also requires the auditors to identify the events or conditions that contribute to the occurrence of fraud or *fraud risk factors*. An environment in a company that is not effectively controlled may contribute to fraud. The auditor must provide reasonable assurance that financial statements are free from material misstatement, whether due to error or fraud. The above standards and guidelines have helped the auditors to better implement their duty in detecting fraud in financial statements (Albrecht, Albrecht & Albrecht, 2008). However, the higher expectation by investors and shareholders for auditors to detect fraud in financial statement has widened this gap (Hegazy &Kassem, 2010). Fraud is a type of internal risk that can occur especially when the internal control is weak and it contributes to the issuance of modified audit opinion by the auditor.

In terms of governance, Farber (2005) found that companies with fraud have poor governance, such as fewer experts in audit committee, fewer independent board members and fewer audit committee meetings. As auditors, they can use some methods to detect fraud during their audit work, such as red flags of fraud. Saksena (2008) found in his study that red flags are helpful to auditors to detect the possibility of fraud in the financial statement. Hegazy and Kassem (2010) also found in their study that red flags are helpful to auditors in performing their audit work to detect fraud. Meanwhile, Vicky, Hoffman, Morgan and Patton (1996) supported that the use of red flags in fraud detection helps auditors to do a better job in assessing the fraud risks. They also added that the red flags aid the auditor to classify the most important warnings regarding the possibility of fraud in the financial statement since the auditing standards do not provide detailed techniques for auditors to assess and detect fraud risks.

Another element that contributes to the quality of financial reporting is ethical value of executive leadership. COSO (1992) says that executive management and internal audit are the important elements in corporate governance to support the internal control system. Both elements also contribute to the quality of financial reporting (IIA, 2005). The ethical behavior showed by the top executives may influence the work done by employees, including accounting staff (Arel, Beaudoin & Cianci, 2012); and may also influence the judgment of auditors (Douglas, Davidson & Schwartz, 2001). More importantly, D'Aquila (1998) argued that ethical culture practised by top management greatly impacts on the financial reporting decisions. This argument is agreed to by Victor and Cullen (1988); and Sweeney, Arnold and Pierce (2010) that top management creates the policies that form the culture for the whole company or organisation.

Besides the ethical value of executive leaders, the internal audit function factor is also a component that influences the financial reporting decision. Internal audit function evaluates, monitors and gives assurance on the effectiveness of the internal control system (Kaplan & Schultz, 2007; Arel *et al.*, 2012). Asare, Davidson and Gramling (2008) said that the internal auditor responds to the changes in management incentives that influence the management's action on reporting while internal audit function responds in ambiguous situations that affect the financial reporting process.

Arel *et al.* (2012), in their latest study, combined both elements of ethical behaviour of top management and internal audit function on the financial reporting decision. The mediating effect was moral intensity. The journal entry records without supporting documents was used as the dependent variable. The result indicates that ethical behaviour and internal audit function interact with each significantly with the likelihood of accountants recording journal entries without supporting documents. Accountants are less likely to record when there are weak leaders and strong internal audit function. The study also found that the interactive effect on ethical leaders and internal audit function is fully mediated by perception of moral intensity. Accountants who have moral intensity will be less likely to make journal record entries without supporting documents.

There are many users of financial reporting, such as investors, lenders, management, authorities and the public. How they interpret the financial statement and financial reporting is different; it depends on how far they understand the technical terms in the report and the extent to which the report is useful for them (Duncan & Moriarty, 1998; Church, Davis & McCracken, 2008; Gray, Turner, Coram & Mock, 2011). The standard audit report is issued to accommodate all the users of the financial statement The standard audit report adds value and credibility to financial statement and facilitates the users to easily understand and make correct decisions (Coram, Mock, Turner & Gray, 2011). However, previous studies have found that there are gaps in how users and auditors perceive the financial statement (Low, 1984; Best, Buckby & Tan, 2001; McEnroe & Martens, 2001). Gay and Schelluch (1993) supported that the gap occurs due to the financial statement's reliability and role of auditors in adding value to the financial statement.

Asare and Wright (2012) classified the communication gap into three main groups and two types of gaps: Macro-Gap and Micro-Gap. Macro-Gap refers to the expectation by stakeholders of what the audit should do (Porter, 1993); while Micro-Gap arises due to the use of technical words in a financial statement which causes different interpretation by the users (Gray *et al.*, 2011). One of the examples that the users may have different perception from auditors on financial reporting is about the company's going-concern issues (Carmichael & Pany, 1993). Users of financial statement and financial reporting may have high level of confidence when auditors highlight the company's viability in future but the auditor him/herself has lower level of confidence in such a situation (Asare & Wright, 2012).

2.7 Conclusion

This second chapter provides the literature on the previous studies relating to this study. Auditor opinion, risk and risk management as well as corporate governance literature are discussed. Factors influencing modified audit opinion are also highlighted in the chapter.

CHAPTER THREE

RESEARCH METHOD

3.1 Theoretical Framework

The theoretical framework for this study covers the existence of a separate RMC, characteristics of RMC (independent variables) and control variables in relation to modified audit opinion (dependent variable). Previous studies have examined the relationship between corporate governance structure, board structure, audit committee structure and modified or qualified audit opinion. However, there are only a small number of published studies on the relationship between RMC's characteristics and modified audit opinion. This study provides a theoretical framework based on the previous literature on the relationship between corporate governance structure, board structure, audit committee structure and modified or qualified audit opinion. The research model is presented in Figure 3.1 which shows a hypothesised relationship between a separate RMC, characteristics of RMC, control variables and modified audit opinion.

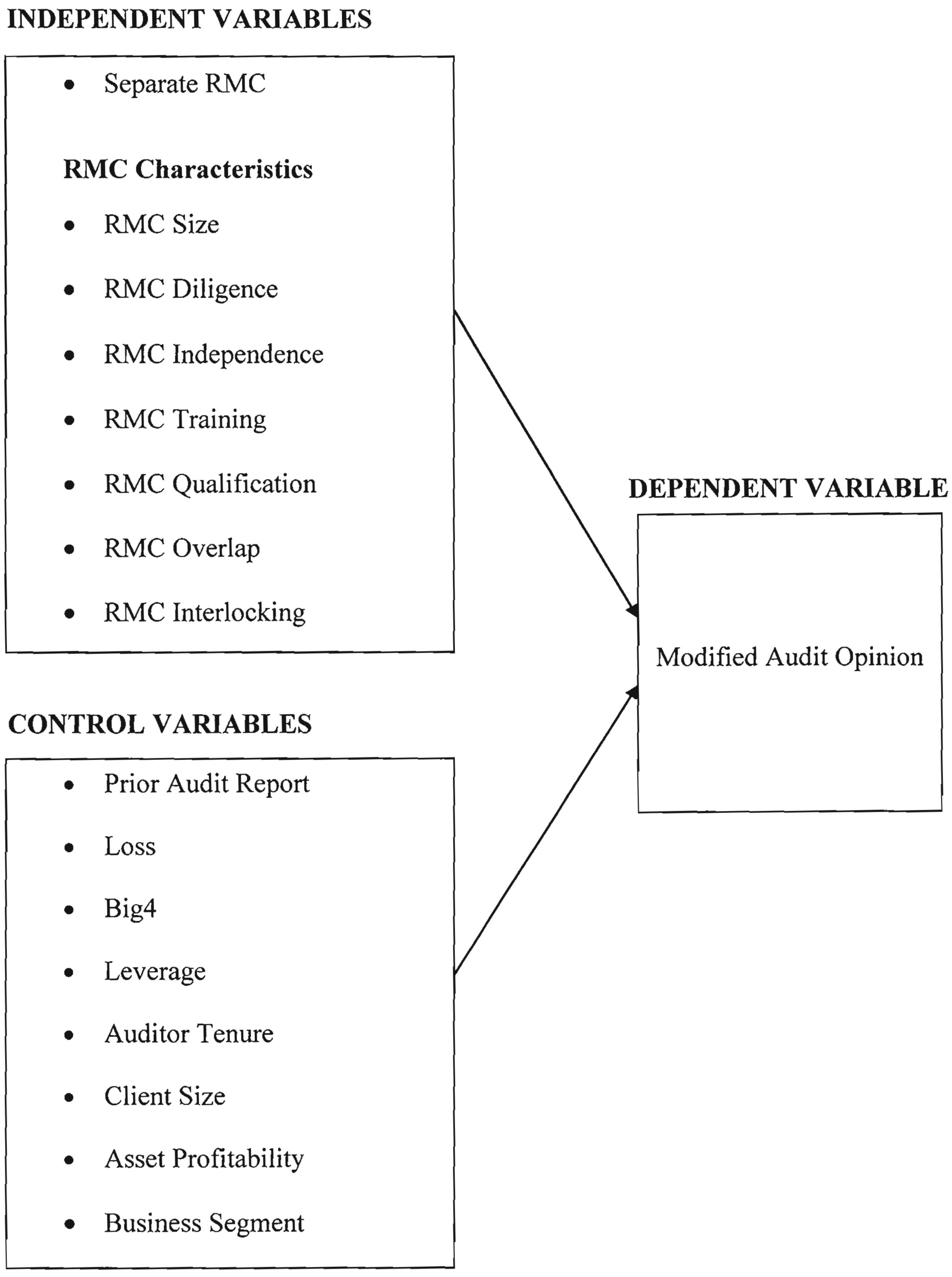

Figure 3.1
Theoretical Framework for Separate RMC, RMC Characteristics and Modified Audit Opinion

The agency theory and resource dependency theory (RDT) are applied as the underpinning theories in this study.

3.1.1 Agency Theory

The agency theory explains about the relationship between principal and agent, whereby "a contract under which one or more persons (the principal) engage/s with another person (the agent) to perform some services on their behalf which involve delegating some decision-making activities to the agent" (Jensen & Meckling, 1976). The theory emerged at the time of expansion of capitalism in the late 1800s and early 1900s which led to a widespread separation of the ownership and control functions of the firm (Berle & Means, 1932). The objective of the agency theory is to reduce "agency cost" by establishing internal controls. This is done in two ways: by forming a financial incentive scheme that aims at aligning principal's and agent's interests and governance structure where board of directors perform audits; and performance evaluations on the managers (Alange & Steiber, 2009).

From the corporate governance view, adequate monitoring mechanisms need to be established to protect shareholders from management's conflict of interests which is called "agency cost" (Fama & Jensen, 1983). Generally, in corporate governance studies, two key elements have been raised. Firstly, how the composition of board of directors affects company performance; and secondly, how the leadership structure of the company affects company performance (Barnhart & Rosenstein, 1998; Dalton, Daily, Ellstrand & Johnson, 1998).

The agency theory has been used by previous studies to examine the board committees' structure (see Benz & Frey, 2007; Ruigrok, Peck, Tacheva, Greve & Hu, 2006; Subramaniam *et al*., 2009). The board committees are predicted to emerge in a situation where agency cost is higher, such as in more complex companies, bigger companies and companies with higher financial leverage (Subramaniam *et al*., 2009). The argument is supported in an earlier study by Davis, Schoorman and Donaldson (1997) that in terms of risk orientation, the agency theory is seen as a control mechanism whereby the RMC acts as the principal. In this study, the RMC and its composition, is seen as a principal and performs the oversight function over the management (agent) in terms of risk management. The RMC, as a sub-committee of the BODs, acts on behalf of the shareholders (principal), to protect the shareholders' investment and reduce agency cost.

Lambert (2001) assumed that the agent generally acts on his or her own interests. However, Davis *et al*. (1997) argued that managers are not opportunistic, but are motivated to act in the interests of their organisations to maximise the shareholders' wealth by increasing organisational performance. The agency theory is focused on human behaviour whereby the relationship between principal and agent is at a crucial point (Subramaniam *et al*., 2009). In terms of board committee structure, Bradbury (1990); Carson (2002); and Chau and Leung (2006) supported the agency theory that the board characteristics, such as its independence and the emergence of independent chairman are potential factors affecting board structure.

In another view, Stulz (2000) revealed that there are different risk perceptions between managers and shareholders since managers tend to implement risk strategies based on their preferences but shareholders act to avoid the higher risks. The manager pretends compensation benefit as the higher the level of risk, the higher the reward for them (Berger & Ofek, 1995).

3.1.2 Resource Dependency Theory (RDT)

The other major theory of corporate governance is the RDT. The RDT was developed by Pfeffer and Salancik (1978) which links the organisation and external resources. They argued that an organisation depends on resources which are a basis of power. However, those resources are often in the hand of other organisations or firms. As a result, the external resources become critical and crucial to the organisation which needs those resources at the same time. Organisations depend on multidimensional resources, like labour, capital and raw materials (Pfeffer & Salancik, 1978). They also argued that the RDT has implications on recruitment of board members and employees, organisational structure and any other external organisational links. The argument is supported by Erakovic and Goel (2008) that decision makers, such as board and management, have an active role in seeking the external resources, reducing environmental uncertainties and developing various links with other companies. In terms of the board, there is an essential link between the organisation or company and the essential resources that it needs to maximise performance (Pfeffer, 1973). The organisation needs the board as an essential resource and to provide a bridge between the organisation and other external resources.

The value of a specific resource will change; as an example, a board with high level links to the external environment will provide the company access to various resources (Nicholson & Kiel, 2007). A previous study done by Lynall, Golde and Hillman (2003) see that in managing external relationship, the board, as a key organisational body, could provide critical resources and protect the organisation from environmental uncertainties. For scarcity of resources, the board plays an active role in searching for crucial resources and reducing the pressure from other organisations by engaging in inter-organisational relationships (Pfeffer & Salancik, 1978).

In inter-organisational relationships, the board can provide external information, access to external institutions, expert knowledge and advice (Hillman, Cannella & Paetzold, 2000). In addition, inter-organisational link is important and can affect the organisation (Salancik, 1979). A clear example is the workers' union through which workers demand for particular job benefits packages. Boyd (1990) argued that a company becomes more dependent on its environment and may adapt by looking for additional access or control over external resources.

A study done by Jackling and Johl (2009) supported the resource dependency perspective that more multiple directorships with external directors being dominant is likely to increase the companies' performance. The same study also supported the RDT that a significant relationship exists between board size and companies' performance. The RDT is also supported by another study (Chen, Dyball & Wright, 2009) that interlocking directors with additionl industry knowledge have significant and positive impact on the level of diversification. The expertise of these external board members can improve the companies' performance or diversification. The results from the above studies are consistent with the work done by Fich and Shivdasani (2006) that interlocking directors link the company with external resources and the environment to maximise performance.

For this study, the RMC, as a board committee, provides a resources to the company (Ong & Wan, 2008). Board members, including RMC members, can provide some benefits to the company, such as access to capital resources (Mizruchi & Stearns, 1988; Provan, 1980); experiences and competencies (Baysinger & Hoskisson, 1990); and a good relationship with other stakeholders (Hillman & Dalziel, 2003). Alange and Steiber (2009), in their study, supported the above argument that the board plays an important role as supplier of critical resources to the company. Ong and Wan (2008) supported that risk management and protecting shareholders are crucial monitoring roles of the board. An effective RMC with its composition is an asset to the organisation besides being a bridge to external resources.

From another perspective, the RDT sees the independent board members, such as members of the RMC, as providing the link to the external environment for strategic information (Stiles & Taylor, 2000; Palmer & Barber, 2001). Ong and Wan (2008) added outside directors are important in securing essential resources for the company. Zahra and Pearce (1989) argued that the ability of the board to link the company to crucial resources is seen as one of its key roles. Baysinger and Zardkoohi (1986) stressed that information, including outside information, is a specific resource that is important to the company. More importantly, the larger portion of outside directors on the board, including in the RMC, tends to attract more scant resources (Provan, 1980).

3.2 Hypotheses Development

Since there are very limited studies on the characteristics of the RMC, this study adopts the board's characteristics and audit committee's characteristics as the variables as well as the hypotheses. The adoption is believed to be valid and reliable due to the status of the RMC as a board committee.

3.2.1 Independent Variables

3.2.1.1 Separate RMC

Since the setting up of a separate or distinct RMC is still voluntary in most countries including Malaysia, the function of risk management is sometimes combined with the Audit Committee or directly under the BODs of the company (Subramaniam *et al.*, 2009). Harrison (1987) reported that the RMC, as a sub-committee of the BODs, is seen as specifically enhancing the accountability of the board as it provides an independent oversight of various board activities. This is also supported by Fields and Keys (2003) that the RMC has gained popularity as an important oversight committee. The argument is parallel to the agency theory that a separate RMC as a board committee should act on behalf of the shareholders.

Under the agency theory, a separate RMC acts as the principal while management acts as agent. The responsibility of a separate RMC (principal) is to safeguard the investment portfolio of the shareholders and to ensure higher returns from that investment. Its main function is to ensure the risks associated with the investment portfolio are at an acceptable level. The main responsibility of the management (agent) is to ensure the management process in the company is running well, including the management of the shareholders' investment portfolio.

The establishment of a separate RMC might reduce the burden of tasks of the audit committee as it has enough responsibility for accounting transactions (Bates & Leclerc, 2009; Lawlor, 2012). They also added that broader focus of risks can be performed by a stand-alone RMC while audit committee members, based on their skills and experiences, can focus on financial reporting and accounting. Risk management is a broader concept that encompasses internal and external risks, with external risk being more complex and related to company's business environmental risks. The complexity of the company's business risks may justify a different approach for managing risks than by just assigning it to the audit committee. The establishment of a separate board level risk committee is the best way to overcome this (Protiviti, 2010). A separate RMC with its strong composition, its terms of reference, its process and its main function to focus on the company's risk profile, may reduce the level of risks, whether it comes from internal or external sources.

RMC members with relevant academic qualifications, experiences and expertise, support the RDT in that board committee members are essential resources to the company. and at the same time. provide the external link between the organisation and other external resources (Mizruchi & Stearns, 1988; Provan, 1980; Baysinger & Hoskisson, 1990; Hillman & Dalziel, 2003). Hence, the level of risks faced by the company is less and the issuance of modified audit opinion by the auditor due to reason of risks can be reduced.

The full BODs have to consider the composition of the separate RMC and the potential need for additional board members besides finding a sufficient number of independent directors with the necessary skills. This could be a challenge for many boards (Bates & Leclerc, 2009). This opinion is shared by Bugalla *et al.*(2010) that the committee should comprise independent directors with special skills and competencies for risk management. Lang & Jagtiani (2010) added that a risk committee distinct from the BODs and senior management is needed together with powerful risk function and appropriate resources and skills.

Although the main function of the RMC is to oversee the risk profile of the company, it also has the function to identify, manage and monitor all the risks related to the company. The audit committee meets the internal and external auditor to discuss the accounting issues without the attendance of management; this may be similarly applied by the RMC to meet the chief risk officer or chief executive officer to discuss the risk issues. In addition, the RMC also has to meet the internal and external auditor relating to risk issues of the company since the RMC is also a board committee. The company should have a chief risk officer seperately overseeing the risk management function rather than relying on the internal control system that comprises internal audit, legal or compliance functions (Deutsch, 2012).

Due to complexity of non-financial risks, the board can no longer rely on the audit committee alone to manage the risks faced by the company (Brown, Steen and Foreman, 2009). Currently, corporate and market regulators in most countries have begun to focus on governance aspects in the company, particularly on risk management and risk oversight function.

The risk management process should be performed by Malaysian companies as a fulfillment of the requirements under the MCCG 2007 (revised) at part 2, AA, I, p 10 and part 2, BB, VII, p 16; and MCCG (2012). The code clearly states that the board has principle responsibility for the risk process, including the identification of principle risks up to the implementation of an appropriate system to manage those risks. A separate , as a board committee, can enhance the effectiveness of risk oversight function by the BODs. In terms of the resource dependency view, a separate RMC with its composition may provide sufficient skills, knowledge and competencies to monitor the risks involved in the organisation.

In terms of financial instruments disclosure, Hassan *et al.* (2012) found a positively strong association between the establishment of the RMC and the quality of financial instruments disclosure. Subramaniam *et al.* (2009) added that the existence of a separate RMC that focuses on the risk profile can increase the quality of internal monitoring in relation to risk management. Thus, the probability of the company receiving modified audit opinion is less and the first hypothesis is generated as follows:

H1: The existence of a separate or distinct RMC is negatively associated with the probability that the company will receive modified audit report.

3.2.1.2 RMC Size

Based on available data, the size of the RMC is three to four members. A smaller board size is seen to be better for oversight responsibility and to monitor financial reporting and related internal control (Farinha & Viana, 2009). However, in their study, the result showed the insignificant relationship between board size and the company receiving modified audit report. It means board size seems to have no influence on modified audit opinion. The result is consistent with the earlier study by Wenyao and Qin (2007) which found insignificant relationship between board size and audit opinion and the characteristic of board size was irrelevant to the audit opinion issued. Regardless of the above argument, size of a board or RMC should be adequate to perform the oversight function as mentioned in the agency theory perspective.

Xie, Davidson and Dadalt (2003) reported the negative relationship between board size and earnings management activities. Eisenberg *et al.* (1998) and Yermack (1996) found smaller BODs has more market value and high company profitability. In terms of accounting fraud, Beasley (1996) found a positive relationship between the number of board members and the occurrence of accounting fraud. However, Boyd (1990) argued that sometimes, the small board size is due to the scarcity of resources or competitive uncertainties. The lack of intended resources with specific talent in external environment leads to scarcity of resources.

An earlier study by Pucheta-Martinez and Fuentes (2007) found a positive relationship between audit committee size and the company receiving qualified audit opinion. John and Senbet (1998) argued that the board will increase its monitoring capacity if the number of board members increases, while Jensen (1993) reported earlier that an oversized board will face difficulties in making decisions because of a variety of opinions put forward. Even if more members sit on the RMC, its effectiveness may be questionable because they may rely on other members to perform their tasks. Further, though the size of the RMC may be big, but if qualified members are inadequate, the effectiveness of the RMC is questionable. This is consistent with the RDT that board or RMC members should have appropriate qualifications, whether in terms of academic qualification and experiences because they are the crucial resources to the company.

Therefore, the study suggests that RMC size can influence the probability that modified audit report will be issued by the auditor. A smaller RMC size is better for directors' monitoring functions with less probability that the auditor will issue modified audit report. This situation leads to the second hypothesis:

H2: RMC size is positively associated with the probability that the company will receive modified audit report.

3.2.1.3 RMC Diligence

RMC diligence includes the number of meetings held during the financial year. Using the number of meetings as a proxy to characterise RMC diligence, Xie *et al.* (2003) disclosed a negative relationship between board diligence and qualified audit report. Farinha and Viana (2009) supported the argument that the higher the board diligence, the lower the probability of the company receiving modified audit opinion. Pucheta-Martinez and Fuentes (2007) also supported that the company with higher audit committee meetings reduces the possibility of the company receiving a qualified audit opinion. RMC diligence is seen as one of the initiatives by the board to perform its oversight function on the management (agent); this is consistent with the agency theory in which the RMC acts as the principal. For the RDT, RMC meetings is a platform to share knowledge and information among experts. This is a crucial and critical resource for the organisation

Companies with audit opinion problems held fewer audit committee meetings during the financial year (McMullen & Raghunandan, 1996; Archambeault & Dezoort, 2001). In the study on audit committee meetings and audit quality proxied by audit fee, Mat Yasin and Puat

Nelson (2012) found a positive relationship between them. An audit committee that meets frequently demands a higher quality of audit. They need more investigation by the external auditor when there are issues on financial reporting.

In this study, it is proposed that more RMC meetings lead to many issues relating to risk management to be discussed with less probability of the company receiving modified audit opinion. The next hypothesis is tested as follows:

H3: RMC diligence is negatively associated with the probability that the company will receive modified audit report.

3.2.1.4 RMC Independence

The quality of individuals who serve on the RMC is an important indicator for effective monitoring of risk matters. The RMC is seen to be more efficient if the members come from the outside or are independent members because they have the incentive to develop their reputation as experts (Fama & Jensen, 1983). The monitoring and oversight functions performed by such members adhere more to the related approved standards, laws and regulations. Any violation of the standards and requirements will only create a negative perception among the outside firms that have an interest in their expertise (Carcello & Neal, 2000). This is consistent with the agency theory view where outside or independent RMC members will be able to monitor any self-interested actions by managers and lower agency cost (Nicholson & Kiel, 2007).

The RMC in a company monitors corporate governance (Sarens & Abdolmohammadi, 2011). Donnelly and Mulcahy (2008) found that an independent board can reduce the information asymmetry between manager (agent) and owner (principal). It is argued that an independent RMC is free from managerial influence when dealing with external auditors and this type of directors also encourage the appointment of higher quality external auditors (Salleh, Stewart & Manson, 2006). In other words, the agency cost can be reduced when independent board member sit on the BODs.

Pucheta-Martinez and Fuentes (2007) found a significant influence between audit committee with more independent members and receipt of qualified audit report. The higher the number of independent audit committee members, the less the probability a modified audit report will be received. In terms of discretionary accruals, the audit committee with larger independent members is positively associated with that issue because of the possible limited access to pertinent financial information compared to the audit committee with insiders (Md Yusof, 2010). Eisenberg *et al.* (1998) and Yermack (1996), in their study, reported that non-executive board members probably will increase the company's market value and profitability.

Independent board members, whether sitting as members of the full BODs or sub-committees of the board, such as the RMC, have greater incentives than insiders to provide financial oversight (Baber, Liang & Zhu, 2012). Armstrong and Weber (2009); and Bushman, Chen, Engel and Smith (2004) argued that outside or independents directors are typically less informed about a firm's specific factors that influence the quality of financial reporting. Although those independent directors or independent RMC members have incentive to promote the quality of financial reporting, their ability to provide quality oversight is restricted by lack of relevant information and understanding of financial reporting in detail.

In Malaysia, according to the MCCG (2000; 2007; 2012), all the audit committee members should be non-executive members and the committee should have at least three members. For the BODs, as prescribed by the Listing Requirements, membership should comprise at least two board members or one-third of the board members must be non-executive members. In the UK, the Combined Code (2010) recommends that at least half the board, excluding the chairman, must be independent non-executive directors (INEDs); while the Australian Securities Exchange (2010, 2nd edition, Corporate Governance Council) explains a majority of the board should be independent directors

Xie *et al.* (2003) said non-executive board members reduce the probability of a company being involved in accounting fraud and this is consistent with the study by Klein (2002; Beasley (1996); Peasnell, Pope and Young (2005). Younas *et al.* (2011) also found a significant relationship between board, committee members' independence and default risk. However, Wenyao and Qin (2007) found insignificant relationship between independent board members and modified audit opinion. Thus, in this study, the RMC as a sub-committee of the BODs, is used and the next hypothesis is tested as:

H4: RMC independence is negatively associated with the probability that the company will receive modified audit report.

3.2.1.5 RMC Training

Although the risk management process and its disclosure are guided by the MCCG, the effectiveness is bound to the persons responsible to implement the process who are the boards' members (MCCG, part 2, AA, 1, p 10, 2007). As the agency theory suggests, continuous training and educational programmes are important board characteristics (Roy, 2011). McIntyre and Murphy (2009) and Magan (2007) argued that higher accredited external training attended by board members is an important element contributing to board expertise. Roy (2011) supported that a strong knowledge base is crucial to understanding, evaluating and handling complex corporate issues. According to the

RDT, training may provide the competencies needed by RMC members and the organisation.

RMC members should have sufficient training on risk portfolio, including understanding of theory, concept of risk and the real business operations, such as going-concern, internal control and risk management trainings. Sufficient training for RMC members will ensure the oversight role is performed as intended. In the BM Listing Requirements (Paragraph 15.08), it is clearly stated that BODs must attend the training as prescribed by BM from time to time and each director must state the reason for non-attendance in the company's annual report. A survey by the Institute of Directors, UK (1998) found that only 27 percent of respondents claimed to have attended appropriate training courses.

Besides the independence factor, personal traits, relevant knowledge and specific skills are needed by the board members to become a leading company in the industry (Roy, 2008). Yatim (2009) suggested in her study that the members with enough risk training engage more actively in risk management due to sufficient risk exposure given to them.

Zona and Zattoni (2007) and Carpenter and Westphal (2001) found a positive relationship between directors' knowledge and skills and the board's monitoring role and strategic decision involvement. Thomas, KiddandFernandez-Araoz (2007) argued that the board could add value to the company if the lack of directorship competencies are addressed. Lastly, by gathering together for training, directors can have a network to share their ideas and learn from their peers on other boards (Coulson-Thomas, 2008). This situation leads to the following hypothesis:

H5: RMC training is negatively associated with the probability that the company will receive modified audit report.

3.2.1.6 RMC Qualification

Yatim (2009) suggested the audit committee members with finance or accounting background have better understanding of risk management activities and engage more actively in risk management processes. DeZoort and Salterio (2001) supported that board members with finance and accounting backgrounds have better understanding of the auditing issues, including risk awareness and risk detection. Carcello and Neal (2003) argued that a financial expert will be more effective in supporting the auditor's decision to issue going-concern opinion.

M. Iyer, Bamber and Griffin (2013) documented that the BODs positively intend to appoint audit committee members with accounting or financial expertise. The same situation is expected when establishing the RMC, where the members should have accounting or financial qualifications, since this committee oversees the internal control system (Lawlor, 2012). It includes the compliance and operational risks . It is vital for RMC members to have sufficient knowledge and qualification for them to understand the risks inherent in the company. Accounting and finance academic backgrounds are very important for RMC's members because this qualification provides a lot of knowledge relating to risks that surround the business operations, accounting, finance and business strategies.

The study by Keune and Johnstone (2012) found that audit committee members with greater financial expertise are less likely to allow managers to waive material misstatement in the financial statement. They also report that the professional qualification of the audit committee members helps them to maintain their reputation for not compromising with the management. Puat Nelson and Devi (2013) documented in their study that audit committee members with accounting affiliation are negatively associated with earnings management. They look for higher quality of financial reporting demanded by investors. The same situation applies for the RMC whereby members of the RMC with accounting and finance backgrounds look for higher quality and better financial reporting.

The inclusion of more expert directors in the audit committee can improve the quality of financial reporting, in particular of disclosure. It can reduce information asymmetry (Akhtaruddin & Haron (2010). Chung, Ho and Kim (2004); and Ho and Wong (2001) said that experts in the board committee serve as a means of reducing information asymmetry, managerial opportunism, improving disclosure quality and enhancing the effectiveness of resources as argued under the RDT. Having an academic background, such as in accounting and finance, as well as industry-specific knowledge by board members, would enable them to better understand the company issues and problems (Roberts, McNulty & Stiles, 2005). Md Yusof (2010) argued that audit committee with higher proportion of financial experts would lead to credible financial reporting.

The ability to govern also depends on the knowledge and skills of the board members (Lorsch, 1995). This is supported by Pettigrew & McNulty (1995) that to be effective in monitoring strategic decisions, directors should be individuals with relevant knowledge and expertise. The Listing Requirements (Paragraph 15.09) of BM also mandate that at least one board member, namely of the audit committee, must be a member of the MIA. RMC members with finance and accounting background would be expected to perform their duties, especially in relation to risk awareness and risk identification. In RMC, it is suggested majority of the members should have accounting and finance backgrounds since this type of qualification gives them the needed knowledge. Therefore, the preceding argument generates the hypothesis as below:

H6: RMC qualification is negatively associated with the probability that the company will receive modified audit report.

3.2.1.7 RMC Overlap

RMC overlap refers to the two or more functions of RMC members on different board committees. The Federation of European Accountants, Institute of Chartered Accountants Australia and the Centre for Audit Quality (2013), at their roundtable discussion in Brussels and New York City, believe that overlapping membership between the audit and risk committees is important in fostering effective communication on key issues relating risk oversight. The formation of several board committees needs several talented members (Carcello & Neal, 2003). One director might be a member of two or more board committees. A member in the audit committee might be a member of the RMC. This overlapping directorship is viewed as an insight into the corporate governance mechanism (Zajac & Westphal, 1996).

Bettenhausen and Murnighan (1985) argued that the experience and knowledge from other board memberships can be shared. Alderfer (1986) mentioned that multiple board membership experience has an effect on board decisions and this is consistent with the resource dependency perspective that the board as an organisational resource should have a pool of experiences. Most importantly, and under the agency view, several board membership experiences increase the board's oversight control on behalf of shareholders (Mizruchi, 1992).

The overlapping of members among board committees is advantageous because all the committees are board committees and not related to management function (Carcello & Neal, 2000). The poor performance of a company is caused by companies having less overlapping directorships (Gilson, 1990). This argument is supported by Kaplan and Reishus (1990) that having less overlapping directorships leads to financially distressed companies.

However, members of RMC with more tasks in other board committees may face difficulties in performing their tasks. They may lack concentration or focus on risk issues. Hence, the effectiveness of their function as RMC member is at a minimum level. Overall, the risks faced by the company cannot be monitored well by the RMC and this can draw the attention of the auditor. Hence, modified audit report due to reason of risks may be issued by the auditor.

On the other hand, members of the RMC with higher overlapping or more tasks in the other board committees may look for better jobs.

They may not have the time to focus fully on risk issues This attracts the attention of the auditor and some of the issues may lead to issuance of modified audit opinion. Thus, the next hypothesis is as follows:

H7: RMC overlap is positively associated with the probability that the company will receive modified audit report.

3.2.1.8 RMC Interlocking

RMC interlocking refers to situation where one director is a member of the BODs or any other board's committee of a company and at the same time, is a member of other companies' board committees (Haniffa & Hudaib, 2006). The vast experience and knowledge of this kind of member will enhance the integrity of internal control and oversight functions (Yatim, 2009; Mohd Saleh, Mohd Iskandar & Rahmat, 2005). Interlocking directors seek to maintain favourable reputation and increase their attractiveness as candidates for appointment in other companies (Zajac & Westphal, 1996; Fama, 1980). Fich and Shivdasani (2007); Vafeas (1999); and Ferris, Jagannathan and Prichard (2003) added that interlocking directors are alerted their reputation to provide effective financial reporting oversight.

However, Kamardin and Haron (2011) found a negative relationship between director interlocking and management oversight roles, i.e., there is no relationship between director interlocking and director's performance evaluation roles. Beasley (1996) added in his study that fraud is likely happen when outside directors hold more than two other directorships. In terms of firm performance, director interlocking has no influence on that variable (Che Haat, Abdul Rahman & Mahenthiran, 2008). Under the resource dependency argument, outside directors could provide critical resources and protect the organisations from environmental uncertainties (Pfeffer & Salancik, 1978). They can provide crucial resources and reduce the pressure from other organisations by engaging in inter-organisational relationships. Hillman *et al.* (2000) supported that external board members can provide external information, access to external institutions, expert knowledge and advice.

Haniffa and Cooke (2002) reported that multiple directorships or directors interlocking is common among Malaysian PLCs. This is consistent with the BM's Listing Requirements (Paragraph 15.06), that BODs must not hold more than 25 directorships, with 10 directorships for listed companies and 15 directorships for non-listed companies. The next hypothesis tested is:

H8: RMC interlocking is negatively associated with the probability that the company will receive modified audit report.

3.2.2 Control Variables

Prior Audit Report

Another factor for a company to receive modified audit opinion is whether the company has prior experience of receiving modified or qualified audit report. The company has a potential to receive the same audit report if circumstances that led to the previous financial statement or any other business operations have still not been addressed (Pucheta-Martinez & Feuntes, 2007). The above is supported by Mutchler, Hopwood and McKeown (1997) that companies receiving qualified audit report in the prior year have more probability of receiving the same type of report in the current year. This situation creates more potential for the auditor to issue modified audit report if the old issues have not been solved well.

However, Nogler (1995) is concerned the companies that have received modified audit opinion must make improvement to receive a clean audit opinion in the subsequent year. Thus, a positive association between prior audit report and current modified audit report is expected.

Loss

If a company reports consecutive losses, this will be likely to have an impact on auditor's opinion (Farinha & Viana, 2009). They have proved this argument in their study that the existence of consecutive losses positively impacts on the issuance of modified opinion by the auditor. The result is also consistent with the study done by Pucheta-Martinez and Fuentes (2007) that a company that reported losses in the prior year has a positive relationship with the probability of receiving qualified audit report in the current year. Companies reporting consecutives losses are characterised by greater financial risks and modified opinion will be issued. Thus, it is expected there is a positive relationship between consecutives losses and current modified audit report.

Big 4

Generally, in auditing literature, Big 4 audit firms provide more superior audit quality than non-Big 4 audit firms (Lawrence, Minutti-Meza & Zhang, 2011) and high-quality auditors (Big 4) are more likely to detect earnings management or fraud because of their superior knowledge and experiences (Francis, Maydew & Sparks, 1999; Becker, DeFond, Jiambalvo & Subramanyam, 1998). Francis and Krishnan (1999) added that Big 4 audit firms are alert on high level of accruals and always set in mind the high level of that probability emerging.

Francis (2004); Barton (2005); and Moizer (1997) also supported that large companies tend to use the auditing services of Big 4 audit firms as this type of firm offers quality audit services. Lennox (1999) concurred that Big 4 audit firms are more stringent and the quality or independence of the audit report is not questionable. Consequently, modified audit report will be issued if certain reasons necessitate this type of audit report..

Farinha and Viana (2009) reported in their study that Big 4 audit firms have no significant relationship with modified opinion issued by the auditor. Some previous studies have confirmed the higher credibility of financial report audited by Big 4 audit firms (see Teoh & Wong, 1993; De Angelo, 1981; Francis & Wang, 2008; Pittman & Fortin, 2004; Khurana & Raman, 2004; Mansi, Maxwell & Miller, 2004). Specifically, for client-specific litigation risk, there are differences in audit quality between Big4 and non Big-4 audit firms (Sun & Liu, 2011). In this study, the researcher expects a positive association between Big 4 audit firm and modified audit report.

Leverage

Leverage refers to the total debts of a company to the total assets owned. It determines the ability of the company to meet financial obligations. Under the agency theory, there is a conflict between principal (shareholders) and agent (manager) in a company (Jensen & Meckling, 1976). The same situation occurs in leverage where there is a conflict between debt holders and management (DeFond, 1992; Francis & Wilson, 1988). When the debts in the company's capital structure increase, there is a need for monitoring the level of leverage on behalf of debt holders. Monitoring is also crucial to measure the company's ability to repay those loans in the future.

Chow (1982) and Abdel-Khalik (1993) reported in their studies that there is a positive association between level of debts or leverage and demand for external auditing. This finding is supported by Watts and Zimmerman (1983) that external auditor assurance reduces the costs of monitoring by debt lenders due to the external auditor enhancing the quality of financial reporting.

High financial obligation adversely affects the company (Pucheta-Martinez & Feuntes, 2007). The financial health of the company is also a reason why the auditor issues qualified or modified audit report (Chen & Church, 1992; Carcello, Hermanson & Huss, 1995; Willikens, Bauwhede & Gaeremynch, 2004; Mutchler *et al.*, 1997). It is also consistent with the study done by Younas *et al.* (2011) that leverage has positive association with expected default risk and leverage is the main variable that affects the risk management system (Lookman, 2003). However, Cremers and Nair (2005) argued that higher leverage is equivalent to strong corporate governance mechanisms since self-financing does not have strong corporate governance elements. Therefore, the expected sign between high leverage and modified audit report is positive.

Auditor Tenure

According to Shockley (1982), a long-term relationship between the client and auditor will lead to less rigorous and blind reliance on the client. Also, Vanstraelen (2000) reported a long-term relationship reduces the auditor's willingness to issue a qualified audit report. Al-Thuneibat, AiIssa and Ata Baker (2011), Deis and Giroux (1992), Copley and Doucet (1993) supported that a long audit tenure affects the audit performed by the auditor.

However, Boone, Khurana and Raman (2008) argued that a long-term relationship with client is crucial for the auditor to understand specific knowledge about the client's accounting system, internal control, operations as well as the client's industry features. Shafie, Wan Hussin, Md. Yusof and Md Hussain (2009) evidenced that auditor tenure is positively associated with the auditor reporting quality which means a clean audit report will be issued with long tenure of engagement with the same auditor.

Some researchers have studied the effectiveness of rotation or mandatory rotation of external auditor. For instance, Lu and Sivaramakrishnan (2009) examined the effect of mandatory audit firm rotation on company's investment decision; while Kaplan and Mauldin (2008) investigated the relationship between audit firm rotation and independence related perceptions. The result of this study revealed that audit firm rotation does not strengthen independence appearance among non-professional investors. Li (2010) also added that auditor tenure threatens auditor independence, especially in smaller firms. In terms of audit quality, Jackson, Moldrich and Roebuck (2008) found that mandatory audit firm rotation does not increase audit quality and auditor independence.

The IFAC Code of Ethics (IFAC, 2010) does not mention about the external audit firm rotation and only discusses internal rotation. According to paragraph 290.150 of the Code, senior personnel of internal auditing team should be rotated to reduce the risk of independence and self-interests. Meanwhile, the European Commission, through its Recommendation Paper in May 2002, also stipulated the internal auditor rotation as a safeguard to reduce independence risk if key personnel are involved over a long period.

In this study, the researcher expects there is a negative relationship between auditor tenure and modified audit report.

Client Size

The size of client may influence the auditor in issuing his or her audit opinion (Pucheta-Martinez & Feuntes, 2007). They argued the risk of damage to auditor's reputation and risk of litigation are of concern to the auditor. Hence, a more independent audit approach will be adopted and it is more likely modified audit report will be issued. The arguments made by Pucheta-Martinez and Fuentes (2007) are consistent with Reynolds and Francis (2000) that larger client size would increase the auditor's concerns.

However, McKeown, Mutchler and Hopwood (1991) found a negative relationship between client size and the receipt of qualified audit report. This finding is supported by other studies (see Carcello *et al.*, 1995; Mutchler *et al.*, 1997). De Angelo (1981) warned that the issuance of modified or qualified audit report could result in not hiring this audit service in future, especially for first time auditors. Nevertheless, the researcher expects a positive relationship between client size and the issuance of modified audit report by the auditor.

Asset Profitability

Larger asset profitability (Return On Assets - ROA) would lead to a lower probability of a company being issued a modified audit report and low-risk evaluation by the auditor (Farinha & Viana, 2009). However, Masyitoh and Adhariani (2010) found an insignificant relationship between profitability and qualified audit report. This means, profitability has no effect on the decision made by the auditor to issue qualified or modified audit report.

Bradshaw, Richardson and Sloan (2001) found a negative relationship between performance and the receipt of modified audit opinion. When the company gains higher asset profitability, the stakeholders, including the auditor, feel that the company is operating well. Higher asset profitability also signals that the management is operating well and is financially stable. The auditor will just make some small risk evaluations under such a situation. Hence, the researcher expects that higher asset profitability will reduce the probability of the company receiving modified audit opinion. The argument leads to the negative relationship expectation between asset profitability and modified audit report.

Business Segment

Normally, if a company has two or more business segments, it tends to set up a RMC for better oversight function at board level. The operating of different types of businesses needs effective monitoring by the BODs and the establishment of a RMC. The RMC can address the issues of risks faced by the company, particularly the business and external environmental risks (Yatim, 2010; Subramaniam *et al*., 2009). Two or more business segments of a company impact on the company's risk management process. There is more awareness on the risk issues especially for the risks related to the business environment. Companies with more business segments or portfolios tend to have a strong risk management framework, including a separate RMC. This initiative by the company causes risk to be at a controllable and manageable level. Further, this situation causes less issuance of modified audit opinion due to risk reasons. Therefore, the company with two or more business segments is expected to have a negative relationship with the issuance of modified audit report by the auditor.

Table 3.1 below summarises the agency theory and RDT as the underpinning theories in this study for specific independent variables.

Table 3.1
The Underpinning Theories and the Independent Variables

Agency Theory	**Resource Dependency Theory (RDT)**
Separate RMC	RMC Size
RMC Size	RMC Diligence
RMC Independence	RMC Training
RMC Overlap	RMC Qualification
	RMC Interlocking

3.3 Operational Definitions

The operational definitions for the selected variables in this study are as follows:

1) Risk management committee (RMC) refers to a committee under the BODs or a sub-committee of the BODs. The members of the committee comprise members of the BODs. The function of this committee is to help the BODs on the risk management profile of the company (Subramaniam *et al.*, 2009 & Yatim, 2009).

2) Separate RMC or stand-alone committee refers to a board committee which has the duty only on risk management of the company. Sometimes, the name 'RMC' is combined with audit committee or other committees. This will then be a joint committee and not a separate RMC (Subramaniam *et al.*, 2009 & Yatim, 2009).

3) RMC's characteristics refer to the features of the RMC itself and its members. They are RMC size, RMC diligence, RMC independence, RMC training, RMC qualification, RMC overlap and RMC interlocking. The tests on these variables have been done by Subramniam *et al.* (2009); Ahmad-Zaluki and Wan-Hussin (2010); Carcello and Neal (2000); Pucheta-Martinez and Fuentes (2007); Farinha and Viana (2009); and Ballesta and Garcia-Meca (2005).

4) RMC size refers to the number of members sitting on the RMC (see Ballesta & Garcia-Meca, 2005; Wenyao & Qin, 2007; Iyengar *et al.*, 2010).

5) RMC diligence refers to the number of meetings held during the financial year (Xie, Davidson & DaDalt, 2003; Farinha & Viana, 2009).

6) RMC independence refers to the number of independent non-executive members sitting on the RMC (see Fama & Jensen, 1983; Farinha & Viana, 2009; Pucheta-Martinez & Fuentes, 2007).

7) RMC training refers to the number of risk-related trainings attended by the RMC members (Farinha & Viana, 2009).

8) RMC qualification refers to the members of RMC who have formal accounting or financial educational background (Yatim, 2009).

9) RMC overlap refers to the two or more functions of RMC members on the different board committees. A member of RMC might be a member of the audit committee or other board committees at the same time (Carcello & Neal, 2000).

10) RMC interlocking refers to the situation where a member of the RMC is also a member of the RMC or other board committees of different companies (Iyengar *et al.*, 2010).

11) Prior audit report refers to the audit report that a company has received for prior financial year (Pucheta-Martinez & Fuentes, 2007; Carcello & Neal, 2000).

12) Loss refers to the consecutive losses recorded by a company (Farinha & Viana, 2009; Pucheta-Martinez & Fuentes, 2007). Consecutive losses in this study refer to the last two years a company has recorded losses.

13) Big 4 refers to the four largest international audit firms in the world. They are PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young and KPMG (Kabir, Sharma, Islam & Salat, 2011).

14) Leverage refers to the total debts of a company to the total assets owned. It is measured by the total debts divided by the total assets (Pucheta-Martinez & Fuentes, 2007).

15) Auditor tenure refers to the number of years of engagement with the same audit firm (see Ghosh & Moon, 2005; Vanstraelen, 2000).

16) Client size refers to the total assets owned by a company (Pucheta-Martinez & Fuentes, 2007; Carcello & Neal, 2000).

17) Asset profitability refers to the ratio between earnings before interest, tax and extraordinary income to total assets (Farinha & Viana, 2009).

18) Business segment refers to the different types of businesses a company operates at the same time. A company may operate several types of businesses (industries) (Yatim, 2010).

19) Modified audit opinion is a type of audit report issued by the independent auditor and for the purpose of this study, modified audit opinion refers to the unqualified with explanatory paragraph (modified wording), qualified, adverse and disclaimer audit report received by a company (ISA 700; ISA 705; Arens *et al.*, 2009; Masyitoh & Adhariani, 2010; Millichamp & Taylor, 2008).

3.4 Variables Definition and Measurement

The data collected for this study consists of three main categories: dependent variable, independent variables and control variables.

3.4.1 Dependent Variable

Modified Audit Opinion (MA)

Modified audit opinion is the dependent variable tested in this study. According to Aren *et al.* (2009), there are five types of audit reports, namely standard unqualified or clean audit report; unqualified with explanatory paragraph or modified wording; qualified report; adverse report; and disclaimer audit report. For the purpose of this study, the unqualified with explanatory paragraph (modified wording), qualified (except for), adverse and disclaimer audit report are classified as modified audit opinion. Blay *et al.* (2011) reported that modified or qualified audit opinion issued by the auditor evidences that there is a substantial amount of doubt about the future viability of the company. The researcher read the auditor's report carefully in order to know what type of audit report has been issued to the company. If a company received a modified audit report, the data is valued as '1' in the worksheet and if a company received the audit report other than modified audit report, the value of '0' is coded accordingly. This measurement has been applied by Ballesta and Garcia-Meca (2005), Caramanis and Spathis (2006), Dopuch, Hothausen and Leftwich (1987) and Ireland (2003).

3.4.2 Independent Variables

Separate RMC (SEPRMC)

For this independent variable, the researcher read and checked details of the availability of a separate RMC or the function of risk management is mentioned but the task and responsibility is assigned to other board committees, such as audit committee. Careful reading was required to identify the type of risk management implemented in the company. In some cases, the company may have the title 'RMC' or audit and risk management committee or nothing is mentioned about risk management. The researcher considers the existence of a separate RMC if the committee has a single committee with title of 'risk management committee' without combination with any other committees, including audit committee. Any combination of task and responsibility of risk management with other committees' tasks is considered 'no existence of separate RMC (Combined RMC)'. For the purpose of this study, if the company has a separate RMC, it is coded as '1' and if a company does not have a separate RMC, the value of '0' is coded. This criterion has been used by previous studies, such as Subramaniam *et al.* (2009) and Yatim (2009).

RMC Size (RMCSIZE)

RMC size is the total number of RMC members sitting on the committee until the end of the financial year. A member is considered as a RMC member if the appointment as member is at least six months and above. If the appointment as RMC member is below six months or the resignation is above six months from the financial year end, he or she is not considered as RMC member. The actual number of RMC members was counted and then keyed-into the worksheet (see Farinha & Viana, 2009; Pucheta-Martinez & Fuentes 2007).

RMC Diligence (RMCDILI)

RMC diligence refers to the number of RMC meetings held during the financial year. The researcher calculated how many meetings had been held by the RMC during the financial year. The data can be accessed directly through the company's annual report from the section on RMC meetings. Then, the number of meetings was entered into the worksheet. Normally, four to six meetings are held by the company during the financial year. This measurement for the RMC has been practiced by Xie *et al.* (2003) and Farinha and Viana (2009).

RMC Independence (RMCINDE)

RMC independence refers to the number of independent non-executive members on the RMC. The data can be accessed through the section on directors' profile and composition of RMC in the company's annual report. The number of independent non-executive members was divided by the total number of RMC members and then the total was generated (see Fama & Jensen, 1983; Farinha & Viana, 2009; Pucheta-Martinez & Fuentes, 2007).

RMC Training (RMCTRAI)

RMC Training measures how many risk-related trainings have been attended by members of RMC during the accounting year. Normally, there are various trainings offered to RMC members since they are the members of the board committee as well. Usually, the trainings are organised by the regulators, authorities and professional bodies, such as SC, BM and MIA. For the purpose of this study, the researcher only considered the training related to risks or risk management attended by the members of the RMC, such as risk assessment training, internal control training and business strategy risk training. Then, the number of trainings attended was keyed-into the worksheet. Farinha and Viana (2009) and Yatim (2009) have practiced this measurement.

RMC Qualification (RMCQUAL)

For the RMC qualification, the researcher carefully read the section about directors' profile to identify the qualifications of the RMC's members. For this study, the researcher looked up the formal accounting or finance educational backgrounds of the RMC members and if the academic level is at least a bachelor's degree and above. The figure was generated by the total number of RMC members with the said qualification divided by the total number of members sitting on the RMC (see Yatim, 2009).

RMC Overlap (RMCOVER)

RMC overlap refers to the two or more functions of RMC members on the different board committees. A member of the RMC might be a member of the audit committee or other board committees at the same time. For a company, a member of the RMC or any other board committee can become a member of other board committees, such as the Remuneration Committee and Audit Committee at the same time but not all the members are in such a situation. For measurement purposes, researcher compared the composition of RMC with all the other board committees to identify the members of RMC with two or more functions at the same time. Then, the total number of RMC members with two or more functions was divided by the total number of RMC members. This measurement has been applied by Carcello and Neal (2000).

RMC Interlocking (RMCINTER)

RMC interlocking refers to the situation where a member of the RMC is also a member of the RMC or other board committees of different companies. The members of the RMC or other board committees are the representatives from the shareholders and also experts in certain areas. At the same time, the representative of shareholders has share equity in other companies and also a board member in those companies. The situation also happens to experts who are appointed by the different companies as a RMC or other board members. For the purpose of this study, the researcher identified the names of the RMC members and made cross-reference to BM's database to identify the RMC members who are also members of the RMCs or board committees of other companies. Finally, the number was calculated by the total number of RMC members with more than one board membership at different companies divided by the total number of RMC members. The rule has been used by Iyengar *et al.* (2010).

3.4.3 Control Variables

Prior Audit Report (PRAUREP)

Prior audit report refers to the audit report that a company has received for the prior financial year. The researcher read the independent auditor's report at the end of the annual report booklet, in order to identify the type of audit report. For measurement purposes, the researcher coded a dummy of '1' if the company had received modified audit opinion for the prior financial year's audit and a dummy of '0' if the company received a clean audit opinion for the prior financial year's audit. This measurement has been used by previous studies (Pucheta-Martinez & Fuentes, 2007; Carcello & Neal, 2000).

Loss (LOSS)

Loss in this study refers to the consecutive losses recorded by a company and the term 'consecutive losses' in this study refers to the last two years a company has recorded losses. The data on loss can be accessed through the profit and loss statement or income statement in the financial statement. The researcher coded a dummy of '1' for the company reporting loss in either or both of the two previous financial years and a dummy of '0' otherwise. Farinha and Viana (2009) and Pucheta-Martinez and Fuentes (2007) have applied this rule for their previous studies.

Big4 (BIG4)

Big 4 refers to the four largest international audit firms in the world. They are PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young and KPMG. The researcher looked at the bottom of the auditor's report sheet to identify the audit firm that audited the company. The name of auditor and audit firm are stated there. If the audit firm is one of the Big 4, the data is coded as '1' and if a non-a Big 4 firm audited the company, the data is coded as '0'. Other studies have used this criterion for their research (Yatim, 2010, Kabir *et al.*, 2011; Farinha & Viana, 2009; Pucheta-Martinez & Fuentes, 2007).

Leverage (LEV)

Leverage in this study refers to the total debt of a company to the total assets owned. It is measured by the total debts divided by the total assets. For this type of control variable, the researcher made a calculation of the total debts divided by the total assets. The result was entered into the worksheet. Total debts and total assets are reported in the balance sheet statement. There are studies which have applied this rule for measuring this variable (see Pucheta-Martinez & Fuentes, 2007; Ballesta & Garcia-Meca, 2005; Yatim, 2010; Lawrence *et al.*, 2011).

Auditor Tenure (AUTEN)

For auditor tenure, the researcher reviewed the companies' annual report for every financial year in the period of study which is from 2004 until 2009. The researcher identified how many years the company has been engaged with the same audit firm. The number of years of engagement with the same audit firm was keyed-in into the worksheet. This measurement has also been applied by previous studies, such as Pucheta-Martinez and Fuentes (2007).

Client Size (CLSIZE)

Client Size is also adopted as a control variable in this study. For the purpose of this study, the researcher measured the variable by looking at the total assets (natural log of total assets in millions of RM) owned by the company. The total assets are valued in Ringgit Malaysia since the Malaysian PLCs use the RM for all their transactions and records. The data of total assets can be accessed through the balance sheet statement and the value was entered into the worksheet. The use of this variable and measurement has been practiced by Pucheta-Martinez and Fuentes (2007) and Carcello and Neal (2000).

Asset Profitability (ASSPRO)

Asset profitability refers to the ratio between earnings before interest, tax and extraordinary income to the total assets. This data can be obtained from the income statement and the total assets from the balance sheet statement. The result after the calculation of that ratio was entered into the worksheet. Farinha and Viana (2009) have applied this measurement in their study.

Business Segment (BUSSEG)

The researcher ensured how many types of businesses or segments a company owns and is operating. The data can be accessed through the company's annual report which is normally available in the first few pages of the report. If the company has two or more business segments, a dummy value of '1' is coded and if the company is operating just one business segment, the value of '0'is coded accordingly.

Table 3.2 below summarises the measurement for each of the dependent, independent and control variables for this study as well as expected direction.

Table 3.2
The Measurement for Dependent, Independent and Control Variables and Expected Direction

Acronym	Variables	Measurements	Expected Direction
	Dependent		
(MA)	Modified Audit Opinion	1, if received modified audit opinion, otherwise 0	-
	Independent		
SEPRMC	Separate RMC	1, if the existence of separate RMC, otherwise 0	Negative
RMCSIZE	RMC Size	number of RMC members at financial year-end	Positive
RMCDILI	RMC Diligence	number of RMC meetings during the financial year	Negative
RMCINDE	RMC Independence	proportion of independent non-executive members on the RMC	Negative
RMCTRAI	RMC Training	number of risk/risk management related training to RMC members	Negative
RMCQUAL	RMC Qualification	proportion of RMC members with accounting or finance qualification	Negative
RMCOVER	RMC Overlap	proportion of RMC members with two or more functions on different board committees	Positive

RMCINTER	RMC Interlocking	proportion of RMC members with more than one different company's board membership	Negative
	Control		
PRAUREP	Prior Audit Report	1, if the company received modified audit opinion in the prior year, otherwise 0	Positive
LOSS	Loss	1, if the company reported loss in either or both of the two previous years, otherwise 0	Positive
BIG4	Big4	1, if the auditor is BIG 4, otherwise 0	Positive
LEV	Leverage	total debts/total assets	Positive
AUTEN	Auditor Tenure	number of years of engagement with the same audit firm	Negative
CLSIZE	Client Size	natural log of total assets (in millions of Ringgit Malaysia)	Positive
ASSPRO	Asset Profitability	ratio between earnings before interest, tax and extraordinary income and total assets	Negative
BUSSEG	Business Segment	1, if the company has two or more business segments, otherwise 0	Negative

3.5 Sources of Data

Secondary data is used for this study. The companies' annual reports published in BM's website were downloaded accordingly. The study also used the financial datastream (Thomson Datastream), and other articles that are considered relevant to the study. Table 3.3 summarises the sources of data for this study.

Table 3.3
Data Sources

Variables	Acronyms	Sources	Section/Part
Dependent Variable			
-Modified Audit Opinion	MA	Annual Report	Auditor's report/statement
Independent Variables			
-Separate RMC	SEPRMC	Annual Report	Corporate governance report
- RMC Size	RMCSIZE	Bursa Malaysia Database	
- RMC Diligence	RMCDILI	Datastream	RMC members' profiles
- RMC Independence	RMCINDE		Director/chairman's statement
- RMC Training	RMCTRAI		RMC/board committee's profile
- RMC Qualification	RMCQUAL		
- RMC Overlap	RMCOVER		
- RMC Interlocking	RMCINTER		
Control Variables			
- Prior Audit Report	PRAUREP		
- Loss	LOSS	Annual Report	Income statement
- Big4	BIG4	Financial Statement	Balance sheet
- Leverage	LEV	Notes to The Account	Cash flow
- Auditor Tenure	AUTEN	Datastream	
- Client Size	CLSIZE	Bursa Malaysia Database	
- Asset Profitability	ASSPRO		
- Business Segment	BUSSEG		

3.6 Population Frame

The population frame for this study is all the PLCs, excluding banking and financial institutions, listed on BM's website from the period of financial year ended 2004 until 2009. Based on the data gathered through the BM's website, there are more than 130 companies with modified audit report for the same period (2004-2009) and more than 200 companies which have a separate or a stand-alone RMC's disclosure for the said period (Bursa Malaysia's website, 2012; Yatim, 2009; 2010). Banking and financial institutions are omitted from the sample as the nature and regulations of these firms are significantly different from non-financial companies. The PLCs are chosen for this study. PLCs must publish their annual reports that are publicly available and can be accessed through the BM's website. The annual reports are presented in accordance to the requirement of BM's regulations and Malaysian Companies Act 1965. The data in the annual reports are credible. The Thomson Datastream is also used to complement the annual report data, such as the data on the companies' financial value (assets, revenue, profit, etc.) as well as market share price.

3.7 Sampling Design and Data Collection

The researcher used samples rather than collect data from the entire population because only certain characteristics of population are selected. Later, a match sampling approach was adopted as a control procedure (see Ballesta & Garcia-Meca, 2005; Wenyao & Qin, 2007; Sekaran, 2003). Firstly, the researcher selected the companies with modified audit report for the period of study (2004-2009). Then, they were matched to the control samples which have a clean audit report based on the condition that the paired companies are in the same industry, very similar in size (total assets) and in the same financial year (Ballesta & Garcia-Meca, 2005; Wenyao & Qin, 2007). To ensure reliability and independence, once a control company has been matched to the corresponding company in the test sample in a particular year, it is not matched again with another company (test sample) in another year (Ballesta & Garcia-Meca, 2005). Besides, any company that did not state whether it has a separate or combined RMC or risk management, was omitted from the sample. Finally, in this study, there are 150 samples with modified audit opinion matched with 150 samples with clean audit opinion. Therefore, the total number of samples in this study is 300 samples.

To enhance the accuracy of the data collected, data was cross-referenced to other sources whenever possible. The data relating to the implementation of risk management, directors' profile, directors' report, corporate governance statement and independent auditor's report were gathered from the company's annual report; while the financial data, such as total assets, total debts and total earnings were gathered from the company's financial statement, notes to the accounts and cross-referenced to

Thomson Datastream. Table 3.4 below summarises the types of modified audit opinion for each particular year, including clean audit opinion.

Table 3.4:
Types of Modified Audit Opinion for Each Particular Year

Types of Modified Audit Opinion	Year 2004	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
Unqualified with Explanatory Paragraph	12	10	8	9	13	20
Qualified	4	5	5	8	9	9
Adverse	1	0	0	0	0	0
Disclaimer	10	5	6	7	4	5
Clean	27	20	19	24	26	34

3.8 Research Model

MA=β0 + β1 SEPRMC + β2 RMCSIZE + β3 RMCDILI + β4 RMCINDE + β5 RMCTRAI + β6 RMCQUAL + β7 RMCOVER + β8 RMCINTER + β9 PRAUREP + β10 LOSS + β11 BIG4 + β12 LEV + β13 AUTEN + β14 CLSIZE + β15 ASSPRO + β16 BUSSEG + ε

where :-

MA	-Modified Audit Opinion 1, if received modified audit, otherwise 0

SEPRMC	-Separate RMC 1, if the existence of separate RMC, otherwise 0
RMCSIZE	-RMC Size number of RMC members at financial year-end
RMCDILI	-RMC Diligence number of RMC meetings during the financial year
RMCINDE	-RMC Independence proportion of independent non-executive members on the RMC
RMCTRAI	-RMC Training number of risk/risk management related training to RMC members
RMCQUAL	-RMC Qualification proportion of RMC members with accounting or finance qualification
RMCOVER	-RMC Overlap proportion of RMC members with two or more functions on different board committees
RMCINTER	-RMC Interlocking proportion of RMC members with more than one different company's board membership
PRAUREP	-Prior Audit Report 1, if the company received modified audit opinion in the prior year, otherwise 0

LOSS	-Loss 1, if the company reported loss in either or both of the two previous years, otherwise 0
BIG4	-Big4 1, if the auditor is BIG 4, otherwise 0
LEV	-Leverage total debts/total assets
AUTEN	-Auditor Tenure number of years of engagement with the same audit firm
CLSIZE	-Client Size natural log of total assets (in millions of Ringgit Malaysia)
ASSPRO	-Asset Profitability ratio between earnings before interest, tax and extraordinary income and total assets
BUSSEG	-Business Segment 1, if the company has two or more business segments, otherwise 0

3.9 Data Analysis

This study adopted several statistical tests to examine the characteristics of variables and hypotheses by applying the statistical package for the social sciences (SPSS) programme. Firstly, the descriptive analysis is used to describe the characteristics of the samples - mainly, mean, median, mode and standard deviation. Then, the logistic regression analysis is applied to analyse the relationship among the variables or hypotheses in this study. Further, the sensitivity analysis is done to test the endogeneity (simultaneity) and sample selection bias. The sub-sample analysis is also performed to test certain variables where the redefinition of measurement is done accordingly. Interaction or moderation test is applied to see whether there are simultaneous effects between two independent variables against the dependent variable. Additional analysis is done on the independent members sitting on the BODs. The aim is to get evidence on the importance of independent board members against modified audit opinion or how far this type of board members affect the acceptance of that audit opinion. Lastly, the researcher performs a regression assumption test for multicollinearity, homoscedasticity, outliers and exclusion restriction test.

3.10 Conclusion

This chapter discusses the methodology applied in the study. The theoretical framework is presented together with the theories used as the underpinning theories in this study. The chapter also discusses the hypotheses development for each variable that constitutes the framework of this study. Then, the variables' definition and measurement together with the expected directions of the variables are explained in detail in this chapter. It also explains the sources of data, population and sampling design, including the data collection method. Lastly, the research model is provided and the data analysis is highlighted at the end of the chapter.

CHAPTER FOUR

RESULTS AND DISCUSSION

4.0 Introduction

This chapter explains the statistical analyses, such as the descriptive analysis, correlation analysis and logistic regression analysis used in this study. These three types of analyses are the main analyses applied to see the characteristics of the samples, the degree of correlation among the independent variables and to know what are the variables in the models which are significant or otherwise to the dependent variable. The reasons why the logistic regression analysis is applied in this study together with the assumption of that analysis is also highlighted. Additional analysis on certain variables, including control variables, is done to gain extra knowledge on those variables.

4.1 Result of the Descriptive Statistics

Table 4.1 presents the descriptive statistics result for all the modified audit opinion and clean audit opinion companies, as well as the result of the t-test. Descriptive statistics present the characteristics of the samples in the study, including mean, minimum, maximum and standard deviation. It represents all the variables (continuous variables) in the study, including independent and control variables. The study conducted the test for the two sets of samples, each comprising 150 samples with a total of 300 samples. The first sample represents the companies with modified audit opinion report and the second sample represents the companies with clean audit opinion. The tests for these separate samples were done to see whether there are differences for the characteristics of the variables between these two groups of samples; while the independent sample t-test was performed to compare the mean of the variables for the companies with modified audit opinion and the companies with clean audit opinion (i.e., 150 against 150). This t-test evaluates whether the mean of the two groups statistically differs from each other. The independent sample t-test is applied when there are two different groups. Thus, in this study, the group which received modified audit opinion and the group which received clean audit opinion are tested.

For RMCSIZE, the result for three categories of companies (all, modified and clean companies) are quite similar with average three members. However, in the modified audit opinion companies, two members are recorded as minimum and seven as maximum. It is different in clean audit opinion companies; the result shows between three and six RMC members. The different result indicates that modified audit opinion companies sometimes have a very small RMC and sometimes, it can be big. Yet, the t-test reveals statistically insignificant relationship for RMCSIZE. It means that RMCSIZE in modified audit opinion companies and clean audit opinion companies has no impact. The size of the RMC in the modified audit opinion companies and clean audit opinion companies is not very different. It also indicates that the mean of the samples for both groups of samples is quite similar in terms of RMCSIZE. The companies with modified audit opinion and with clean audit opinion are quite similar in terms of the number of members in the RMC.

For RMCDILI, the result records all the groups of samples had an average of five RMC meetings during the financial year. However, in the sample of clean audit opinion companies, the maximum meetings held was 13 times; while for the modified audit opinion companies, the result shows 12 meetings held during the financial year. However, the difference in mean between these two different groups is statistically insignificant as shown in the result of the t-test. In this situation, the number of meetings held by the RMC for the modified audit opinion companies and clean audit opinion companies is quite similar. There is no significant difference for the number of meetings held by the RMC for both groups of samples. Companies with modified audit opinion and companies with clean audit opinion held almost the same number of RMC meetings during the financial year.

For RMCINDE, the group of companies with clean audit opinion stated an average of 78 percent of RMC members with status of INEDs. For the modified audit opinion companies, the percentage is lower than the first group with 75 percent of RMC members with status of INEDs. In comparison, the clean audit opinion companies have more independence in terms of status of RMC members compared to the modified audit opinion companies. Further, the mean difference of these two groups of samples is statistically significant at level of $p < 0.1$ (SPSS report at 2 tailed significance). This indicates that there is a significant difference in terms of mean for the companies with modified audit opinion and companies with clean audit opinion for the number of independent members in the RMC. The result reveals that the number of independent members in the RMC in the clean audit opinion group sample is higher than the modified audit opinion group sample. The result is also consistent with earlier expectation by the researcher that companies with higher number of RMC members with status of independent members may receive clean audit opinion. In other words, both groups of samples (modified and clean audit opinion companies) have difference in terms of the number of INEDs in the RMC.

For RMCTRAI, both groups of samples, including all companies, show the risk-related trainings attended by the RMC members with a maximum of six times during the financial year, while none or never attended risk-related trainings is the minimum. On average, all the groups of samples state two risk-related trainings attended during the financial year; the result also shows there is a statistical significance ($p < 0.1$) for mean as revealed by the result of the t-test. The result of the t-test also indicates that both groups of samples (modified audit opinion companies and clean audit opinion companies) have a significant difference for the number of risk-related trainings attended by the members of the RMC. The group of samples with clean audit opinion stated higher number of risk-related trainings attended by the members of the RMC compared to the group of samples with modified audit opinion. It also means that the risk-related trainings attended by the RMC' members help them to carry out their risk oversight function.

For RMCQUAL, in terms of mean, the result shows a larger percentage for clean audit opinion companies with 39 percent of RMC members having accounting or finance backgrounds; while for the modified audit opinion companies, 37 percent of their RMC members have the qualification as mentioned above. Both groups of samples record zero percent as minimum and 100 percent as maximum for RMC members with accounting or finance background. However, in terms of mean difference, the result of the t-test is statistically insignificant for this variable. In indicates that the proportion of members of RMC with accounting and finance academic background in the group of samples of modified audit opinion companies and the group of samples of clean audit opinion companies is quite similar in terms of mean or average value. Both groups of samples (modified and clean audit opinion companies) have no significant difference for the proportion of members of RMC with accounting and finance academic background.

For RMCOVER, both groups of samples, including all companies, have minimum of zero percent of RMC members having overlapping status or not holding some other board committee membership in the same company; while 100 percent is the maximum for the RMC members with overlapping status for all the categories of samples. On average, for the modified audit opinion companies, RMCOVER is 77 percent of RMC members with overlapping status and 72 percent for clean audit opinion companies. This difference is statistically significant but at a weak level ($p < 0.1$) as shown by the t-test. Hence, there is a significant difference for the proportion of RMC members with overlapping status for the modified audit opinion companies and clean audit opinion companies groups. The modified audit opinion companies stated higher proportion of RMC members with RMCOVER or holding more than one board committee membership compared to the clean audit opinion companies group. This result is as expected by the researcher that holding more than one board committee membership causes a lack of concentration of the RMC mmbers on their tasks, and therefore contributing to the issuance of modified audit opinion.

Lastly, for RMCINTER, all the groups of samples (all companies, modified and clean audit opinion companies) have an average of 67 percent of the members of RMC having interlocking status, meaning members of the RMC hold positions as members of board committees of the other companies simultaneously. All the groups of samples also had zero percent as minimum and 100 percent as maximum. For the result of t-test, the mean difference between the modified and clean audit opinion companies is statistically not significant. Both the groups of samples have quite similar proportion of members of the RMC with interlocking status or holding more than one board committee membership in other companies. There is no significant difference in terms of interlocking status for RMC members for both groups of samples (modified and clean audit opinion companies).

For LEV, the sample of modified audit opinion companies stated 557 percent as maximum for debts over assets; with only 72 percent of debts over assets as maximum for the samples of clean audit opinion companies. For mean value, the result showed 118 percent recorded for debts over assets for the modified audit opinion companies. For the sample of clean audit opinion companies, only 16 percent recorded debts over assets owned by the companies. This difference of mean is statistically significant ($p < 0.05$) as shown in the result of the t-test. This indicates that there is a significant difference for LEV or debt level between modified audit opinion companies and clean audit opinion companies sample groups. The modified audit opinion companies recorded higher level of debts compared to the clean audit opinion companies. The higher debt level or LEV may contribute to the company's financial instability in future and this will cause problem for the viability of the company. Hence, the issue of going-concern emerges and the going-concern audit opinion or modified opinion is issued by the auditor.

For AUTEN, the descriptive analysis reveals ten years and eleven years of audit tenure as maximum for the sample of modified and clean audit opinion companies, respectively. Both groups of samples recorded one year of audit tenure as minimum. However, there is a slight difference for mean value where the result shows four years of audit tenure for the sample of modified audit opinion companies and five years of audit tenure for the sample of clean audit opinion companies. The difference of mean between these two groups (modified and clean audit opinion compnies) in terms of years of engagement with the same audit firm is statistically significant at the 10 percent level (SPSS report 2 tailed for significance).

For CLSIZE, both groups of samples (modified and clean audit opinion companies) recorded above RM 900 million of total assets as maximum value. The sample of modified audit opinion companies recorded an average of RM 231 million of total assets while the sample of clean audit opinion companies recorded an average of RM 184 million of total assets. The difference of average value is statistically significant at a weak level of 10 percent; the result also indicates that both groups of samples (modified and clean audit opinion companies) have significant difference for the total assets.

The descriptive analysis also reveals the result for ASSPRO. For the sample of modified audit opinion companies, the result shows a minimum negative value of 20.65 points. This indicates the companies operated at a loss; while for the maximum value, the result shows an operating profit of 11 points. For the sample of clean audit opinion companies, the value of loss is 1.41 points and profit of 0.43 points for the minimum and maximum, respectively. For average value, a loss of 0.35 points and profit of 0.01 points is recorded for the sample of modified and clean audit opinion companies, respectively. The result of t-test shows a statistically significant relationship ($p < 0.5$) for this variable. The result also shows that loss is made by the modified audit opinion companies group; while profit is gained by the clean audit opinion companies group in terms of mean or average value. The loss made by the companies may create instability for the company's financial portfolio and modified audit opinion may be issued by the auditor for these companies.

Table 4.1
Result of the Descriptive Statistics for All (N=300), Modified (N=150) and Clean Audit Opinion Companies (N=150) (Continuous Variables)

	All Companies				Modified Audit Opinion Co				Clean Audit Opinion Co				t-test	Sig (2-tailed)
	Min	Max	Mean	Std Deviation	Min	Max	Mean	Std Deviation	Min	Max	Mean	Std Deviation	t value	
RMCSIZE	2.00	7.00	3.2967	0.70021	2.00	7.00	3.3000	0.76632	3.00	6.00	3.2933	0.62976	-0.082	0.934
RMCDILI	0.00	13.00	4.8300	1.53044	1.00	12.00	4.9067	1.41111	0.00	13.00	4.7533	1.64230	-0.867	0.386
RMCINDE	0.00	1.00	0.7644	0.19363	0.00	1.00	0.7466	0.18869	0.00	1.00	0.7823	0.19746	1.597	0.111
RMCTRAI	0.00	6.00	2.4467	1.1066	0.00	6.00	2.3533	1.14186	0.00	6.00	2.5400	1.06582	1.464	0.144
RMCQUAL	0.00	1.00	0.3841	0.1706	0.00	1.00	0.3733	0.17945	0.00	1.00	0.3948	0.16115	1.093	0.275
RMCOVER	0.00	1.00	0.7445	0.27349	0.00	1.00	0.7652	0.24877	0.00	1.00	0.7238	0.29554	-1.314	0.190
RMCINTER	0.00	1.00	0.6686	0.2962	0.00	1.00	0.6773	0.28973	0.00	1.00	0.6599	0.30326	-0.509	0.611
LEV	0.00	55.74	0.6718	3.89812	0.00	55.74	1.1830	5.47188	0.00	0.72	0.1606	0.15830	-2.287	0.024
AUTEN	1.00	11.00	4.6867	2.75447	1.00	10.00	4.4533	2.54776	1.00	11.00	4.9200	2.93674	1.470	0.143
CLSIZE	1.00	991.00	207.4300	245.32021	1.00	991.00	230.6900	264.86605	1.00	948.00	184.1700	222.54117	-1.647	0.101
ASSPRO	-20.65	11.08	-0.1689	1.50203	-20.65	11.08	-0.3526	2.10298	-1.41	0.43	0.0148	0.19204	2.130	0.035

Variable Definition:

RMCSIZE = number of RMC members at financial year-end
RMCDILI = number of RMC meetings during the financial year
RMCINDE = proportion of independent non-executive members on the RMC
RMCTRAI = number of risk/risk management related training to RMC members
RMCQUAL = proportion of RMC members with accounting or finance qualification

RMCOVER	= proportion of RMC members with dual or more functions on different board committees
RMCINTER	= proportion of RMC members with more than one different company's board members
LEV	= total debt/total asset
AUTEN	= number of years of engagement with the same audit firm
CLSIZE	= natural log of total assets (in millions of Ringgit Malaysia)
ASSPRO	= ratio between earning before interest, tax and extraordinary income and total asset

Table 4.2 presents the results of the frequency distribution for categorical or dichotomous variables, such as SEPRMC, PRAUREP, LOSS, BIG4 and BUSSEG used in this study. For SEPRMC, only nine companies have a separate RMC for the modified audit companies group; while 30 companies have a separate RMC for the clean audit opinion companies group. The result shows that the clean audit opinion companies prefer to establish a separate RMC; this result is consistent with the expectation of the researcher that clean audit opinion companies have the commitment to set up a separate RMC compared to the modified audit opinion companies. This commitment may create better oversight function for the companies' risk profile, thus further reducing the risk issues faced. Consequently, the issuance of modified audit opinion by the auditor due to risk reasons may be reduced.

For PRAUREP, the result reveals more differences in terms of prior modified audit opinion received by both groups of companies (modified and clean audit opinion companies). For modified audit opinion companies, there are 101 companies that received modified audit opinion for prior financial year; while for the clean audit opinion companies group, only one company received modified audit opinion for prior financial year. This result indicates that modified audit opinion received in the prior financial year has greater impact on the current financial year. The risk issues that led to the modified audit opinion in prior financial year may not have been addressed well in the current financial year and this situation causes a similar modified audit opinion to be issued by the auditor.

The result from this analysis shows that both groups of samples (modified and clean audit opinion companies) have more differences in terms of LOSS reported by the company. There are 66 companies or samples that reported loss in either or both the two previous financial years for the clean audit opinion companies; while it is almost double the number of companies that reported loss in either or both of the two previous financial years for the modified audit opinion companies. This situation indicates that loss reported for previous financial years affects the judgment of issuance of modified audit opinion by the auditor. The loss reported for previous financial years may create instability for the company's current financial portfolio or may create difficultly for the company's current investment if there are no capital injections by the investors or shareholders. Thus, a modified audit opinion may be issued by the company.

For BIG4, both groups of samples (modified and clean audit opinion companies) show that they are quite similar in terms of number of companies or samples engaged with big4 or non big4 audit firms. However, there is a higher number of companies or samples engaged with non-big4 audit firms compared to big4 audit firms for both groups of samples. For BUSSEG, both groups of samples (modified and clean audit opinion companies) mostly have two or more business segments. Most companies for both groups of samples have more than one business portfolios rather than a single business portfolio.

Table 4.2

Result of the Frequency Distribution for All (N=300), Modified (N=150) and Clean Audit Opinion Companies (N=150) (Categorical/Dichotomous Variables)

	All Companies		Modified Audit Opinion Co		Clean Audit Opinion Co	
	Frequency	Percentage	Frequency	Percentage	Frequency	Percentage
SEPRMC						
Non-existence Separate RMC	261	87	141	94	120	80
Existence Separate RMC	39	13	9	6	30	20
Total	300	100	150	100	150	100
PRAUREP						
Received Clean Opinion	198	66	49	32.7	149	99.3
Received Modified Opinion	102	34	101	67.3	1	0.7
Total	300	100	150	100	150	100
LOSS						
Non-reported Loss	113	37.7	29	19.3	84	56
Reported Loss	187	62.3	121	80.7	66	44
Total	300	100	150	100	150	100
BIG4						
Non-Big4 Auditor	169	56.3	80	53.3	89	59.3
Big4 Auditor	131	43.7	70	46.7	61	40.7
Total	300	100	150	100	150	100

Table 4.2 (Continued)

BUSSEG						
Non Business Segment	6	2	5	3.3	1	0.7
Two or More Bus Segment	294	98	145	96.7	149	99.3
Total	300	100	150	100	150	100

Variable Definition:

SEPRMC	= 1, if the existence of separate RMC, otherwise 0
PRAUREP	= 1, if the company received modified audit opinion at prior year, otherwise 0
LOSS	= 1, if the company reported loss in either or both of the two previous years, otherwise 0
BIG4	= 1, if the auditor of the BIG 4, otherwise 0
BUSSEG	= 1, if the company has two or more business segments, otherwise 0

4.2 Result of Correlation (Pearson Correlation Matrix)

Table 4.3 reports the result of correlation among the variables. The correlations are quite low, generally below 0.3, except for MA, PRAUREP, LEV, ASSPRO and LOSS which are correlated by construction. Most of the variables are significant, whether at 0.01 or 0.05 levels. The highest correlation is between MA and PRAUREP with level of significance at 0.01; followed by the pair of LEV and ASSPRO (0.01); MA and LOSS (0.01); and pair of LOSS and PRAUREP, also at 0.01 level of significance.

SEPRMC is significantly correlated with MA at one percent level of significance with level of correlation at 21 percent (negative sign). It means the existence of a separate RMC impacts the receipt of modified audit opinion issued. The existence of this separate RMC probably can reduce the issuance of modified audit opinion. This result reveals that the first research question is answered, i.e., whether the existence of a separate RMC has influence on the receipt of modified audit opinion for the company. The result also indicates that the first research objective is met. The result is consistent with the argument by Subramaniam *et al.* (2009) and Yatim (2009; 2010) that the existence of a separate RMC may affect the company's risk management profile and corporate governance. For the other variables, such as Prior Audit Report, Loss, Leverage and Asset Profitability, the result shows that they are also significantly correlated to modified audit opinion. Each of them is significantly correlated to the modified audit opinion variable. For Prior Audit Report, Loss and Leverage, the result shows they are correlated to modified audit opinion with a positive sign, indicating that, for example, the higher the level of leverage, the higher the probability of the company receiving modified audit opinion. This result is consistent with the finding of a study done by Chen & Church (1992); Carcello *et al.* (1995); Willikens *et al.* (2004); and Mutchler *et al.* (1997) that a company's higher level of debt is a reason for modified audit opinion.

Separate RMC is also significantly correlated to RMC Size with level of significance at one percent and correlated at 25 percent level (positive sign). It indicates that the size of a RMC influences the establishment of a separate RMC in the company. If there is a larger RMC, a separate RMC that is distinct from the audit committee can be established. There are sufficient members to set up another board committee responsible for the company's risk profile as a whole. The result also shows that RMC Training is significantly correlated (positive sign) with Separate RMC at one percent level of significance and at 27 percent level of correlation. It means that the existence of a separate RMC encourages the members of the RMC to attend more risk-related trainings. They are motivated and committed to gain the extra knowledge on crucial risk matters.

The same situation also applies for RMC Size and RMC Diligence, where the bigger the size of the RMC and the more the RMC meetings, more risk-related trainings are attended by the members of RMC. Both RMC Size and RMC Diligence are significantly correlated to RMC Training (positive sign). More members in the RMC are committed to attend risk-related trainings. Further, more RMC meetings also encourage them to attend risk-related trainings, whether organised by the government, regulators and private organisations. Finally, RMC Overlapping is significantly correlated with RMC Independence with positive sign. It is correlated at the five percent level of significance and correlated at the 12 percent level. It indicates that even if there are more members in the RMC with overlapping status or holding more than one board committee membership, they still are of the status of INEDs. They are aware of their independence and executive status as members of the RMC. This result also indicates that they are also thinking about the independence of the RMC itself, even though they have responsibilities in other board committees.

Table 4.3
Result of Correlation (Pearson Correlation Matrix). N = 300

	MA	SEP RMC	RMC SIZE	RMC DILI	RMC INDE	RMC TRAI	RMC QUAL	RMC OVER	RMC INTER	PRAUREP	LOSS	BIG4	LEV	AUTEN	CLSIZE	ASSPRO	BUSSEG
MA	1	-.208**	.005	.050	-.092	-.084	-.063	.076	.029	.704**	.378**	.060	.131*	-.085	.095	-.122*	-.095
SEPRMC		1	.247**	.037	-.211**	.274**	-.041	-.052	-.053	-.131*	-.027	.019	-.038	.095	.180**	.052	.055
RMCSIZE			1	-.025	-.145*	.221**	-.213**	-.178**	-.047	-.073	-.024	.117*	-.029	.050	.018	.036	.027
RMCDILI				1	.029	.120*	-.041	.073	.000	.066	.026	.032	-.030	.024	.062	.162**	-.016
RMCINDE					1	-.072	.046	.121*	.088	-.092	-.036	-.045	-.078	-.004	-.112	-.035	.062
RMCTRAI						1	-.026	-.018	-.068	-.023	.215**	-.015	-.040	.088	.065	.023	.058
RMCQUAL							1	.095	.083	.064	.003	.125*	.036	-.089	-.003	-.125*	.089
RMCOVER								1	.078	-.023	-.008	-.106	-.139*	.060	.035	-.020	.070

Table 4.3
(Continue)

RMCINTER	1	.049	.001	.119*	.040	.133*	-.034	-.069	.001
PRAUREP		1	.369**	.063	.148*	-.049	.089	-.056	-.048
LOSS			1	.033	.089	-.016	-.013	-.084	-.013
BIG4				1	-.009	.205**	.108	-.027	-.018
LEV					1	-.063	-.065	-.485**	.014
AUTEN						1	.122*	-.018	-.060
CLSIZE							1	.039	.012
ASSPRO								1	-.011
BUSSEG									1

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

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

Variable Definition:

MA	= 1, if received modified audit, otherwise 0
SEPRMC	= 1, if the existence of separate RMC, otherwise 0
RMCSIZE	= number of RMC members at financial year-end
RMCDILI	= number of RMC meetings during the financial year
RMCINDE	= proportion of independent non-executive members on the RMC
RMCTRAI	= number of risk/risk management related training to RMC members
RMCQUAL	= proportion of RMC members with accounting or finance qualification
RMCOVER	= proportion of RMC members with dual or more functions on different board committees
RMCINTER	= proportion of RMC members with more than one different company's board members
PRAUREP	= 1, if the company received modified audit opinion at prior year, otherwise 0
LOSS	= 1, if the company reported loss in either or both of the two previous years, otherwise 0
BIG4	= 1, if the auditor of the BIG 4, otherwise 0
LEV	= total debt/total asset
AUTEN	= number of years of engagement with the same audit firm
CLSIZE	= natural log of total assets (in millions of Ringgit Malaysia)
ASSPRO	= ratio between earning before interest, tax and extraordinary income and total asset
BUSSEG	= 1, if the company has two or more business segments, otherwise 0

4.3 Logistic Regression

4.3.1 Assumption of Logistic Regression

Logistic regression is a specialised form of regression that is formulated to predict and explain a binary (two-group) categorical variable rather than a metric dependent measure. In logistic regression, the normality assumptions of the variables are not met and also accommodate non-metric variables through dummy variable coding. In other words, logistic regression analysis can be described as estimating the relationship between a single non-metric (binary/categorical/dichotomous) dependent variable and a set of metric or non-metric independent variables as follows:

Y1	=	X1 + X2 + X3 +......+Xn
(Binary non-metric)		(Non-metric and metric)

For this study, the logistic regression analysis is chosen because the research model fits the rules and assumption of this analysis. Modified audit opinion (dependent variable) is a non-metric or categorical variable; while the independent variables are metric variables (e.g., RMC Size, RMC Independence and RMC Overlapping) and non-metric variables (Separate RMC, Big 4 and Business Segment).

The advantage of logistic regression compared to discriminant analysis and multiple regression is the latter two lack the assumptions required in a logistic regression analysis. It does not requires any specific distribution form of the independent variables and issues, such as heteroscedasticity do not come into play as they do in discriminant analysis. Moreover, logistic regression does not require linear relationship between the independent variables and the dependent variable as does multiple regression

4.3.2 Result of the Logistic Regression

Table 4.4 reports the logistic regression result. The Table consists of four panels which Panel A testing control variables only. For Panel B, the original model in this study is tested which contains the independent and control variables; while in Panel C, the researcher examines the new variables (characteristics of audit committee) together with the existing control variables. Lastly, for Panel D, the combination of independent variables (characteristics of RMC), new variables (characteristics of audit committee) and existing control variables are examined in the model.

Panel A (Control Variables)

For Panel A, the model reports the level of correct classification (the percentage of correct predictions) at almost 91 percent while Cox & Snell R Square and Nagelkerke R Square are reported at 59 percent and 78 percent, respectively. The Chi-square test is reported at 264.665 and the model is significant at level of 0.00 ($p < 0.01$). Still in Panel A, the result shows that some control variables are statistically significant (PRAUREP, LOSS, LEV and BUSSEG). All of these control variables are also significant in the other Panels (Panel B, C and D) except for variable of BUSSEG which is not significant in Panel C. This result reveals the influence of these factors (variables) on modified audit opinion issued by the auditors. They have impact on the likelihood of the issuance of modified audit opinion in Malaysia.

Panel B (Separate RMC, RMC Characteristics and Control Variables)

In Panel B, the original model of the study is examined which contains the hypotheses of independent variables (characteristics of RMC) and control variables. The model reports the level of correct classification at 92 percent with Cox & Snell R Square and Nagelkerke R Square at 62 percent and 83 percent, respectively. Meanwhile, the Chi-square test is reported at 290.565, and generally, the model is significant at level of 0.00 ($p < 0.01$). Some hypotheses are statistically significant, such as SEPRMC, RMCQUAL and RMCOVER; while for the control variables, they are PRAUREP, LOSS, LEV and BUSSEG. Most of the hypotheses are significant in the expected direction, except for hypothesis of RMCOVER which is significant in a positive direction.

Separate RMC (SEPRMC)

For hypothesis of SEPRMC, it is statistically significant at five percent level and follows the proposed direction with negative sign. For coefficient, SEPRMC reports at more than 200 percent and it means that if a company has a separate RMC, the probability of the company not receiving modified audit opinion is at 200 percent. The examples of companies that have separate RMC are Opcom Holdings Berhad, Bolton Berhad and Genetec Technology Berhad.

The result supports the argument by Subramaniam *et al.* (2009) that the existence of a separate RMC that focuses on the risk profile is also able to increase the quality of internal monitoring in relation to risk management. Consequently, the likelihood of the company receiving modified audit report, particularly for risk issues, is less. Harrison (1987) reported that the RMC is seen to specifically enhance the accountability of the board as it provides an independent oversight of various board activities, especially risk issues. Due to the contribution of the RMC, Fields and Keys (2003) argued that the RMC has gained popularity as an important oversight committee even though most of the countries are still not making it a mandatory requirement to establish a separate RMC.

The result supports the proposition of the first hypothesis (SEPRMC) that the existence of a separate RMC influences the company not to receive modified audit report. This result is also consistent with the requirement under MCCG 2000, 2007 and 2012, which clearly states that the board has principle responsibility on the risk process, including the identification of principle risks up to the implementation of an appropriate system to manage those risks. Consequently, the establishment of a separate RMC, as a board committee, can enhance the effectiveness of risk oversight function by the BODs as reported in the result of this study, i.e., the existence of a separate RMC has an impact on the company to not receive modified audit opinion. More importantly, this result answers the first research question and research objective that the existence of a separate RMC influences the company not to receive modified audit opinion.

RMC Size (RMCSIZE)

For the second hypothesis (RMCSIZE), the result is statistically not significant to modified audit opinion, leading to the conclusion that RMC Size seems to have no influence on modified audit opinion. The result is consistent with the earlier study by Wenyao and Qin (2007) which found insignificant relationship between board size and audit opinion. However, the result is inconsistent with the finding of Xie *et al.* (2003) that there is a negative relationship between board size and earnings management activities. Beasley (1996) found a positive relationship between the number of board members and the occurrence of accounting fraud. In terms of modified audit opinion, the number of members in the RMC has no impact. The previous study by Wenyao and Qin (2007) revealed that board size has no impact on audit opinion. This is similar to RMC size where it is statistically insignificant to modified audit opinion. Regardless of how many members comprise the RMC, they are not able to address the issue of risks faced by the company. Even though there are more members in the RMC, the other factors, such as qualification, experience, skill, competence and commitment also play a more important role in the effectiveness of handling risk tasks. Hence, the issue of risks must be addressed well to prevent the issuance of modified audit opinion due to risk reasons.

In short, for this hypothesis and regardless of the number of members in the RMC, it may not influence the issuance of modified audit opinion and the condition does not support the second hypothesis.

RMC Diligence (RMCDILI)

The result also shows that there is no relationship between RMCDILI and modified audit opinion. It is statistically insignificant at the one percent, five percent or 10 percent significance levels for this hypothesis. However, some previous studies found different findings. As an example, Farinha and Viana (2009) found negative relationship between board diligence and modified audit opinion. Xie *et al.* (2003) also found negative association between board diligence and qualified audit opinion. The result reveals that the number of RMC meetings does not influence the effectiveness of work on risk issues faced by the company. RMC meetings might not discuss in-depth, specifically issues of risk, and consequently those issues may not be addressed well. Another element is the continuous actions by the relevant parties in the organisation. Although some specific issue of risks may be discussed in detail in the RMC meeting, perhaps no continuous actions by the relevant parties or departmentst in the company are taken for those issues; hence, the risks faced by the company are not addressed and managed properly. Hence, modified audit opinion due to those risk issues will be issued by the auditor.

In other words, the number of meetings held by the RMC is not a factor for the receipt of modified audit report by a company. The result does not support the third hypothesis.

RMC Independence (RMCINDE)

For the next hypothesis, RMCINDE, the result is also statistically not significant. There is no association between RMCINDE and modified audit opinion. The result is consistent with the finding of a study done by Wenyao and Qin (2007) where they found insignificant relationship between independent board members and receipt of modified audit opinion. In terms of audit committee, Pucheta-Martinez and Fuentes (2007) found a significant influence between audit committee with more independent members and receipt of qualified audit report. Xie *et al.* (2003) added that the non-executive board members reduce the probability of a company being involved in accounting fraud. The status of INEDs in the RMC does not influence the effectiveness of work on risks. Although they are independent and have no relationship with the company, the lack of knowledge on management issues works against them when they undertake the tasks relating to risks. They might be experienced on the external business environment but they are not involved in the management activities and some issues relating to risks are hidden. This situation needs talented and skillful RMC members who can understand in-depth the management's activities. Hence, the crucial issues of risk cannot be addressed and managed properly, leading to the issuance of modified audit opinion due to these risk issues.

As a conclusion, the result reveals that the INEDs in the RMC is not a factor for the issuance of modified audit opinion. This type of committee members (INEDs) have no role in influencing the receipt of modified audit opinion in terms of risk issues. As a conclusion, there is no support for this hypothesis.

RMC Training (RMCTRAI)

The result also shows no relationship between RMCTRAI and the issuance of modified audit opinion. It is statistically insignificant to the variable. The finding is inconsistent with the result of a study by Zona and Zattoni (2007); and Carpenter and Westphal (2001) where they found a positive relationship between directors' knowledge and skills and the board's monitoring role and strategic decision involvement. Perhaps, the trainings attended by the members of the RMC are not enough for them or the types of those trainings might not be relevant to the specific risk issues faced by the company. Consequently, the real issues of risk cannot be addressed well by the RMC members. Hence, modified audit opinion will be issued by the auditor due to these issues of risk.

The situation leads to the argument that the risks-related training attended by the RMC members have no relationship to the issuance of modified audit report. This indication provides no support for the hypothesis of RMC Training. Hence, more risks-related trainings are needed by members of the RMC which can help them to gain the relevant knowledge, particularly on risk issues. Training that is related to the company's business environment should be given to members of the RMC. These requirements are consistent with BM's Listing Requirements (Paragraph 15.08) which requires the members of the BODs to attend relevant trainings from time to time.

RMC Qualification (RMCQUAL)

For RMCQUAL, it is statistically significant ($p < 0.05$) with negative sign following the proposed direction. It is reported at more than 400 percent for beta coefficient and it means that if the members of the RMC have accounting or finance academic background, the likelihood of the company not receiving modified audit opinion is at 400 percent. The result is consistent with the argument by DeZoort and Salterio (2001) that board members with finance and accounting backgrounds have better understanding of auditing issues, including risk awareness and risk detection. Yatim (2009) suggested the audit committee members with finance or accounting background have better understanding on risk management activities and engage more actively in the risk management process. Chung *et al.* (2004) and Ho and Wong (2001) found that the composition of experts in board committees serves as a means of reducing information asymmetry, managerial opportunism, improving disclosure quality and enhancing the effectiveness of resources.

The knowledge gained by the RMC members through formal studies in accounting and finance is an advantage to them. They have learned the internal and external threats being in a business organisation as well as the strategic solutions for the threats faced. They can manage the risk profile of the organisation, which may attract the auditor's attention. Therefore, issuance of modified audit opinion due to risk issues is less. This result supports the proposed hypothesis that RMC Qualification is negatively associated with the probability of the company receiving modified audit opinion. This result also answers the second research question and second research objective that RMC qualification influences the company to receive modified audit opinion.

Although the result of the t-test reveals that RMC Qualification is not significant, the result of regression analysis (Logistic Regression) reveals it is significant to modified audit opinion. The t-test analysis is done to know whether there are differences for mean or average values for the same variable (RMC Qualification) between two different groups of samples (modified and clean audit opinion companies). That analysis is done to see the extent of the differences in terms of proportion of RMC members who have accounting or finance academic background between the two groups of samples. However, in the regression analysis (Logistic Regression), all the independent variables, including RMC Qualification, are tested simultaneously to the dependent variable (modified audit opinion). This analysis tests directly all the independent variables to the dependent variable and the result of this analysis is more appropriate to know whether a variable is significantly related to the dependent variable or otherwise. The result of regression analysis is a means to know whether the independent variable (RMC Qualification) is significantly related or not to the dependent variable (modified audit opinion) regardless of the individual variable tested in the t-test analysis. The same situation also occurs in the correlation analysis where the analysis is done to know whether there is interrelationship or correlation between two independent variables. Hence, the regression analysis is more appropriate to know whether the independent variables are significant to the dependent variable or otherwise. The result of this analysis helps to determine which independent variables are significant to the dependent variable.

RMC Overlap (RMCOVER)

There is a significant ($p < 0.05$) positive association between RMCOVER and modified audit opinion received by the company. The statistical result shows more than 250 percent for beta coefficient for this variable, meaning that if there are RMC members with overlapping status of more than 250 percent, the company will receive modified audit opinion.

As expected in this study, there is a positive association between RMC overlapping and modified audit opinion. Some reasons could explain this situation. Although the experience and knowledge from the other board memberships can be shared and improvements undertaken as reported by Bettenhausen and Murnighan (1985), the burden of tasks has to be borne by the RMC members. They might not be able to perform well as a RMC member even if they are successful in the other board committees. This is because they have to spend a lot of time in several board committees and cannot afford to spend more time focusing on their tasks of risk oversight as required of RMC members. The other reason might be due to the knowledge gained through multiple board memberships (Mizruchi, 1992). The highest awareness on risk issues probably receives the highest attention by the auditor before a modified audit opinion is issued. As a conclusion, the result provides support to this hypothesis. This variable also answers the second research question and research objective that RMC overlapping influences the company to receive modified audit opinion issued by the auditor.

RMC Interlocking (RMCINTER)

Lastly, the result reveals no support for the hypothesis of RMCINTER. It is statistically not significant and there is no association between RMCINTER and modified audit opinion. The finding is consistent with the study done by Che Haat *et al.* (2008) that there is no influence between director interlocking and firm performance. Kamardin and Haron (2011) added they found no impact between director interlocking and directors' performance evaluation roles.

Although the RMC has members with the status of multiple directorships, there is no influence on the receipt of more or less modified audit opinion and the result provides no support for this hypothesis. In other words, there is no relationship between RMCINTER and modified audit opinion. In this situation, the directors with status of more interlocking directorships should take advantage of their multiple experiences. They have a lot of experience which can help them to address the issues in the company, especially risk issues. If the experiences that they have are not fully utilised, it cannot help the company to address the risks faced.

Control Variables

Prior Audit Report (PRAUREP)

The control variable, PRAUREP is statistically significant ($p < 0.01$) with a positive sign as proposed earlier. Its coefficient is recorded at more than 600 percent, indicating that if a company received modified audit report in the prior year, there is a 600 percent likelihood that the company will receive modified audit report again in the current year.

The result is consistent with some previous researches by Pucheta-Martinez and Feuntes (2007); and Mutchler *et al.* (1997). They found that companies which received modified audit opinion in the prior year have higher probability of receiving the same in the current year. Companies that received modified audit opinion in the prior year may not have been able to solve the issues in the current year. Hence, they will probably receive the same modified audit opinion in the current year. As a conclusion, Prior Audit Report has a strong association with modified audit opinion issued by the auditor.

Loss (LOSS)

The second control variable is LOSS and it is also statistically significant at the 10 percent level with a positive sign. Its coefficient is around 87 percent, meaning that if a company made a loss in previous years, there is 87 percent probability the company will receive modified audit opinion in the current year.

The result supports the findings of a study by Farinha and Viana (2009) that the existence of consecutive losses has a positive impact on the issuance of modified opinion by the auditor. Pucheta-Martinez and Fuentes (2007) also added that companies reporting losses in prior years have a positive relationship with the probability of receiving qualified audit report in the current year. Loss made by the companies has impact on the financial stability and future business operations. Eventually, it incurs the risk of going-concern and from the above result, LOSS has a positive relationship with modified audit opinion.

Leverage (LEV)

For LEV, the result is statistically significant ($p < 0.01$) and with a positive direction as expected. It is the highest among the variables for beta coefficient with more than 700 percent. It means that if a company stated higher value of leverage, the probability of the company receiving modified audit opinion is 700 percent higher. This result is also consistent with the finding of Pucheta-Martinez and Feuntes (2007), who found a positively significant relationship between leverage and auditor's modified opinion report.

The finding is highly expected by the researcher that a company with higher debts will face difficulties in the future. Leverage determines the ability of the company to meet its financial obligations. Higher provision for debts repayment should be made by the company in the future and this condition will affect the future investment in terms of new investments, products and operational development. The risk is higher for this type of company, particularly for financial obligations and development, further affecting the issuance of modified audit opinion. Hence, LEV has very strong influence on the issuance of modified audit opinion by the auditor.

Business Segment (BUSSEG)

This variable is statistically significant at 10 percent level of significance (SPSS report 2-tailed for significance). It reports negative sign as proposed in this study with beta coefficient of more than 200 percent. It means that if a company has more than two business segments, the likelihood of the company not receiving modified audit opinion is more than 200 percent.

Companies with more business segments or operations tend to establish a separate RMC. This board committee is needed for the companies to improve the risks oversight function at board level due to having more business operations and segments. The condition creates more awareness and effective management of risk profile by the RMC. Hence, the probability of the company receiving modified audit report, particularly on risk issues, is less. Based on this result, business segment has a negative association with the issuance of modified audit opinion.

The remaining control variables, BIG4, AUTEN, CLSIZE, and ASSPRO, are statistically not significant. There are no associations between them and modified audit opinion issued. For BIG4, the result is statistically insignificant and there is no relationship between Big 4 audit firms and modified audit opinion. The finding indicates that Big 4 audit firms have no influence on the issuance of modified audit opinion by the auditor. This situation is consistent with study done by Farinha and Viana (2009) that Big 4 audit firms have no significant relationship with modified opinion issued by the auditor.

For AUTEN, the tenure or period of engagement between a client and the auditor does not influence the issuance of modified audit opinion by the auditor. Auditor tenure with the client does not contradict the auditor's work of professional. The finding also contradicts the result of a study by Shafie *et al.* (2009) that auditor tenure is positively associated with the audit report quality, which means a clean audit report is issued with long tenure of engagement with the same auditor. In the situation of a company facing risk issues, the auditor is not influenced by the other minor factors considering the time spent with the client and the quality of financial reporting are most crucial (Copley & Doucet, 2003).

For CLSIZE, the auditor is not influenced by the size of a client in implementing audit work. Without considering the size of the client, the audit is implemented well on the other important factors, particularly risk management and internal control, even though some researchers have mentioned about loss of hiring an audit service in future especially first time auditors if modified audit opinion is issued (De Angelo, 1981). Therefore, in this study, there is no association between client size and modified audit opinion.

Lastly, ASSPRO is measured by the ratio between operating profits and total assets, or in other words, operating profitability. The result is statistically insignificant between asset profitability and modified audit opinion, consistent with the finding by Masyitoh and Adhariani (2010), who found no relationship between asset profitability and qualified audit opinion. The result evidences that profitability has no effect on the decision made by the auditor to issue modified audit report. Although the company reported higher profits in the current year, other reasons, for example, going-concern, are more important to the auditor in issuing his or her professional opinion.

Panel C (Audit Committee Characteristics and Control Variables)

In Panel C, the researcher examined the characteristics of audit committee (AC Expert, AC Meeting and AC Independence) and existing control variables. ACEXPERT is measured by determining the proportion of AC members with accounting or finance academic background. For ACMEET, the measurement is based on the number of AC meetings during the financial year while for ACINDE, it is the proportion of INEDs on the AC.

The model reports a level of correct classification at 90 percent with Cox & Snell R Square and Nagelkerke R Square at 60 percent and 80 percent, respectively. Meanwhile, the Chi-square test is reported at 273.219 and generally, the model is significant at a level of 0.00 ($p < 0.01$). From the result of logistic regression, it shows only AC Expert is statistically significant (p <

0.5) with negative sign. For beta coefficient, it is more than 400 percent, indicating that if a company's AC members have accounting or finance academic background, the probability of the company not receiving modified audit opinion is more than 400 percent. This finding is consistent with the arguments by Yatim (2009) and DeZoort and Salterio (2001) that board members, including audit committee members with finance or accounting background, have better understanding of risk management activities and auditing issues. The result also reports that there is a strong negative relationship between members of audit committee with accounting or finance academic background and modified audit opinion. The knowledge gained by this committee members benefit the company especially on the internal and external risk issues. They are also able to manage all risks of the company.

For AC Meeting and AC Independence, the result is not statistically significant to modified audit opinion. They have no association with the issuance of modified audit opinion by the auditor. However, this finding is inconsistent with the result of Pucheta-Martinez and Fuentes (2007) who found statistical significance for AC Meeting, AC Independence and qualified audit opinion. However, it must be remembered that Pucheta-Martinez and Fuentes (2007) measured the dependent variable (qualified audit opinion) by determining only error and non-compliance reasons compared to this study where determination of modified audit opinion is measured for all elements of risks. For control variables, PRAUREP, LOSS and LEV are statistically significant with modified audit opinion; while the remaining variables are statistically insignificant.

Panel D (Separate RMC, RMC Characteristics, Audit Committee Characteristics and Control Variables)

In Panel D, the combination of all variables, including characteristics of RMC, characteristics of AC and control variables are tested in the model. The model reports the level of correct classification at 92 percent with Cox & Snell R Square and Nagelkerke R Square at 62 percent and 83 percent, respectively. Meanwhile, the Chi-square test is at 292.407 and generally, the model is significant at a level of 0.00 ($p < 0.01$). All the characteristics of AC (AC Expert, AC Meeting and AC Independence) are statistically not significant to modified audit opinion. Otherwise, some hypotheses from characteristics of RMC are statistically significant such as Separate RMC, RMC Independence and RMC Overlapping. The reason why the variables of AC are not significant is because the role played by this board committee, particularly on risk oversight function, is taken over by the new board committee, i.e., the RMC. The RMC, as a board committee, is able to implement its oversight function for risk management without depending on the AC. This is evidenced by statistical result where some variables of RMC are still significant even though it is combined with the variables of AC; otherwise, the AC variables are statistically insignificant. For control variables, some of them are statistically significant as in the result of the original model of this study. They are Prior Audit Report, Loss, Leverage and Business Segment.

$$MA = \beta 0 + \beta 1\ SEPRMC + \beta 2\ RMCSIZE + \beta 3\ RMCDILI + \beta 4\ RMCINDE + \beta 5\ RMCTRAI + \beta 6\ RMCQUAL + \beta 7\ RMCOVER + \beta 8\ RMCINTER + \beta 9\ PRAUREP + \beta 10\ LOSS + \beta 11\ BIG4 + \beta 12\ LEV + \beta 13\ AUTEN + \beta 14\ CLSIZE + \beta 15\ ASSPRO + \beta 16\ BUSSEG + \varepsilon$$

Table 4.4
Result of the Logistic Regressions

Variables	**Expected Sign**	**Panel A CV**			**Panel B RMC + CV**			**Panel C AC + CV**			**Panel D RMC + AC + CV**		
Independent Variables		**Coefficient**	**Wald test**	**p-value**	**Coefficient**	**Wald test**	**p-value**	**Coefficient**	**Wald test**	**p-value**	**Coefficient**	**Wald test**	**p-value**
SEPRMC	-				-2.362	6.466	.011				-2.568	5.227	.022
RMCSIZE	+				.277	.478	.489				.336	.590	.442
RMCDILI	-				-.003	.000	.984				.497	.302	.583
RMCINDE	-				-1.693	1.329	.249				-4.329	2.424	.120
RMCTRAI	-				-.177	.635	.426				-.188	.690	.406
RMCQUAL	-				-4.371	5.251	.022				1.865	.021	.884
RMCOVER	+				2.635	5.055	.025				3.105	5.712	.017
RMCINTER	-				.016	.000	.984				-.105	.017	.895

ACEXPERT								-4.374	6.417	.011	-6.084	.234	.629
ACMEET								.021	.021	.885	-.515	.314	.575
ACINDE								-1.348	.886	.347	3.445	1.286	.257
Control Variables													
PRAUREP	+	6.020	25.529	.000	6.466	26.819	.000	6.293	26.595	.000	6.532	26.631	.000
LOSS	+	.659	2.283	.131	.879	2.923	.087	.784	2.960	.085	.971	3.480	.062
BIG4	+	.362	.713	.398	.386	.601	.438	.150	.112	.738	.459	.786	.375
LEV	+	6.722	33.525	.000	7.347	28.033	.000	6.707	30.510	.000	7.411	28.070	.000
AUTEN	-	-.104	1.552	.213	-.121	1.598	.206	-.118	1.827	.177	-.119	1.541	.214
CLSIZE	+	.001	.360	.549	.001	.794	.373	.001	.549	.459	.001	.376	.540
ASSPRO	-	-.250	1.167	.280	-.237	.832	.362	-.294	.246	.232	-.240	.802	.370
BUSSEG	-	-2.570	2.457	.117	-2.315	2.049	.152	-1.911	1.074	.300	-2.558	2.512	.113
Constant	?	-.746	.198	.656	-.784	.077	.782	1.202	.263	.608	-1.702	.343	.558
Chi-square(sig)		264.665 (.000)			290.565 (.000)			273.219 (.000)			292.407 (.000)		
Cox & Snell R Square		.586			.620			.598			.623		
Nagelkerke		.782			.827			.797			.830		

R Square Classification	90.70%	91.70%	90.30%	92.00%
N	300	300	300	300

Variable Definition:

SEPRMC	= 1, if the existence of separate RMC, otherwise 0
RMCSIZE	= number of RMC members at financial year-end
RMCDILI	= number of RMC meetings during the financial year
RMCINDE	= proportion of independent non-executive members on the RMC
RMCTRAI	= number of risk/risk management related training to RMC members
RMCQUAL	= proportion of RMC members with accounting or finance qualification
RMCOVER	= proportion of RMC members with dual or more functions on different board committees
RMCINTER	= proportion of RMC members with more than one different company's board members
PRAUREP	= 1, if the company received modified audit opinion at prior year, otherwise 0
LOSS	= 1, if the company reported loss in either or both of the two previous years, otherwise 0
BIG4	= 1, if the auditor of the BIG 4, otherwise 0
LEV	= total debt/total asset
AUTEN	= number of years of engagement with the same audit firm
CLSIZE	= natural log of total assets (in millions of Ringgit Malaysia)
ASSPRO	= ratio between earning before interest, tax and extraordinary income and total asset
BUSSEG	= 1, if the company has two or more business segments, otherwise 0
ACEXPERT	= proportion of AC members with accounting or finance qualification
ACMEET	= number of AC meeting during financial year
ACINDE	= proportion of independent non-executive members on the AC
CV	= control variable
RMC	= risk management committee
AC	= audit committee

Summary of the Result of Logistic Regression

Table 4.5 reports the summary of the result of logistic regression, where the original model in this study consists of RMC characteristics and control variables, while the full result is presented in Panel B of Table 4.4.

Table 4.5
Summary of the Result of Logistic Regression

Hypothesis/Variable	Acronym	Direction	Remark
Separate RMC	SEPRMC	Negative	Supported
RMC Size	RMCSIZE	Positive	Not Supported
RMC Diligence	RMCDILI	Negative	Not Supported
RMC Independence	RMCINDE	Negative	Not Supported
RMC Training	RMCTRAI	Negative	Not Supported
RMC Qualification	RMCQUAL	Negative	Supported
RMC Overlapping	RMCOVER	Positive	Supported
RMC Interlocking	RMCINTER	Positive	Not Supported

4.4 Additional Analysis

Asset Profitability (ASSPRO)

Table 4.6 reports the result of sensitive analysis on ASSPRO. The result reported for this variable in t-test and correlation is statistically significant but in logistic regression, the result is statistically insignificant. The researcher redefined ASSPRO in the following manner: ASSPROSUB takes the value of

1 when the company reported operating loss, otherwise 0. In 300 observations of samples, it is found that 140 samples (47 percent) reported operating loss, while the remaining samples (160) reported operating profit. The result as revealed in Table 4.5 shows that this variable with new redefinition is statistically significant with five percent level of significance and with positive direction. For beta coefficient, it is more than 100 percent, indicating that if a company reported operating loss, the likelihood of the company receiving modified audit opinion is more than 100 percent. Generally, Asset Profitability in this study has an impact or influence on the issuance of modified audit opinion.

Table 4.6

Result of Logistic Regression for Sub sample of Asset Profitability

	Expected Sign	Coefficient (B)	Wald test	p-value
SEPRMC	-	-2.323	5.621	.018
RMCSIZE	+	.324	.566	.452
RMCDILI	-	-.034	.051	.822
RMCINDE	-	-2.045	1.836	.175
RMCTRAI	-	-.175	.576	.448
RMCQUAL	-	-3.797	4.216	.040
RMCOVER	+	2.653	4.867	.027
RMCINTER	-	.146	.033	.856
PRAUREP	+	6.475	30.134	.000
LOSS	+	.169	.066	.797
BIG4	+	.481	.873	.350
LEV	+	7.392	28.416	.000
AUTEN	-	-.124	1.590	.207
CLSIZE	+	.001	1.007	.316
ASSPROSUB	+	1.246	4.059	.044
BUSSEG	-	-2.068	1.342	.247
Constant		-1.250	.179	.672

Chi-square (sig)	294.299 (.000)
Cox & Snell R Square	.625
Nagelkerke R Square	.833
Classification	91.30%
N	300

Variable Definition:

SEPRMC = 1, if the existence of separate RMC, otherwise 0
RMCSIZE = number of RMC members at financial year-end
RMCDILI = number of RMC meetings during the financial year
RMCINDE = proportion of independent non-executive members on the RMC
RMCTRAI = number of risk/risk management related training to RMC members
RMCQUAL = proportion of RMC members with accounting or finance qualification
RMCOVER = proportion of RMC members with dual or more functions on different board committees
RMCINTER = proportion of RMC members with more than one different company's board members
PRAUREP = 1, if the company received modified audit opinion in the prior year, otherwise 0

LOSS	= 1, if the company reported loss in either or both of the two previous years, otherwise 0
BIG4	= 1, if the auditor of the BIG 4, otherwise 0
LEV	= total debt/total asset
AUTEN	= number of years of engagement with the same audit firm
CLSIZE	= natural log of total assets (in millions of Ringgit Malaysia)
ASSPROSUB	= 1, if reported lower value or operating loss, otherwise 0
BUSSEG	= 1, if the company has two or more business segments, otherwise 0

Business Segment

The result of Logistic Regression analysis proved that a SEPRMC has negative relationship with modified audit report and BUSSEG also has negative association with modified audit report. Theoretically, the companies which have a separate RMC can reduce the receipt of modified audit opinion; companies with two or more business segments probably have a separate RMC; and the likehood of this type of company receiving modified audit report is also less. However, there are nine companies in the sample which have two or more business segments and also separate RMC but which still received modified audit opinion. The researcher performed additional analysis on this situation and the result reveals that loss and prior audit report are the other factors or contributors for the receipt of modified audit opinion. Even though those companies have separate RMC, the other factors, such as loss and prior audit report have impact on the receipt of modified audit opinion. This is consistent with the result of logistic analysis that LOSS and PRAUREP have significant relationship with modified audit report.

BOD Independence

The researcher also performed additional analysis on BODs' independence in the companies. The number of board members and total number of independent members were calculated for the samples. The proportion of BODs' independent members against BODs size was used as a variable in this analysis. The result of logistic regression as in Table 4.7 reveals that this variable is not statistically significant. The results indicate that BODs' independence probably does not influence the receipt of modified audit opinion. This result is consistent with the study done by Farinha and Viana (2009) that proportion of non-executive members on BODs probably reduces the receipt of modified audit opinion by the companies. Earlier studies by Klein (2002) and Beasley (1996) also documented that the larger proportion of non-executive BODs or BODs' independent members probably reduce accounting fraud and earnings management. The latest study by Sahlan (2011) also found that the presence of independent members on the BODs improves the company's financial reporting and financial disclosure.

In this study, the analysis on BODs' independence was done together with the existence of a separate RMC, where this new board committee is statistically significant to modified audit opinion. The role of the BODs relating to the company's financial reporting, accounting fraud and earnings management (as in studies by previous researchers) are taken over by the separate RMC. A separate RMC focusing on the company's risk profile can successfully execute its function of risk oversight, including the risks of earnings management and accounting fraud. The above result also shows that a separate RMC is still statistically significant to modified audit opinion even when BODs' independence is tested together. As a conclusion, BODs' independence may not influence the receipt of modified audit opinion when there is a separate RMC in the company which can successfully execute its function on the company's risk profile.

Table 4.7
Result of Logistic Regression for BOD Independence

	Expected Sign	Coefficient (B)	Wald Test	p-value
SEPRMC	-	-2.390	6.514	.011
RMCSIZE	+	.254	.400	.527
RMCDILI	-	.003	.000	.985
RMCINDE	-	-1.577	1.125	.289
RMCTRAI	-	-.193	.731	.393
RMCQUAL	-	-4.347	5.166	.023
RMCOVER	+	2.548	4.692	.030
RMCINTER	-	.011	.000	.989
PRAUREP	+	6.449	26.450	.000
LOSS	+	.899	3.035	.081
BIG4	+	.367	.540	.462
LEV	+	7.340	27.928	.000
AUTEN	-	-.122	1.628	.202
CLSIZE	+	.001	.821	.365
ASSPRO	-	-.222	.732	.392
BUSSEG	-	-2.470	2.218	.136
BODINDE	-	-1.101	.239	.625
Constant		-.040	.000	.990

Chi-square (sig)	290.805 (.000)
Cox & Snell R Square	.621
Nagelkerke R Square	.828
Classification	91.3
N	300

Variable Definition:

SEPRMC	= 1, if the existence of separate RMC, otherwise 0
RMCSIZE	= number of RMC members at financial year-end
RMCDILI	= number of RMC meetings during the financial year
RMCINDE	= proportion of independent non-executive members on the RMC
RMCTRAI	= number of risk/risk management related training to RMC members
RMCQUAL	= proportion of RMC members with accounting or finance qualification

RMCOVER	= proportion of RMC members with dual or more functions on different board committees
RMCINTER	= proportion of RMC members with more than one different company's board members
BODINDE	= proportion of independent non-executive members on BOD
PRAUREP	= 1, if the company received modified audit opinion at prior year, otherwise 0
LOSS	= 1, if the company reported loss in either or both of the two previous years, otherwise 0
BIG4	= 1, if the auditor of the BIG 4, otherwise 0
LEV	= total debt/total asset
AUTEN	= number of years of engagement with the same audit firm
CLSIZE	= natural log of total assets (in millions of Ringgit Malaysia)
ASSPRO	= ratio between earning before interest, tax and extraordinary income and total asset
BUSSEG	= 1, if the company has two or more business segments, otherwise 0

Interaction Test

Interaction test is done to know whether the interaction or combination between two continuous or explanatory variables has a simultaneous influence on the dependent variable (modified audit opinion). Some continuous variables, such as RMC Size, RMC Independence, RMC Diligence, RMC Training, Auditor Tenure and Client Size were tested to know whether there are simultaneous effects on modified audit opinion after an interaction between two of them are tested. Those variables are selected and tested because under logistic regression analysis where the study's model was tested, they were not statistically significant to modified audit opinion even though they were initially expected to have a relationship with modified audit opinion. Thus, the interaction between two continuous variables was tested to know whether they have a simultaneous effect on modified audit opinion.

The researcher interacted RMC Size and Client Size to know whether this interaction has simultaneous effect or is statistically significant to modified audit opinion. The result as shown at Table 4.8 reveals that the interaction between RMC Size and Client Size is statistically significant to modified audit opinion. The result also shows that RMC Size, RMC Qualification and RMC Overlapping that were initially significant to modified audit opinion are still significant to modified audit opinion although the new variable of the interaction of RMC Size and Client Size is added to the model. The result indicates that the size of RMC and the size of the client company have simultaneous effect on modified audit opinion. The bigger the size of the

RMC and the bigger the size of the client company in terms of total assets, the probability of the company receiving modified audit opinion is higher. This new variable has positive relationship with modified audit opinion. Reynolds and Francis (2000) argued that the larger client company size would increase the concern of the auditor, in that a bigger RMC would lead to a lack of responsibility by RMC's members since they tend to rely on the other members to perform their tasks on risk issues. This argument is consistent with the earlier argument by Farinha and Viana (2009) that smaller board committee is better for executing the oversight function. Consequently, both situations have simultaneous effect on modified audit opinion where the bigger the size of the RMC and the bigger the size of the client company, the probability of the company receiving modified audit opinion is also greater. Therefore, this result answers the second research question that RMC Size and Client Size have simultaneous influence on the reeipt of modified audit opinion; the second research objective is therefore also met.

Table 4.8

Result of Logistic Regression for Interaction of Between RMC Size and Client Size

	Expected Sign	Coefficient (B)	Wald Test	p- value
SEPRMC	-	-2.905	6.835	.009
RMCSIZE	+	-.134	.075	.785
RMCDILI	-	-.010	.004	.952
RMCINDE	-	-1.180	.618	.432
RMCTRAI	-	-.148	.418	.518
RMCQUAL	-	-4.687	5.917	.015
RMCOVER	+	3.250	6.318	.012
RMCINTER	-	-.183	.052	.820
PRAUREP	+	6.623	26.770	.000
LOSS	+	.972	3.480	.062
BIG4	+	.453	.796	.372
LEV	+	7.419	28.305	.000
AUTEN	-	-.114	1.398	.237
CLSIZE	+	-.007	1.748	.186
ASSPRO	-	-.261	.964	.326
BUSSEG	-	-2.507	2.543	.111
RMCSIZEXCLSIZE	+	.002	2.297	.130
Constant		-.022	.000	.994

Chi-square (sig)	293.365 (.000)
Cox & Snell R Square	.624
Nagelkerke R Square	.832
Classification	92 %
N	300

Variable Definition:

SEPRMC	= 1, if the existence of separate RMC, otherwise 0
RMCSIZE	= number of RMC members at financial year-end
RMCDILI	= number of RMC meetings during the financial year
RMCINDE	= proportion of independent non-executive members on the RMC
RMCTRAI	= number of risk/risk management related training to RMC members
RMCQUAL	= proportion of RMC members with accounting or finance qualification
RMCOVER	= proportion of RMC members with dual or more functions on different board committees
RMCINTER	= proportion of RMC members with more than one different company's board members

PRAUREP	= 1, if the company received modified audit opinion at prior year, otherwise 0
LOSS	= 1, if the company reported loss in either or both of the two previous years, otherwise 0
BIG4	= 1, if the auditor of the BIG 4, otherwise 0
LEV	= total debt/total asset
AUTEN	= number of years of engagement with the same audit firm
CLSIZE	= natural log of total assets (in millions of Ringgit Malaysia)
ASSPRO	= ratio between earning before interest, tax and extraordinary income and total asset
BUSSEG	= 1, if the company has two or more business segments, otherwise 0
RMCSIZEXCLSIZE	= Interaction of between RMCSIZE and CLSIZE

Another interaction test by the researcher is between RMC Diligence and Auditor Tenure. These two continuous variables were interacted and tested to know whether there is simultaneous effect on modified audit opinion. The result of logistic regression analysis as shown in Table 4.9 reveals that this new variable that interacted between RMC Diligence and Auditor Tenure is statistically significant to modified audit opinion with negative direction. This means that the number of RMC meetings and the number of years of engagement with the same audit firm have simultaneous effect on modified audit opinion. The higher the number of RMC meetings and the longer the number of years of engagement with the same audit firm, the probability of the company receiving modified audit opinion is less.

This result is consistent with the findings of previous studies done by Xie *at al.* (2003); Farinha and Viana (2009); and Pucheta-Martinez and Fuentes (2007) that the more the number of board meetings, such as audit and RMC meetings, the probability of the company receiving modified audit opinion is less. For auditor tenure, this result supports the previous study by Shafie *et al.* (2009) that the longer tenure of engagement with the same audit firm reduces receipt of modified audit opinion. The long-term engagement with the same auditor results in the auditor understanding the client's business operations and environment better and more effective advice can be given by the auditor. Hence, the issues of risk are reduced and the probability of the company receiving modified audit opinion due to risks is also less. The same situation also occurs for RMC Diligence where the higher the number of meetings held by the RMC that focuses on risk issues, the issues of risk are reduced and the probability of the company receiving modified audit opinion due to those risks is less. These two situations of interaction between RMC Diligence and Auditor Tenure have simultaneous effect on modified audit opinion; the result answers the second research question that the interaction between RMC Diligence and Auditor Tenure has influence on the receipt of modified audit opinion. The second research objective is also met where these two continuous variables are interacted and tested and found to have influence on modified audit opinion.

Table 4.9
Result of Logistic Regression for Interaction of Between RMC Diligence and Auditor Tenure

	Expected Sign	Coefficient (B)	Wald Test	p-value
SEPRMC	-	-2.465	6.272	.012
RMCSIZE	+	.268	.425	.514
RMCDILI	-	.502	2.322	.128
RMCINDE	-	-1.691	1.272	.259
RMCTRAI	-	-.128	.319	.572
RMCQUAL	-	-5.372	6.529	.011
RMCOVER	+	2.736	5.269	.022
RMCINTER	-	.240	.090	.765
PRAUREP	+	6.549	27.902	.000
LOSS	+	1.029	3.744	.053
BIG4	+	.295	.340	.560
LEV	+	7.461	27.540	.000
AUTEN	-	.584	2.208	.137
CLSIZE	+	.001	1.406	.236
ASSPRO	-	-.359	1.592	.207
BUSSEG	-	-2.314	1.859	.173
RMCDILIXAUTEN	-	-.153	3.315	.069
Constant		-3.209	.967	.325

Chi-square (sig)	293.850 (.000)
Cox & Snell R Square	.625
Nagelkerke R Square	.833
Classification	92 %
N	300

Variable Definition:

SEPRMC	= 1, if the existence of separate RMC, otherwise 0
RMCSIZE	= number of RMC members at financial year-end
RMCDILI	= number of RMC meetings during the financial year
RMCINDE	= proportion of independent non-executive members on the RMC
RMCTRAI	= number of risk/risk management related training to RMC members
RMCQUAL	= proportion of RMC members with accounting or finance qualification

RMCOVER	= proportion of RMC members with dual or more functions on different board committees
RMCINTER	= proportion of RMC members with more than one different company's board members
PRAUREP	= 1, if the company received modified audit opinion at prior year, otherwise 0
LOSS	= 1, if the company reported loss in either or both of the two previous years, otherwise 0
BIG4	= 1, if the auditor of the BIG 4, otherwise 0
LEV	= total debt/total asset
AUTEN	= number of years of engagement with the same audit firm
CLSIZE	= natural log of total assets (in millions of Ringgit Malaysia)
ASSPRO	= ratio between earning before interest, tax and extraordinary income and total asset
BUSSEG	= 1, if the company has two or more business segments, otherwise 0
RMCDILIXAUTEN	= Interaction of between RMCDILI and AUTEN

Table 4.10 presents the result of logistic regression for interaction between RMC Training and Client Size. The result of this interaction is statistically insignificant to modified audit opinion. The interaction of RMC Training and Client Size that creates a new variable does not have simultaneous effect on modified audit opinion. The risk trainings attended by the RMC members and the size of client company in terms of total assets have no simultaneous influence on the receipt of modified audit opinion. The number of risk trainings and the total assets of the client company have no simultaneous relationship with modified audit opinion.

The same situation applies for the interaction between RMC Independence and Auditor Tenure, where the result of logistic regression as presented in Table 4.11 reveals this interaction is statistically insignificant to modified audit opinion. The status of RMC members as INEDS and the number of years of engagement with the same audit firm have no simultaneous influence on the receipt of modified audit opinion. Although there are a larger number of RMC members with status of INEDs and a long-term engagement with the same audit firm, the interaction of these two variables has no relationship with modified audit opinion.

Table 4.10
Result of Logistic Regression for Interaction of Between RMC Training and Client Size

	Expected Sign	Coefficient (B)	Wald Test	p-value
SEPRMC	-	-2.371	6.452	.011
RMCSIZE	+	.292	.527	.468
RMCDILI	-	.003	.000	.987
RMCINDE	-	-1.474	.927	.336
RMCTRAI	-	-.263	.878	.349
RMCQUAL	-	-4.319	5.069	.024
RMCOVER	+	2.723	5.212	.022
RMCINTER	-	.027	.001	.973
PRAUREP	+	6.495	26.924	.000
LOSS	+	.944	3.139	.076
BIG4	+	.374	.560	.454
LEV	+	7.297	27.617	.000
AUTEN	-	-.109	1.248	.264
CLSIZE	+	.000	.024	.878
ASSPRO	-	-.246	.872	.350
BUSSEG	-	-2.381	2.161	.142
RMCTRAIXCLSIZE	-	.001	.260	.610
Constant		-.923	.104	.747

Chi-square (sig)	290.826 (.000)
Cox & Snell R Square	.621
Nagelkerke R Square	.828
Classification	91.30%
N	300

Variable Definition:

SEPRMC = 1, if the existence of separate RMC, otherwise 0
RMCSIZE = number of RMC members at financial year-end
RMCDILI = number of RMC meetings during the financial year
RMCINDE = proportion of independent non-executive members on the RMC
RMCTRAI = number of risk/risk management related training to RMC members

RMCQUAL	= proportion of RMC members with accounting or finance qualification
RMCOVER	= proportion of RMC members with dual or more functions on different board committees
RMCINTER	= proportion of RMC members with more than one different company's board members
PRAUREP	= 1, if the company received modified audit opinion at prior year, otherwise 0
LOSS	= 1, if the company reported loss in either or both of the two previous years, otherwise 0
BIG4	= 1, if the auditor of the BIG 4, otherwise 0
LEV	= total debt/total asset
AUTEN	= number of years of engagement with the same audit firm
CLSIZE	= natural log of total assets (in millions of Ringgit Malaysia)
ASSPRO	= ratio between earning before interest, tax and extraordinary income and total asset
BUSSEG	= 1, if the company has two or more business segments, otherwise 0
RMCTRAIXCLSIZE	= Interaction of between RMCTRAI and CLSIZE

Table 4.11
Result of Logistic Regression for Interaction of Between RMC Independence and Auditor Tenure

	Expected Sign	Coefficient (B)	Wald Test	p-value
SEPRMC	-	-2.378	6.463	.011
RMCSIZE	+	.284	.492	.483
RMCDILI	-	-.002	.000	.989
RMCINDE	-	-1.352	.201	.654
RMCTRAI	-	-.180	.648	.421
RMCQUAL	-	-4.362	5.226	.022
RMCOVER	+	2.630	5.022	.025
RMCINTER	-	.013	.000	.987
PRAUREP	+	6.469	26.930	.000
LOSS	+	.872	2.842	.092
BIG4	+	.391	.612	.434
LEV	+	7.365	27.778	.000
AUTEN	-	-.066	.023	.878
CLSIZE	+	.001	.802	.371
ASSPRO	-	-.240	.846	.358
BUSSEG	-	-2.309	2.035	.154
RMCINDEXAUTEN	-	-.071	.017	.897
Constant		-1.082	.088	.767

Chi-square (sig)	290.581 (.000)
Cox & Snell R Square	.620
Nagelkerke R Square	.827
Classification	91.70%
N	300

Variable Definition:

SEPRMC = 1, if the existence of separate RMC, otherwise 0
RMCSIZE = number of RMC members at financial year-end
RMCDILI = number of RMC meetings during the financial year
RMCINDE = proportion of independent non-executive members on the RMC

RMCTRAI	= number of risk/risk management related training to RMC members
RMCQUAL	= proportion of RMC members with accounting or finance qualification
RMCOVER	= proportion of RMC members with dual or more functions on different board committees
RMCINTER	= proportion of RMC members with more than one different company's board members
PRAUREP	= 1, if the company received modified audit opinion at prior year, otherwise 0
LOSS	= 1, if the company reported loss in either or both of the two previous years, otherwise 0
BIG4	= 1, if the auditor of the BIG 4, otherwise 0
LEV	= total debt/total asset
AUTEN	= number of years of engagement with the same audit firm
CLSIZE	= natural log of total assets (in millions of Ringgit Malaysia)
ASSPRO	= ratio between earning before interest, tax and extraordinary income and total asset
BUSSEG	= 1, if the company has two or more business segments, otherwise 0
RMCINDEXAUTEN	= Interaction of between RMCINDE and AUTEN

4.5 Conclusion

This chapter provides the results of statistical analysis for this study. Descriptive analysis is done to characterise the samples of the study as well as frequency distribution for categorical data. Correlation analysis is also done to see the correlation among the variables in the framework. More important is the analysis of logistics regression where the main framework of the study is examined. Lastly, the researcher also provides additional analysis in this chapter.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATION

5.1 Summary of the Study

The objective of the study is to examine the relationship between the RMC's characteristics and modified audit opinion issued by the auditors in Malaysia. The data from the companies' annual reports for the period of 2004 until 2009 are collected and used in this study. Based on the past literature and issues that have been discussed, two research questions and two research objectives are developed in this study. Meanwhile, based on the previous literature, standards and codes appropriate to this study, eight independent variables (Separate RMC, RMC Size, RMC Diligence, RMC Independence, RMC Training, RMC Qualification, RMC Overlap and RMC Interlocking) together with eight control variables (Prior Audit Report, Loss, Big4, Leverage, Auditor Tenure, Client Size, Asset Profitability and Business Segment) are developed to form the research framework, while Modified Audit Opinion is the dependent variable.

In terms of analysis, the SPSS computer software is used to examine the study framework and model. Logistic regression analysis is used to test the research model and the results from this analysis reveal some hypotheses are supported and significant to modified audit opinion. The hypotheses of Separate RMC, RMC Qualification and RMC Overlapping are supported and significant to modified audit opinion. The existence of a separate RMC probably will reduce the issuance of modified audit opinion. There is a negative relationship between separate RMC and modified audit opinion. For RMC Qualification, there is a negative relationship between this hypothesis and modified audit opinion, where if the members of the RMC have accounting or finance academic qualification, the likelihood of the company receiving modified audit opinion is less. Lastly, there is a positive association between RMC Overlapping and modified audit opinion which means if the members of RMC have overlapping status measured by the members holding more than one board committee membership, the probably of the company receiving modified audit opinion is high. In conclusion, the hypothesis of Separate RMC answers the first research question and the first research objective is met, i.e., the existence of a separate RMC influences the receipt of modified audit opinion by the company; while the hypotheses of RMC Qualification and RMC Overlapping answer the second research question and the second research objective is met, i.e., which RMC characteristics influence the receipt of modified audit opinion. Besides, there are several control variables that also influence the receipt of modified audit opinion by the company, such as Prior Audit Report, Loss, Leverage and Business Segment.

5.2 Significance and Implication of the Study

Significance and implication of the study are discussed in terms of theoretical and knowledge, practical and methodological implications.

5.2.1 Theoretical and Knowledge Implications

This study provides new knowledge for the association between RMC and audit opinion, particularly modified audit opinion. The result documents that the existence of a separate RMC affects the issuance of modified audit opinion by the auditors. The finding contributes to the knowledge and literature that the existence of a separate RMC has implications on modified audit opinion, specifically in the Malaysian environment. The existence of a separate RMC probably will reduce the issuance of modified audit opinion. The finding is consistent with the expectation of the researcher that the existence of a separate RMC can reduce the issuance of modified audit opinion. The existence of a stand-alone or separate RMC with only risk management tasks successfully affects the risk factors to the company and consequently affects the issuance of modified audit opinion particularly on risk reasons. This board committee that only focuses on risk activities, either internal or external risks, can successfully reduce the implication of such risks to the company.

In addition, this study also reveals the relationship between RMC Qualification and modified audit opinion. The study provides evidence that RMC members with accounting or finance academic qualification can reduce the issuance of modified audit opinion. Their knowledge has an effect on the risk management activities, including internal and external risks. They are knowledgeable on internal risks, such as fraud risk; as well as external risks like market or product risks. Further, the RMC members will be more aware of the activities of risk management in the company, especially at the board oversight level. The finding of this study reveals that the RMC members with accounting and finance academic qualification probably can reduce the issuance of modified audit opinion by the auditor.

The study also shows that RMC members with overlapping status have a positive relationship with modified audit opinion. Theoretically, these RMC members have more burden of tasks when sitting on several board committees. They cannot concentrate on the risk profile as required of RMC. members. This situation renders their work on risk activites to be ineffective and raises the rate of issuance of modified audit opinion. As a conclusion, RMC Overlapping has positive association with modified audit opinion.

5.2.2 Practical Implications

The finding of this study has practical implications. Since the establishment of a separate RMC is still voluntary especially in Malaysia, the regulators and policy-markers should be more aware of the importance of this board committee. This study provides evidence on the importance of a separate RMC which can probably reduce the issuance of modified audit opinion particularly for reason of risks. A separate RMC will reduce the audit committee's burden of tasks. Audit committee members have accounting activities whereas RMC members can concentrate on the risk profile of the company, including internal and external risks. The regulators and policy-makers have to consider this situation. A separate RMC in the company to perform the risk oversight function at board level should be looked into by the regulators. This is consistent with MCCG (2000; 2007; 2012) on concern by the BODs for the risk profile of the company. The setting up of a stand-alone board committee that focuses on the company's risk profile entirely is a good measure for risk management process at board level. The result of the statistical analysis in the previous chapter also reveals some characteristics of the audit committee (AC Expert, AC Meeting and AC Independence) have no relationship with modified audit opinion, when AC members sit together with RMC members. This indicates that the risk oversight function is taken over by the RMC.

One another important element in the RMC is the members' academic qualification. The result of this study reports that members of the RMC with accounting or finance academic qualification probably can reduce the issuance of modified audit opinion. These kinds of directors have more knowledge in internal control, which involves accounting and financial transactions as well as the company's external environmental challenges. They have learned about this in their study and experiences gained in previous accounting or finance job environments. The regulators and policy-markers should be aware about the academic qualification of the RMC members as mandated for the audit committee members presently, i.e., one or two members of the RMC must have accounting or finance academic background.

The regulators and policy-makers should also be aware of the overlapping status of board members. They have to look at the number of board committees that the board members sit on. Some board members sit on more than two or three board committees in the same company at the same time. The existing guidelines issued by BM only provide a guideline on interlocking status where a board member can hold not more than 25 directorships (10 for listed companies and 15 for non-listed companies). A guideline for overlapping status of board members is needed due to the finding of this study that RMC members with overlapping status or sitting on more than two board committees affect the issuance of modified audit opinion. They have a huge burden of tasks when sitting on several board committees. They lose concentration in certain boards. In this study, the result reports they lose concentration on the risk profile which can impact on the issuance of modified audit opinion. The regulators and policy-makers should limit the number of board committee memberships.

5.2.3 Methodological Implications

This study uses the data for the period of 2004 until 2009. Companies' annual reports as secondary data are used as the main source of data and information. The researcher developed the research framework and model by examining the characteristics of RMC and control variables as the independent variables. For the dependent variable, modified audit opinion is chosen by the researcher. The result from the statistical analysis reveals that some characteristics of RMC are significant to modified audit opinion, such as Separate RMC, RMC Qualification and RMC Overlapping; while Prior Audit Report, Loss, Leverage and Business Segment as control variables are also significant to modified audit opinion. In terms of methodological implication, this study has successfully developed the framework and model by considering the relationship among the elements or characteristics in the framework and model. Some of them are significant and related with others and some of them have no association with others.

5.3 Limitation and Recommendation for Future Research

This study started in year 2011. The data collected for this study covers the period between 2004 until 2009. Most companies have not yet published their annual reports for financial year ended 2010 at that time. Another limitation is some amendments to certain ISAs. An example is *"emphasis of matter"* in auditor's report (ISA 706) which starting from 2010, this term was classified under the unmodified audit report while in this study, the term *"emphasis of matter"* in auditor's report is classified under the modified audit report and consistent with the ISA standards relevant at that time. Future studies may use the current year's data as there are more challenges for the companies doing their business, especially in terms of risk issues.

This study uses secondary data as the samples whereby the companies' annual reports are used as the main source. May be in the future, researchers can use a different method in data collection, such as interviews with auditors and risk officers. Questionnaires can also be used by researchers to collect primary data. These types of data collection methods are important for researchers to know some other implicit information raised by the auditors or other respondents. This study examines the companies listed on BM. They are guided by the standards, guidelines, procedures and policies approved and endorsed by the Malaysian authorities and generally, the

Malaysian environment is adopted as well. Future studies can be carried out in other countries and environments.

In terms of research framework, this study uses modified audit opinion as the dependent variable. Perhaps, other researchers can use qualified audit opinion or going-concern opinion as the dependent variable in the framework. The scope is different for qualified or going-concern audit opinion compared to modified audit opinion. The treatment for each type of audit report is different and some different results may be produced if a different type of audit report is used.

Lastly, the establishment of the RMC is still voluntary and not mandatory in most countries. The study on the efficiency of this board committee is limited and scant. Future studies should be done on its efficiency in terms of other indicators, like company market share, profit and investment opportunity. Future studies should also examine the roles played by this board committee for these indicators besides the characteristics of the RMC. The relationship between the RMC and audit committee is still at an early stage. More research should be done to see how these two board committees play their roles in a company and whether they complement each other or there is no relationship between them. Hence, more research on the establishment, process and efficiency of this new board committee (RMC) is needed in future.

5.4 Conclusion

In the last chapter, the researcher provides a summary of the study including the research design, methodology, framework, analysis of results and some hypotheses that answer the research questions and research objectives. The significance of the study in terms of knowledge, practical and methodological implications is also provided in this chapter. The limitations of the study and recommendations for future research are provided at the end of this chapter.

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