THE ROLE OF AUDIT QUALITY IN THE
VALUATION OF INITIAL PUBLIC OFFERINGS

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fulfillment of the requirements for the degree of
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by
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ABSTRACT

This study provides an empirical examination of the theoretical model proposed by Datar, Feltham and Hughes (1991) on the demand for audit quality in an initial public offering (IPO) environment by utilizing data from Malaysian IPO market. Consistent with the model, two hypotheses are developed; (1) there is a positive association between audit quality and firm-specific risk, and (2) financial reports attested to by higher quality auditors should have a greater marginal effect on current market value than the reports associated with low quality auditors.

Two models are used to test these predictions. The first one is the auditor choice model, which is a multivariate logistic regression model, while the second one is the valuation model developed by Datar et al. (1991).

No evidence is found to support the predicted positive relationship between audit quality and firm-specific risk. The results are consistent with the expectation that there is a significant effect of audit quality on the market valuation of IPO stocks. This reflects a greater degree of confidence placed by investors on reports approved by high quality auditors. The results are also not sensitive to alternative definitions of variables, omitted variable problems, the presence of outliers or the size effect. Overall, the findings indicate the role of audit quality as a signaling mechanism in the valuation of IPO in Malaysia.
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1.0 INTRODUCTION

Entrepreneurs offering securities when a firm goes public typically possess private information about the future prospects of the firm and have high motivation to communicate these information to investors in order to avoid the securities from being undervalued. A new issue of securities is accompanied by a prospectus that basically contains information about the firm’s historical financial information, current financial status as well as its future prospects. Specifically, a prospectus includes historical profitability, information on the assets, investment plans and economic prospects of the firm and in certain countries, the forecasts of profits and dividends as well as information on the risk factors.

Besides these basic valuation parameters, entrepreneurs will adopt other strategies and disclose data to signal their private knowledge of the firm. There are a variety of signaling mechanisms available to a firm and they can either complement or substitute each other. Among the major signaling mechanisms that have been identified in the accounting literature are the retained ownership or entrepreneur’s shareholding (Leland and Pyle, 1977; and Hughes, 1986), the firm’s debt level (Ross, 1977), direct disclosure of the firm value (Hughes, 1986), underpricing of the issue (Allen and Faulhaber, 1989) as well as auditor
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References


