

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

A research project submitted to the Graduate School in partial  
fulfillment of the requirements for the degree of  
Master of Science (International Accounting),  
Universiti Utara Malaysia

by  
Hartini Jaafar

## **PERMISSION TO USE**

In presenting this research project in partial fulfillment of the requirements for a post graduate degree from Universiti Utara Malaysia, I agree that the University Library may make it freely available for inspection. I further agree that permission for copying of this research project in any manner, in whole or in part, for scholarly purposes may be granted by my supervisor, or in his absence, by the Dean of the Graduate School. It is understood that any copying or publication or use of this research project or parts thereof for financial gain shall not be allowed without my written permission. It is also understood that due recognition shall be given to me and to Universiti Utara Malaysia for any scholarly use which may be made of any material from my research project.

Requests for permission to copy or make other use of materials in this research project, in whole or in part, should be addressed to:

Dean of Graduate School

Universiti Utara Malaysia

06010 UUM Sintok

Kedah Darul Aman

## **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.

## **ACKNOWLEDGEMENTS**

Praise be upon Allah the Almighty for giving me the strength to complete this research project. I would like to take this opportunity to express my special thanks to my supervisor, Dr Ayoib Che Ahmad for his contribution of guidance, knowledge and valuable advice throughout the preparation of this research project. I also would like to thank Dr Wan Nordin Wan Hussin for helping me during the data collection stage. Thank you very much for your help. A special thank you is also extended to my dearest friend, Amizahanum Adam for the help she gave me from day one. Thanks also to the KLSE Library staff. Your assistance is highly appreciated.

I also would like to thank the people in my life because without them this research project would be impossible. Firstly, thank you to my beloved parents, Hajah Asmah Hedzir and Haji Jaafar Md Yusof for their endless love, support and motivation which have brought me this far. My brother Muhamad Ramlan and my two sisters, Haryati and Hidayani, you guys are the most wonderful siblings one could ever have. Thanks for always being there for me. Finally, thank you to all my friends who are involved in the completion of this research project, whether directly or indirectly; Hafizah, Mariana, Elnie, Noraizan, Azlia, Nor Mazizah , Nor Shaliza, Rohami and Mohd Jaafar.

Thank you all and God bless.

Hartini Jaafar

## TABLE OF CONTENTS

	Page
PERMISSION TO USE	i
ABSTRACT	ii
ACKNOWLEDGEMENTS	iii
LIST OF TABLES	viii
1.0 INTRODUCTION	1-2
2.0 OBJECTIVES OF THE STUDY	2-3
3.0 MOTIVATIONS OF THE STUDY	3-4
4.0 IPO PROCESS IN MALAYSIA	
4.1 Listing Requirements	4-5
4.2 The Procedure for IPO and Listing	5-7
5.0 LITERATURE REVIEW ON AUDIT QUALITY	
5.1 Previous Studies on Signaling Mechanisms in IPO Market	7-10
5.2 Audit Quality Research in Malaysia	10-12
6.0 THEORY AND HYPOTHESES DEVELOPMENT	12-19

## 7.0 RESEARCH DESIGN

### 7.1 Model Specifications

7.1.1 The Auditor Choice Model	19-20
7.1.1.1 <i>Dependent Variable</i>	21
7.1.1.2 <i>Hypothesis Variables</i>	21-22
7.1.1.3 <i>Control Variables</i>	22-26

7.1.2 The Valuation Model	26-29
---------------------------	-------

7.2 Sample and Data	29-30
---------------------	-------

## 8.0 EMPIRICAL RESULTS

8.1 Descriptive Analysis	31-33
--------------------------	-------

### 8.2 Regression Analysis

8.2.1 The Auditor Choice Model	34-36
8.2.2 The Valuation Model	36-39

### 8.3 Further Analysis

8.3.1 Alternative Measurements	40-41
8.3.2 Omitted Variables	42-43
8.3.3 The Presence of Outliers	43-44
8.3.4 The Size Effect	44-45

9.0 CONCLUSIONS AND LIMITATIONS	45-48
---------------------------------	-------

References	49-52
------------	-------

## Appendices

### Appendix 1: Summary of the Kuala Lumpur Stock

Exchange (KLSE) Listing Requirements	53-55
--------------------------------------	-------

<b>Appendix 2: Descriptions and Expected Sign of Variables in Auditor Choice Model</b>	<b>56</b>
<b>Appendix 3: List of Audit Firms Acting as Prospectus Auditor for a Sample of 104 IPO Firms from 1998-2001</b>	<b>57</b>
<b>Appendix 4: List of Underwriters for a Sample of 104 IPO Firms from 1998-2001</b>	<b>58</b>
<b>Appendix 5: Descriptions and Expected Sign of Variables in Valuation Model</b>	<b>59</b>
<b>Appendix 6: List of 104 IPO Firms Included in the Sample (1998-2001)</b>	<b>60-62</b>
<b>Appendix 7: Logistic Regression Analysis of Auditor Choice (Using Alternatives Measures of LEV, SRISK and RETAIN)</b>	<b>63</b>
<b>Appendix 8: Regression Results of the Valuation Model (Using V1 as Dependent Variable)</b>	<b>64</b>
<b>Appendix 9: Logistic Regression Analysis of Auditor Choice (Includes Control Variables FOREIGN and LOCAL)</b>	<b>65</b>

**Appendix 10: Logistic Regression Analysis of Auditor Choice**

**(The Presence of Outliers)**

**66**

**Appendix 11: Regression Results of the Valuation Model**

**(Match on Total Assets: n = 62)**

**67**

## **LIST OF TABLES**

**Table 1: Descriptive Statistics for a Sample of 104 IPO Firms Partitioned by  
Audit Quality**

**Table 2: Correlation Matrix for Independent Variables**

**Table 3: Logistic Regression Analysis of Auditor Choice**

**Table 4: Regression Results of the Valuation Model**

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

## **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

The contents of  
the thesis is for  
internal user  
only

## References

Allen, F., and Faulhaber, G.R. (1989). Signaling by Underpricing in the IPO Market. *Journal of Financial Economics*, Vol. 23, pp. 303-323

Ayoib, C.A. and Houghton, K.A. (2001). The Effect of Ethnicity on Audit Pricing. Paper Presented At The Second Asian Academic Accounting Association Conference, Penang, Malaysia.

Balvers, R.J., McDonald, B., and Miller, R.E. (1988). Underpricing of New Issues and the Choice of Auditor as a Signal of Investment Banker Reputation. *The Accounting Review*, Vol. 63(4), pp. 605-622

Beasley, M.S. (1996). An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud. *The Accounting Review*, Vol. 71(4), pp. 443-465

Beatty, R.P. (1989). Auditor Reputation and the Pricing of Initial Public Offerings. *The Accounting Review*, Vol. 64(4), pp. 693-709

Clarkson, P.M., and Simunic, D.A. (1994). The Association Between Audit Quality, Retained Ownership and Firm Specific-Risk in U.S. vs. Canadian IPO Markets. *Journal of Accounting and Economics*, Vol. 17, pp. 207-228

Datar, S.M., Feltham, G.A., and Hughes, J.S. (1991). The Role of Audits and Audit Quality in Valuing New Issues. *Journal of Accounting and Economics*, Vol. 14, pp. 3-49

DeAngelo, L.E. (1981). Auditor Size and Audit Quality. *Journal of Accounting and Economics*, Vol. 3, pp. 183-199

Eichenseher, J.W. (1995). Additional Factors in Audit Pricing – New Evidence From Malaysia. *Accounting Business Review*, Vol. 2(1), pp. 1-26

Feltham, G.A., Hughes, J.S., and Simunic, D.A. (1991). Empirical Assessment of the Impact of Auditor Quality on the Valuation of New Issues. *Journal of Accounting and Economics*, Vol. 14, pp. 375-399

Firth, M.A., Kwok, B.C.H., Liau-Tan, C.K., and Yeo, G.H.H. (1995). Accuracy of Profit Forecasts Contained in IPO Prospectuses. *Accounting and Business Review*, Vol. 1, pp. 1-23

Firth, M., and Liau-Tan, C.K. (1998). Auditor Quality, Signaling, and the Valuation of Initial Public Offerings. *Journal of Business Finance and Accounting*, Vol. 25(1), pp. 145-165

Holland, K.M., and Horton, J.G. (1993). Initial Public Offerings on the Unlisted Securities Market: The Impact of Professional Advisers. *Accounting and Business Research*, Vol. 24(3), pp. 19-34

Hughes, P.J. (1986). Signaling By Direct Disclosure Under Asymmetric Information. *Journal of Accounting and Economics*, Vol. 8, pp. 119-142

Jang, H.J., and Lin, C. (1993). Audit Quality and Trading Volume Reaction: A Study of Initial Public Offering of Stocks. *Journal of Accounting and Public Policy*, Vol. 12, pp. 263-287

Jelic, R., Saadouni, B. and Briston, R. (1998). The Accuracy of Earnings Forecasts in IPO Prospectuses on the KLSE, 1984-1995. *Accounting and Business Research*, Vol. 29(1), pp. 57-72

Kennedy, P. (1998). *A Guide to Econometrics* (4<sup>th</sup> ed.). United Kingdom: Blackwell Publishers Inc.

Lee, C.I., Rosenstein, S., Rangan, N., and Davidson III, W.N. (1992). Board Composition and Shareholder Wealth: The Case of Management Buyouts. *Financial Management*, Vol. 21(1), pp. 58-72

Legal Research Board (1995). *Companies Act 1965 (Act 125) & Subsidiary Legislations (As at 5<sup>th</sup> March 1995)*. Kuala Lumpur: International Law Book Services

Leland, H.E., and Pyle, D.H. (1977). Information Asymmetries, Financial Structures, and Financial Intermediation. *Journal of Finance*, Vol. 32, pp. 371-187

Low, C.K. (1997). *Securities Regulation in Malaysia*. Kuala Lumpur: Malayan Law Journal Sdn. Bhd.

Menon, K., and Williams, D.D. (1991). Auditor Credibility and Initial Public Offerings. *The Accounting Review*, Vol. 66(2), pp. 313-332

Montagu-Pollock, M. (1999). The Humbling of Daim Zainuddin. *AsiaMoney*, Vol. 9 (9), pp. 15-20

O'Sullivan, N. (2000). The Impact of Board Composition and Ownership on Audit Quality: Evidence from Large UK Companies. *British Accounting Review*, Vol. 32, pp. 397-414

Ramanathan, R. (1995). *Introductory Econometrics With Applications* (3<sup>rd</sup> ed.). United States of America: The Dryden Press

Rose, A.M. (1999). Audit Pricing and the Role of Multinational Factors: A Study of the Hong Kong and Malaysian Markets. *Advances in International Accounting*, Vol. 12, pp. 129-155

Ross, S. (1977). The Determination of Financial Structure: The Incentive Signaling Approach. *Bell Journal of Economics*, Vol. 8, pp. 234-253

Simon, D.T., Teo, S., and Trompeter, G. (1992). A Comparative Study of the Market for Audit Services in Hong Kong, Malaysia and Singapore. *The International Journal of Accounting*, Vol. 27, pp. 234-240

Simunic, D.A., and Stein, M. (1987). *Product Differentiation in Auditing: A Study of Auditor Choice in the Market for Unseasoned New Issues* (Vancouver, B.C: Canadian Certified General Accountants' Research Foundation)

Titman, S., and Trueman, B. (1986). Information Quality and the Valuation of New Issues. *Journal of Accounting and Economics*, Vol. 8, pp. 159-172