

# **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  
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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.

## **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

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# **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 this 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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