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**THE RELATIONSHIP BETWEEN MANAGEMENT, AUDIT
COMMITTEE AND EXTERNAL AUDITOR CHARACTERISTICS
AND MODIFIED AUDIT OPINIONS: EVIDENCE FROM
MALAYSIAN LISTED-FIRMS**



By
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Submitted to
Othman Yeop Abdullah Graduate School of Business
Universiti Utara Malaysia,
In Fulfillment of the Requirement for the Degree of Doctor of Philosophy



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(College of Business)
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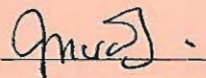
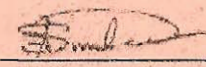

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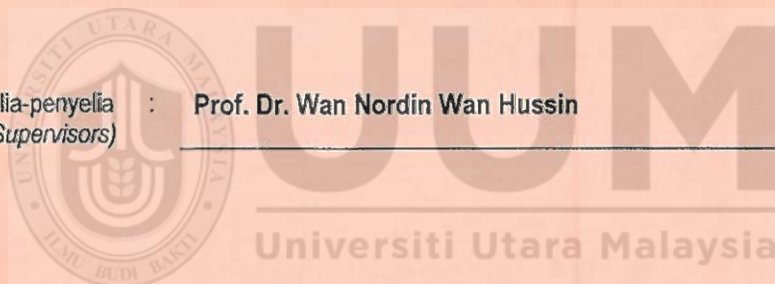
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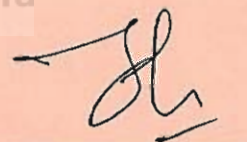
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ABSTRACT

The study is motivated by the distinctive ownership structure in the Malaysian firms which differs from other developed markets. The role of corporate governance in such institutional settings is more crucial. This study primarily examines the characteristics of management, audit committee and the external auditor to ascertain how these governance mechanisms can enhance the financial reporting quality. The data is obtained from the annual reports of the companies listed in Bursa Malaysia. The data related to 120 firm-year observations which received modified audit opinions during the period 2012 to 2016 were matched with the firms which received clean audit opinions based on pre-determined criteria. In total 240 firm-year observations were included in the empirical examination. The statistical methods including univariate and multivariate regression models were employed to examine the study hypotheses. The findings reveal that CEO age, founder status and ownership have a strong association with modified audit opinion. Management is an integral part of the financial reporting process and the findings signify that powerful management considerably influences the reporting outcomes. The results related to the audit committee and its chair illustrate that number of meetings and the busyness of its chair are positively associated with the issuance of modified audit opinion. This finding is interesting in that a busy audit committee chair has a negative influence on the financial reporting quality of the firm. The external audit partner's busyness is also found to be positively associated with the modified audit opinion. This result shows that workload affects the audit efforts of external auditors. Further, interaction analysis reveals that there is a negative impact of the interaction between audit committee independence and CEO duality on the issuance of modified audit opinion. Overall, the results are significant in emerging markets context.

Keywords: Financial Reporting Quality, Modified Audit Opinion, Management, Audit Committee, External Auditor

ABSTRAK

Kajian ini didorong oleh struktur pemilikan tersendiri dalam firma-firma di Malaysia yang berbeza dengan pasaran maju yang lain. Peranan tadbir urus korporat dalam institusi tersebut adalah lebih penting. Kajian ini menyelidik ciri-ciri pengurusan, jawatankuasa audit dan juruaudit luar terutamanya, untuk memastikan cara mekanisme tadbir urus ini dapat meningkatkan kualiti pelaporan kewangan. Data diperoleh daripada laporan tahunan syarikat-syarikat yang tersenarai dalam Bursa Malaysia. Data berkaitan dengan 120 pemerhatian-tahun firma yang menerima pendapat audit yang diubah dalam tempoh 2012 hingga 2016 telah dipadankan dengan syarikat-syarikat yang menerima pendapat audit bersih berdasarkan kriteria yang telah ditentukan. Secara keseluruhannya, sebanyak 240 pemerhatian-tahun firma dimasukkan dalam pemeriksaan empirik. Kaedah statistik termasuklah model regresi univariat dan multivariat telah digunakan untuk meneliti hipotesis kajian. Hasil kajian menunjukkan bahawa usia CEO, status pengasas dan pemilikan saham mempunyai kaitan yang erat dengan pendapat audit yang diubah. Pengurusan merupakan bahagian yang penting dalam proses pelaporan kewangan dan penemuan menunjukkan bahawa pengurusan yang dominan banyak mempengaruhi hasil pelaporan. Hasil yang berkaitan dengan jawatankuasa audit dan pengerusinya menggambarkan bahawa jumlah mesyuarat dan kesibukan pengerusinya mempunyai kaitan yang positif dengan penerbitan pendapat audit yang diubah. Penemuan ini menarik kerana menggambarkan bahawa ketua jawatankuasa audit yang sibuk mempunyai pengaruh negatif terhadap kualiti pelaporan kewangan syarikat. Kesibukan rakan audit luaran juga didapati mempunyai kaitan yang positif dengan pendapat audit yang diubah. Dapatan ini menunjukkan bahawa beban kerja mempengaruhi usaha audit juruaudit luaran. Selanjutnya, analisis interaksi menunjukkan bahawa terdapat kesan negatif terhadap interaksi di antara kebebasan jawatankuasa audit dan kedualan CEO terhadap penerbitan pendapat audit yang diubah. Secara keseluruhannya, penemuan ini penting dalam konteks pasaran baru muncul.

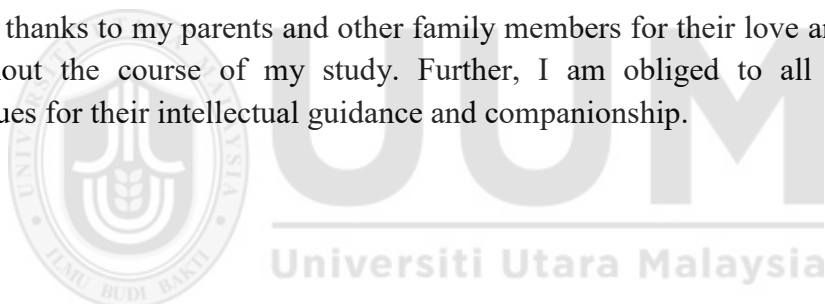
Kata kunci: Kualiti Pelaporan Kewangan, Pendapat Audit yang Diubah, Pengurusan, Jawatankuasa Audit, Juruaudit Luar

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ABBREVIATIONS

| | |
|-------|---|
| AISG | Accountants International Study Group |
| AOB | Audit Oversight Board |
| AQI | Audit Quality Indicators |
| BFI | Banking and Financial Institutions |
| BMLR | Bursa Malaysia Listing Requirements |
| BNM | Bank Negara Malaysia |
| BRC | Blue Ribbon Commission |
| CPAB | Canadian Public Accountability Board |
| FASB | Financial Accounting Standards Board |
| IAASB | International Auditing and Assurance Standards Board |
| IAG | International Auditing Guidelines |
| IAPC | International Auditing Practices Committee |
| IASC | International Accounting Standards Committee |
| ICAEW | Institute of Chartered Accountants in England and Wales |
| IFAC | International Federation of Accountants Council |
| IOSCO | International Organization of Securities Commissions |
| ISA | International Standards on Auditing |
| MCCG | Malaysian Code on Corporate Governance |
| MFRS | Malaysian Financial Reporting Standards |
| MIA | Malaysian Institute of Accountants |
| PCAOB | Public Company Accounting Oversight Board |
| POB | Public Oversight Board |
| SC | Securities Commission |
| SOX | Sarbanes Oxley |
| TWC | Treadway Commission |

CHAPTER ONE: INTRODUCTION

1.1 Overview

In the first section, the study background and motivation is discussed. The next section explains how modified audit opinion and low quality of financial reporting affect the sound growth of Malaysian capital market. The research questions and objectives are also outlined in this chapter. The chapter concludes with the significance and scope of study.

1.2 Background of the Study

An organized and inclusive record of transactions related to the finances of a business is known as accounting. It is crucial for any organization to continue to make profits in order to survive by keeping business finances on track. The performance and financial situation of a firm can be judged through its financial statements. Such statements can have significant implications for the financial market, and hence, must be reliable and accurate (Ozcan, 2016). Financial reporting is central for the policymakers, standard setters and regulators because the disclosed information is directly linked to economic consequences (Ball, 2008). It gives stakeholders an accurate depiction of a company's finances, including their revenues, expenses, profits, capital, and cash flows. Users of financial information may make incorrect decisions related to investment or financing if the financial reports are not of high quality, which subsequently can lead to waste of resources.

Producing statements related to business finances is recognized as the financial reporting process. In Malaysia all public companies are required to prepare financial statements according to the Malaysian financial reporting standards (MFRS) framework, which is identical to international financial reporting standards. Auditing is an essential part of the financial reporting process as independent auditors provides assurance of the integrity of financial information. Statutory audit is a legal requirement for all public limited companies under the Companies Act of 1965 in Malaysia. Investors' decisions are invariably influenced by the information provided in independent audit reports (Dickins & O'Reilly, 2009). External auditors verify the level of consistency and quality of financial reporting (Cohen, Krishnamorthy, & Wright, 2004). Government agencies, investors, creditors, suppliers and stakeholders use audit reports to know the financial condition and viability of a firm's financial position (Anderson, Mansi, & Reeb, 2004).

The final outcome of the audit process is the audit opinion. If the audit opinion issued is modified, it raises concerns amid the quality of financial statements and suggests that there are some irregularities in the financial statements. According to the International Standards on Auditing (ISA 705), a modified audit opinion is issued when "the auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or if the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial reports as a whole are free from material misstatement". Modified audit opinions can be of three types: the qualified, disclaimer or adverse audit opinion (MIA, 2015). Several studies have argued that financial reporting quality is directly linked to modified audit opinion occurrence (Sanchez-Ballesta & Garcia-Meca, 2005; Sundgren, 2009; Farinha & Viana, 2009;

Mendez, Garcia, & Pathan, 2016; Pucheta-Martinez, Bel-Oms, & Olcina-Sempere, 2016; Chen et al., 2016).

According to Chen et al. (2016), independent auditor issues modified audit opinion if he or she is unable to attain satisfactory evidence to conclude that the financial reports are in compliance with the Generally Accepted Accounting Principles (GAAP); or if the financial reports are not free from material misstatements. Farinha and Viana (2009) argue that low financial reporting quality can be seen through modified audit reports. Modified audit opinion can be deemed to be direct evidence of low quality financial statements (Chen, Shimin-Chen, & Su, 2001). When auditors are not satisfied with the accuracy of financial statements and issue a modified audit opinion (disclaimer, qualified or adverse), it indicates that the financial reporting is not of high quality (Haji-Abdullah & Wan-Hussin, 2009). Additionally, Casterella and Johnston (2013) conclude that when financial statements are materially misstated and not adequately prepared by the firm, the auditors issued a modified audit opinion. The auditor observes the financial reporting process and modifies the audit opinion if the financial statements cannot be relied on (Chen, Cumming, Hou, & Lee, 2013). This study is of the view that modified audit opinion in corporate audit reports is directly linked to a lack of financial reporting quality (Sanchez-Ballesta & Garcia-Meca, 2005; Farinha & Viana, 2009; Mendez et al., 2016; Pucheta-Martinez et al., 2016; Chen et al., 2016).

Prior studies have examined various possible determinants of modified audit reports including corporate governance mechanisms, auditor characteristics, market and firm characteristics (Chen et al., 2001; Sanchez-Ballesta & García-Meca, 2005; Caramanis &

Spathis, 2006; Wenyao-Li & Li, 2007; Firth, Fung, & Rui, 2007; Johl, Jubb, & Houghton, 2007; Farinha & Viana, 2009; Firth, Rui, & Wu, 2011; Chen et al., 2013; Sundgren & Svanstrom, 2014; Ji & Lee, 2015; Ishak & Yusof, 2015; Goodwin & Wu, 2016; Lynda, 2016; Lai, Sasmita, Gul, Foo, & Hutchinson, 2018; Chen et al., 2016; Mendez et al., 2016; Pucheta-Martinez et al., 2016). The varied results of these studies pave the way for future research in this respect. Further, it must be noted that most of the research on the factors leading to modified audit opinion, have focused on developed markets rather than emerging economies. Developing emerging economies do not have strong, long-established institutional infrastructure to deal with corporate governance issues as the developed countries like UK, US etc. (McGee, 2009). In Malaysia the ownership structure of firms is more concentrated which create additional agency problems.

Factors that lead to modified or unmodified audit opinion are vital for decision-making (Lam & Mensah, 2006). The agency theory suggests that corporate governance mechanisms in place can determine the type of audit opinion issued (Rusmin, Tower, Brown, & Van-Zahn, 2009). Corporate governance mechanisms must be effective to oversee the reliability of financial reporting process. Previous empirical studies supported the argument that ineffectiveness of corporate governance systems is linked to poor financial reporting quality proxied by modified audit opinion (Sanchez-Ballesta & Garcia-Meca, 2005; Firth et al., 2007; Farinha & Viana, 2009; Pucheta-Martinez et al., 2016).

As it is evident that better governance leads to better reporting practices however, there is a lack of consensus on the factors that constitute high quality financial reporting. Carcello et al. (2011) and Cohen et al. (2002, 2004) stated that there is a need to develop a more inclusive framework which includes all important stakeholders of the governance system. This study is more holistic by focusing on the characteristics of top management, audit committee, and external auditor with regards to the issuance of modified audit opinion. The focus on these three components of the corporate governance mosaic is because they are directly linked to the financial reporting process. The study contributes to and extends the scope of extant literature on corporate governance in the context of Malaysia, essentially by considering modified audit opinion as an indicator of poor financial reporting quality, which has been rarely studied in Malaysia although it is widely used as a proxy of financial reporting quality elsewhere (Sanchez-Ballesta & García-Meca, 2005; Farinha & Viana 2009; Mendez et al., 2016; Pucheta-Martinez et al., 2016; Chen et al., 2016). As mentioned earlier, in Malaysia the agency problem is exacerbated as family ownership, ethnicity, and political influence play important roles (Wan-Muhammad & Wasiuzzaman, 2019) in the governance process.

1.2.1 Management Characteristics

This study incorporates the characteristics of top management as it plays an important role in the financial reporting process of the firm. Most previous studies focus on board and audit committees in examining various accounting and auditing outcomes. Carcello et al. (2011) and Cohen et al. (2004) conclude that governance process and accounting or auditing results are significantly influenced by the management. To make certain that

the financial reports are of high quality, management is mainly responsible for ensuring that the financial reporting system of the firm and the overall control environment work efficiently. How and what features of management can have an impact on the quality of the financial reports is an imperative issue to be examined.

Since the governance mechanisms are significantly influenced by management, it would be worthwhile to include management into the corporate governance (Carcello et al., 2011). The fact that financial reports should be certified by top management of the firm is a requirement under Section 302 of SOX Act (2002). The concern is that managers may use their power to control the financial reporting process for their own benefits rather than the stakeholders" which may lead to the modification of audit opinion. Evidence has shown that 89% of accounting fraud in public companies is due to the involvement of senior management (Beasley, Carcello, Hermanson, & Neal, 2010). Management has a tendency to select directors who will not restrict their actions and are ready to be flaccid participants in the governance process (Patton & Baker, 1987). Indeed, to increase the stakeholders" value, the prime aim of the governance process is to efficiently monitor financial reporting, but to achieve this aim, the role and support of management should not be underrated (Cohen et al., 2002).

Empirical studies related to the role of management have suggested that imprudence in the financial statements is due to the extensive management control over the financial reporting process of firms. Cormier, Lapointe-Antunes, and Magnan (2016) find that CEO power which is demonstrated by his or her decisions and interactions with others is associated with financial misreporting. Governance mechanisms, like the board of

directors, do not seem to be able to prevent financial misreporting if the management is more powerful. Zhao and Chen (2008) support this argument that the companies, in which the CEOs are also the chairpersons of the boards, are involved more in fraudulent financial reporting. Chen et al. (2013) find that companies charged for financial fraud show a greater amount of earnings manipulation by the executives.

Further, as postulated by the agency theory, O'Connor, Priem, Coombs, and Gilley (2006) establish that there is an inverse relationship between fraudulent financial reporting and CEO's stock options. Setiadi et al. (2016) argued that managers having high personal interests do not act in the best interest of the company, but for their self interest. Huang, Rose-Green, and Lee (2012) find that firms meeting or beating analyst earnings forecasts are negatively linked to CEO's age. Beams, Yan, Boonyanet, and Chatraphorn (2016) studied the relationship between the issuance of going concern audit opinion and top management resignations, and find that firms which receive going concern audit opinions in the given year are linked to the resignation of the CEO or CFO in the following year. Ji and Lee (2015) posit that auditors observe managerial overconfidence during the audit process and find that overconfidence of management is linked to going-concern audit opinion. They concluded that auditors do not favorably value overconfident managers in financially distressed companies.

In emerging markets like Malaysia the agency problems are even more crucial. Concentrated shareholdings by individuals, families, and significant political connections are features that distinguish Malaysia from other developed markets. Hasnan et al. (2013) argued that Malaysian institutional features, along with poor

investor protection and weak law enforcement create conditions that are ripe for fraudulent financial reporting. The ownership concentration is viewed as an institutional arrangement that facilitates transactions in a weak property rights environment (Fan & Wong, 2005). Type II agency problems happen as a result of conflicts among controlling and non-controlling shareholders. As control increases, the largest shareholder becomes more entrenched, and their ability to expropriate minority shareholders increases.

Further, politically connected companies are perceived by the market and external auditors to be riskier than non-politically connected companies as these companies generally exhibit poor corporate governance practices (Norziaton et al., 2017). Bliss et al. (2011) provides evidence that politically connected Malaysian firms that have CEO duality are perceived by audit firms as being of higher risk than CEO duality firms without political connection. Tee (2019) argued that CEO power is largely influenced by key institutional settings in an emerging market. It is also evident that company founders on the board support a culture of engaging in falsified financial reporting in Malaysia (Hasnan et al., 2013). This study explores characteristics of management which are associated with modified audit opinions in Malaysian setting as the quality of financial reporting cannot be culturally free (Hashim, 2012).

1.2.2 Audit Committee Characteristics

Audit committee plays a vital role in the corporate governance system through oversight of financial reporting. It includes the internal control over financial reporting, and the external independent audit process. Financial reporting scandals in recent history increased the importance of audit committees in the public firms. The effectiveness of

audit committee is determined by various factors (Cohen et al., 2004). Corporate governance theories such as agency and stewardship confirm that the role of audit committee characteristics (size, expertise, meetings frequency and independence) is essential for efficient financial reporting process. Bedard and Gendron (2010) argued that the quality of financial reporting is significantly affected by audit committee size, independence, frequency of meetings and skills level of its members. Lin and Hwang (2010) conclude that audit committees with better accounting and auditing expertise are more effective in controlling management, to assure the reliability and consistency of financial information in the reporting process. The members with financial or accounting expertise can offer more precise knowledge and thorough insights into the financial reporting of the company.

The strength and collegiality of the audit committee's working relationship with the board of directors, management, internal and external auditors is vital for the efficacy of audit committee. It is observed that external auditors get more support from the audit committee members if they are independent and hold long term stock options (Bierstaker, Cohen, DeZoort, & Hermanson, 2012). Financial misreporting and restatements are negatively related to audit committee independence, meeting frequency and financial expertise of members (Abbott, Parker, & Peters, 2004). Pucheta-Martínez and Fuentes (2007) also evidence that audit committee can contribute more positively to the financial reporting process if it is more independent. Experiential research has also revealed that the audit committee significantly influences the probability of a company to receive a modified audit opinion (Pucheta-Martinez et al., 2016; Sanchez-Ballesta & García-Meca, 2005; Haji-Abdullah & Wan-Hussin, 2009).

Further, Chang, Chen, and Zhou (2013) find that companies with lower audit fees and earnings management have more effective audit committees and this effectiveness also reduces the likelihood of late filing and modified audit opinion. The management may exert more pressure on the auditors to issue unmodified opinion if the audit committee is less independent and also there is more possibility of switching auditors if received going concern opinion (Carcello & Neal, 2003). From the financial reporting perspective, this argument implies that auditors can assertively restrict the poor conduct of management if they have the support of an independent audit committee. Dhaliwal, Naiker, and Navissi (2010) find that accruals quality is positively linked to lower turnover of directors in the firm; if the audit committee members hold fewer directorships; if they are independent and have accounting expertise. Cohen et al. (2013) illustrate that members of the audit committee with just expertise in accounting do not perform as well as members with both industry and accounting expertise. Engel, Hayes, and Wang (2010) conclude that audit committee's independent directors can spend more time and effort to communicate, learn and understand the firm's financial reporting processes if they are financially literate.

The history of audit committees in Malaysia began when the central bank (BNM) advised the financial institutions in the country in 1985 to set up audit committees. The government encouraged the setting up of these committees in listed firms to strengthen the financial reporting and provide an early warning system. Given the importance of an audit committee to the governance structure of a company, the establishment of this committee is mandated for listed issuers by Paragraph 15.09 of Bursa's Listing Requirements. It is also required that all the audit committee members must be non-

executive directors, with a majority of them being independent directors (MCCG, 2017). However, it is evidence that the corporate community in Malaysia favors business and political connections to enable access to business opportunities (Abdul-Wahab et al., 2017). KPMG (2013) reported that in Malaysia, the appointment of independent directors in audit committees is actually based on their influence and network rather than their technical expertise. It is also reported that, in year 2009, most independent directors in the top 300 companies listed on Bursa Malaysia were either retired civil servants or former politicians. The appointment of these directors who lack the skills and expertise raises serious doubts about their ability to fulfill their task as effective audit committee members.

The broadening responsibilities, rising complexities of accounting and risk issues as well as the heightening demand of stakeholders call for audit committees to be more focused than ever in enhancing their efficiency and effectiveness. The MCCG (2017) also acknowledges that to ensure high quality financial reporting, the role of the audit committee chair is very crucial. The audit committee chair must show leadership in setting the overall committee's role, its agenda and work style. The audit committee chair must make sure that the right resources are being engaged to enhance the quality of financial reporting. The chair must make clear the expectations from the audit committee members, management and auditors. The qualification of the audit committee chair affects the risk control, financial reporting and outcomes of the firm (Turley & Zaman, 2007). Further it is considered that duality and busyness may also affect audit committee chairperson's ability to monitor the overall functions of the committee. Jaafar et al. (2016) concluded that boards should reconsider audit committee chairpersons expertise

and busyness so they could fulfill their duties more attentively and with full commitment. The above arguments show that the audit committee is a major component of the governance mosaic by performing a monitoring role over the financial reporting process.

1.2.3 External Auditor Characteristics

External auditors are considered as a vital part of corporate governance to minimize the agency problems (Beasley & Salterio, 2001). The issuance of the audit opinion is a difficult and challenging procedure which involves understanding of client's business as well as obtaining substantive confirmation of accounting estimates (ERM Institute, 2012). According to Bursa Listing's Requirements, the audit and risk management committee of the board of directors is responsible for reviewing, assessing and monitoring the performance, suitability and independence of external auditors. The professed accuracy and comprehensiveness of company's financial reports is compromised if the external auditor lacks independence (Wallace, 2004). By considering Malaysian firms unique ownership structure the role of external auditor in safeguarding accounting information becomes more significant. Fan and Wong (2005) argued that institutional conditions in East Asian economies are complicated, making the governance role of auditors an empirical issue.

The external auditors are precluded from providing any services that may impair their independence or conflict with their role as external auditors. Bell and Griffin (2012) argued that external auditor independence usually measured through non-audit fees or services which is a concern for regulators and standard setters. Considering the

issue of non-audit services in Malaysian family owned companies, Abu-Bakar (2018) showed that there is no association between non-audit services and the issuance of qualified report. This is an indication that in family owned companies, auditor independence is not at risk. Haji-Abdullah et al. (2017) Study hypothesize that non-audit services, audit opinion, the composition of bumiputra directors on board and affiliated directors are associated with fraudulent financial reporting. Results show that joint provision of audit and non-audit services significantly associated with fraud. Hay (2013) concluded that audit reports precision is associated with the non-audit services. The findings associated with non-audit services and the likelihood of receiving modified audit opinion is mixed, and needs further examination (Carson, Fargher, & Zhang, 2016).

Another crucial issue related to the external auditor is the partner workload or busyness. The Audit Oversight Board of Malaysia showed concern regarding audit partner busyness and acknowledged that, “it is imperative for audit partners to have sufficient time to properly lead and supervise audits” (AOB, 2017). It is argued that workload pressure leads to dysfunctional behavior and lower audit quality amongst individual auditors (Lopez & Peters, 2012). Wan-Hussin et al. (2018) concluded that busy auditors are observed to prolong audit report lags. Sundgren and Svanstrom (2014) reveal an inverse relationship between the possibility of a going concern opinion and the number of audit assignments of the audit partner in a year. Ismail et al. (2019) show that auditor’s workload has a negative and insignificant impact on audit quality. However, Goodwin and Wu (2016) conclude that there is no causal association between audit

partner business and audit quality. The results are varied in relation to audit partner's business, which calls for further research.

Overall, the structural and institutional environment in Malaysia has substantial implications for corporate governance and financial reporting quality. This includes companies with concentrated family ownership, groups of companies with pyramid ownership structures, the use of nominees to conceal identities of influential shareholders, the presence of politically connected firms, and cross directorships on the boards of Malaysian publicly listed companies. These institutional features, along with poor investor protection and weak law enforcement in Malaysia, create conditions that cause low quality financial reporting. This study will contribute into the literature related to the financial reporting quality by considering Malaysian corporate governance environment and policies.

1.3 Problem Statement

A number of notable accounting scandals occurred in the United States (US) and in other countries like Enron, Worldcom, Tyco, FreddieMac, AIG, Lehman Brothers and Satyam etc., have raised many questions regarding the financial reporting and governance systems. According to the latest 2020 Global Economic Crime and Fraud Survey of PricewaterhouseCoopers (PWC), almost 47% of companies all over the world have experienced economic or financial fraud in the past 24 months. Two of the most frequent types of reported frauds were asset misappropriation (31%) and accounting/financial statement frauds (28%) as unveiled by the survey. Rezaee (2005) argued that the confidence of market participants in published audited financial

statements is significantly threatened by the financial frauds. The external auditor is considered as an important gatekeeper who inspects the validity of financial statements by issuing an independent audit opinion (Chen et al., 2016).

In Malaysia, an important source of financing is the capital market. The private sector is considered as the engine of growth with vast capital flows, and hence, the capital market plays a significant role in the Malaysian economy. According to the Securities Commission (SC) the capital market of Malaysia expanded to RM3.2 trillion in 2019 from RM3.1 trillion a year earlier. However, regulators are still concerned with the reporting quality of listed firms. The PwC global economic survey (2016) discloses that 30% of the Malaysian companies who reported being the victims of fraud, had losses of more than US\$1 million. The report also reveals that 17% of the fraud in the Malaysian market is due to accounting irregularities. Therefore, higher quality financial information is imperative for the sustainability of the capital market.

Modified audit opinion is interpreted as bad news about the company in the market as such opinion could lead to negative cumulative abnormal returns (Chen, Su, & Zhao, 2000). A number of studies have argued that the incidence of modified audit opinion is directly linked to financial reporting quality (Sanchez-Ballesta & Garcia-Mecca, 2005; Farinha & Viana, 2009; Mendez et al., 2016; Pucheta-Martinez et al., 2016; Chen et al., 2016). Modified audit opinion is considered an external indicator of earnings management (Chen et al., 2016), and is a better proxy for financial reporting quality as it covers both the reporting and auditing processes. When fraudulent activities or irregularities have occurred due to a lack of integrity, external auditor is expected to

issue a modified audit opinion. The modified audit opinion is mainly of three types a qualified audit opinion, an adverse audit opinion and a disclaimer audit opinion (ISA, 705). Further, auditors can report matters which are fundamental to financial statement users, in emphasis of matter paragraph. The Table 1.1 below shows the types of audit opinion which Malaysian public listed firms received throughout the period of 2012 to 2016:

Table 1.1 *Types of audit opinion Malaysian companies received*

| Opinion | Audit Year | | | | | Total |
|---------------------------|------------|------|------|------|------|-------|
| | 2012 | 2013 | 2014 | 2015 | 2016 | |
| Clean/standard unmodified | 844 | 838 | 831 | 807 | 846 | 4166 |
| With emphasis of matter | 46 | 40 | 41 | 61 | 32 | 220 |
| Adverse | 0 | 0 | 0 | 0 | 0 | 0 |
| Disclaimer | 11 | 16 | 11 | 13 | 10 | 61 |
| Qualified | 9 | 10 | 16 | 11 | 13 | 59 |
| Total | 910 | 904 | 899 | 892 | 901 | 4506 |

The modified audit opinion is a red flag that the company's financial statements do not present a true and fair view of the finances, which may further lead to financial frauds (Oh, 2014). This can be observed by looking at the recent enforcement actions taken by the SC of Malaysia against High-5 Conglomerate (formerly Silver Bird), Megan Media Holdings, Transmile Group Bhd., Linear Corporation, Axis Incorporation, Satang Holding Bhd., etc., as these companies received modified audit opinions. This also indicates the lower quality of the financial reporting as these companies failed to provide enough appropriate audit evidence. Financial irregularities which lead to modified audit opinion are regarded as a malfunction of corporate financial reporting. Chen et al. (2013) find that regulatory enforcement actions aligned with corporate fraud are higher if there

is a larger extent of earnings manipulation, and this effect is moderated by a modified audit opinion.

Bursa Malaysia has imposed the requirement of immediate disclosure if any of the listed firms receive a modified audit opinion (Para 9.19, sub-section 37). It is also stated that “the announcement must set out the full details of such modified audit opinion or material uncertainty related to going concern”. The revised auditor reporting standards enhance the communicative value of auditor’s report. It is required that each modified audit opinion or material uncertainty associated to the going concern must be explained. The new section of key audit matters (KAM) has introduced for the matters of more significance according to the auditor’s judgment (IAASB, 2015). By looking at the sample of companies included in this research, a number of firms have been delisted from the stock exchange following the modified audit opinion. This also demonstrates the implications of such an audit report. The Table below lists the delisted firms¹:

Table 1.2 List of firms delisted from Bursa Malaysia after receiving modified audit opinion

| Sr no. | Company Name | Year of MAO | Type of MAO | Delisting Date |
|--------|------------------------------|-------------|-------------|----------------|
| 1 | Fotronics Corporation Berhad | 2012 | Disclaimer | 28/11/2012 |
| 2 | Global Carriers Berhad | 2012 | Disclaimer | 19/12/2014 |
| 3 | Bina Goodyear Berhad | 2013 | Disclaimer | 20/11/2014 |
| 4 | Hexagon Holdings Berhad | 2013 | Disclaimer | 04/07/2014 |
| 5 | INS Bioscience Berhad | 2013 | Disclaimer | 20/01/2014 |
| 6 | Maxtral Industry Berhad | 2013 | Disclaimer | 08/09/2014 |

¹ The sample firms which were delisted after the publication of Raza et al. (2019) are R&A Telecom Bhd (*Delisted on: 29/01/2018*), China Stationary Ltd (*Delisted on: 05/08/2019*), Lion Diversified Bhd (*Delisted on: 20/04/2018*), Nakamichi Corp (*Delisted on: 22/03/2018*), Petrol One Resources Bhd (*Delisted on: 12/12/2018*), Stone Master Corp (*Delisted on: 16/05/2019*), YFG Bhd (*Delisted on: 16/05/2019*), and Maxwell International Corp (*Delisted on: 02/10/2019*).

| | | | | |
|----|--------------------------|------|------------|------------|
| 7 | Patimas Computers Berhad | 2013 | Disclaimer | 21/03/2014 |
| 8 | Hytex Integrated Berhad | 2014 | Disclaimer | 22/01/2015 |
| 9 | IRM Group Berhad | 2014 | Disclaimer | 21/08/2015 |
| 10 | Metal Reclamation Berhad | 2014 | Disclaimer | 23/11/2015 |
| 11 | Lion Corporation Berhad | 2015 | Disclaimer | 12/10/2016 |
| 12 | Scan Associates Berhad | 2015 | Disclaimer | 28/04/2017 |
| 13 | Java Berhad | 2016 | Disclaimer | 17/10/2017 |
| 14 | Perwaja Holdings Berhad | 2016 | Disclaimer | 30/05/2017 |
| 15 | Stemlife Berhad | 2016 | Qualified | 20/02/2017 |

According to Sanchez-Ballesta and Garcia-Meca (2005), modified audit opinion points to the flaws in the monitoring function of corporate governance, which then leads to low financial reporting quality. Johari, Saleh, Jaffar, and Hassan (2008) observe that financial reporting scandals increase the concerns with the ineffectiveness of corporate governance mechanisms, which lead to lower quality financial reporting in the Malaysian setting. In support of this trend, Juhl, Subramaniam, and Cooper (2013) argue that corporate governance factors, like board of directors and internal audit function quality, are inversely related to abnormal accruals (used as proxy for financial reporting quality). Due to the importance of corporate governance, several rules have been implemented by regulators, such as the MCCG 2007, 2012 and 2017.

Prior research on corporate governance related to accounting and auditing outcomes has focused more on the audit committee and the board of directors characteristics (Carcello et al., 2011). The Public Oversight Board (POB, 1993) refers corporate governance as “those oversight activities undertaken by the board of directors and audit committee to ensure the integrity of the financial reporting process”. However, restraining corporate governance to only monitoring activities may underestimate the role which it can play to

enhance the integrity of financial reporting (Cohen et al., 2004). The responsibility of a firm's financial reporting is shared mainly among three players of the corporate governance mosaic; (1) management (2) the board, specifically the audit committee and (3) the external auditor. The management of the firm is responsible for preparing financial statements and develops internal financial controls. The audit committee is responsible for monitoring top management and the financial reporting process to ensure the appropriateness of financial reports used by the stakeholders. The external auditors are responsible for making an independent evaluation of the financial reports, and give a professional opinion on whether or not those reports give a true and fair presentation of the firm's financial position.

By having considerable influence on the other players of reporting process, management is an essential player of corporate governance. Cohen et al. (2002) stated that the governance process will be ineffective unless management allows itself to be monitored. The Global Economic Crime and Fraud Survey of PWC (2020) revealed that senior management is involved in 26% of financial crimes reported, because of their ability (delegated authority levels, system knowledge, or influence) to override or conspire to override internal controls. Under the agency theory, the role of the board and the audit committee is to oversee the management, but it is a complex task to determine the extent of monitoring. For example, even if there is a lack of significant board supervision, the management may perform well, or conversely, even if the board's monitoring role is rigorous, management may not perform adequately (Carcello et al., 2011). Members of the board may be hesitant to challenge the powerful management, if they have been appointed by the management just to accomplish the regulatory requirements. Recent

empirical studies by Hasnan et al. (2013), Cormier et al. (2016) and Tee (2019) confirms the concerns regarding top management power.

Further, as the functions of the audit committee keep on increasing, it becomes more essential for audit committee members, especially the chairperson, to remain updated and attentive to changes in his or her responsibilities. The most important function of the audit committee is to oversee the financial reporting practices and to challenge the complex accounting estimates and judgments prepared by the management. Previous researchers (Bliss et al. 2011; Wan-Muhammad & Wasiuzzaman, 2019; Norziaton et al., 2019) have explored different aspects of an effective audit committee and its impact on accounting outcomes but very few have investigated the modified audit opinion issued by the external auditor.

By playing an important role in observing the quality of financial reporting, external auditors are considered as a vital component of the corporate governance mosaic (Cohen et al., 2004). By collaborating with other stakeholders of the financial reporting process, including management and the audit committee, the auditors' role has become very complex in the governance mosaic. The MCCG (2017) affirmed that the reliability of financial reports is ensured by the independence and objectivity of the external auditors. Whether or not auditors carry out their role adequately and independently is a matter of interest for both regulators and researchers.

Likewise, to achieve quality financial reporting and effective governance, communication among management, audit committee, and external auditor is very

crucial (Sarbanes-Oxley Act, 2002). The scope and the quality of interactions between the external auditor and the audit committee are very much influenced by the management (Cohen, Krishnamoorthy, & Wright, 2002). A more inclusive framework which covers all major stakeholders in the financial reporting process has become more important to strengthen the financial reporting process of the firms.

The research framework of the current study includes the vital players of the financial reporting process. As discussed above, a modified audit opinion indicates lower financial reporting quality which is a potential hazard for the Malaysian capital market. This study examines the influence of management, audit committee and external auditor characteristics on the likelihood of Malaysian listed firms receiving a modified audit opinion. This contributes more knowledge to the governance process to enhance financial reporting quality in Malaysia.

1.4 Research Questions

In view of the foregoing discussion, this study develops the following research questions:

- 1. Is there an association between management, audit committee and external auditor characteristics and modified audit opinions among Malaysian listed-firms?*
- 2. Is there an interaction affect of management and audit committee characteristics on modified audit opinions among Malaysian listed-firms?*

1.5 Research Objectives

Consistent with the above research questions, this study develops the following research objectives:

1. To examine whether there is an association between management, audit committee and external auditor characteristics and modified audit opinions among Malaysian listed-firms.

2. To examine whether there is an interaction affect of management and audit committee characteristics on modified audit opinions among Malaysian listed-firms.

1.6 Significance of the Study

As discussed in the problem statement financial fraud and misreporting are continues threat to the capital market stability (PWC Fraud Survey, 2020), the need to ensure high quality financial reporting is intensified. MCCG (2017) stated that financial disclosures need to provide a just, impartial and reasonable assessment of the company's position and prospects; so companies are more careful in making the policies related to corporate reporting. Since modified audit opinion is considered as an indication of inferior financial reporting quality, this study extends prior studies (Mendez et al., 2016; Pucheta-Martinez et al., 2016; Chen et al., 2016; Farinha & Viana, 2009; Sanchez-Ballesta & García-Meca, 2005) in Malaysian context. It is considered that due to more concentrated ownership structure and political connections (Hasnan et al. 2013; Tee, 2019), Malaysian companies" present crucial challenges of corporate governance practices to ensure credible financial reporting.

Firstly, to establish the factors that contribute to the reliability of financial reporting, this study looks into the preceding literature systematically. Mainly, this study is motivated by Cohen et al. (2004), Carcello et al. (2011), Hasnan et al. (2013), Cormier et al. (2016), Chen et al. (2016), Norziaton et al. (2019) and Tee (2019), as the factors discussed above are still relatively under-researched. Further, the concerns articulated by Global Economic Crime and Fraud Survey of PWC (2016, 2020), and MCCG (2017) are examined empirically. Top Management involvement in 26% of financial and economic crimes as reported in the PWC 2020 survey, make it indispensable to explore the factors which lead to this suspicious behavior of management.

Senior management role in the financial reporting process is central as auditors rely on the audit committee members who may be influenced by management and appointed to simply fulfill regulations. By keeping in view the management power and upper echelon theories the result of this study establish that older and founder CEOs or managing directors are positively associated with modified audit opinion. This result also confirms the concerns related to Malaysia unique ownership structure. In contrast, it is found that CEO equity ownership is negatively associated with modified audit opinion, means aligning the interests of management with shareholders helps to ensure the financial reporting quality in Malaysia. These findings have significant implications for regulators and investors which discussed in the later part.

Secondly, audit committee is responsible to oversee the financial reporting and external audit process of the company. The concerns related to audit committee independence and expertise are highlighted in the MCCG (2017). It is recommended that appointments

to the audit committee should be made by the board and factors such as size, independence and desired skills and qualities of the members should be considered. Further, by acknowledging the importance of audit committee chair MCCG (2017) stated that “the chairman of the audit committee is not the chairman of the board”. So, the audit committee independence along with chairperson duality, busyness and expertise are explored in this study with regards to modified audit opinion.

The findings did not confirm the significant relationship between audit committee independence and chairperson duality with the modified audit opinion in Malaysian setting. However, there is a positive impact of audit committee independence and CEO duality interaction on the financial reporting quality. Further, it is found that audit committee chairperson busyness has negative impact on the financial reporting quality. This finding is an important contribution to the literature as to the best of the researcher’s knowledge, previously, not many studies have examined the audit committee chairperson’s attributes and the accounting outcomes, specifically the likelihood of receiving modified audit opinion.

Thirdly, by providing assurance of the reliability of financial statements the role of external auditors is central in the corporate governance mosaic. Auditors must strictly evaluate the activities of the audit committee and whether management exerts excessive pressure on the members (Cohen et al., 2004). The MCCG (2017) call out for the continuous engagement between the audit committee (particularly the chairman of the committee) and senior management (including executive members of the board) of the company, as well as the internal and external auditors. Hence, the external auditor

characteristics including independence and partner busyness are incorporated into the analysis. The findings confirmed that there is a positive relationship between audit partner busyness and the modified audit opinion, supporting the workload concerns.

Overall, this study provides a unique framework for investigating the association between major players of the corporate governance and financial reporting process and modified audit opinion. It is argued that modified audit opinion is an indication of low quality financial reporting which is a problem for the capital market growth. Most of the research related to this has been carried out in the developed markets, like the US and the UK. It is interesting to explore this issue in an emerging market, like Malaysia. The results of this study are useful for regulators in policy making as well as for investors in assessing the true financial position of firms. The study contributes to the literature considering agency, management power, and upper echelon theories from the Malaysian perspective.

1.7 Summary

The chapter presents the background of the research. It also contains an overview and motivation of the study, the problem statement, research questions and objectives. Significance of the study with regards to Malaysian context is also discussed.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter reviews the extant literature on modified audit opinion and its relationship with the main stakeholders of financial reporting quality included in Cohen et al. (2004) corporate governance mosaic. The available evidence on the relationship between modified audit opinion and the corporate governance mosaic is limited in spite of the merits of modified audit opinion as a direct measurement of financial reporting quality. The underpinning theories are adopted in line with prior studies, and a new theoretical framework related to the power, upper echelon and agency theories is proposed, to better understand the phenomena under investigation. To consider the effect of corporate governance systems on modified audit opinion, a detailed assessment of major players of corporate governance mosaic is conducted, such as, management, the audit committee and the external auditor, which have not been examined simultaneously in previous empirical studies. A summary of the literature review is presented at the end of the chapter.

2.2 History of Audit Reporting

Contemporary auditing came about when corporate directors were required to report the audited income statement and balance sheet to the shareholders, in conformance with the Joint Stock Companies Act (1844), approved by the British parliament. Initially, auditors were not necessarily independent or accounting professionals but the new Companies Act legalized the policy that auditors should be an independent body (Zaiceanu, n.d.). In the US, the first audit report was delivered to the United States Steel

Company in 1903 by an independent audit firm, PricewaterhouseCoopers (Habib, 2013). In 1969, a number of studies by the Accountants International Study Group (AISG) concentrated on comparing the auditing circumstances in the US, Canada and the UK, which then became the basis of auditing standards. After a few years in 1973, the International Accounting Standards Committee (IASC) was established for setting international accounting standards.

In 1978, the International Auditing Practices Committee (IAPC) was formed by the International Federation of Accountants Council (IFAC) and renamed as an IFAC Board in May 2000, to construct a general set of standards for audit reporting. Initially, IAPC disseminated International Auditing Guidelines (IAG), which re-codified in 1991. As a result of their assessment of the role, IAPC was reconstituted as the International Auditing and Assurance Standards Board (IAASB) in 2002. In view of the high public interest, IFAC endorsed a list of reforms in 2003 to enhance its processes of standard setting along with those of the IAASB.

To clarify the standards, the IAASB initiated the clarity project in 2004. This project was accomplished in 2009 with more simplified and reliable ISA (FSB, 2015). Like other countries, the Council of the Malaysian Institute of Accountants (MIA) endorsed the ISA in January 2009, to advance the auditing practices in Malaysia. As affirmed by the MIA, “This standard should be read in conjunction with the Preface to Malaysian Approved Standards on Auditing; Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services; Glossary of Terms and International Framework for Assurance Engagements”.

The IAASB finalized its project in January 2015, which resulted in a set of latest and revised standards on audit reporting with revised versions of ISA 570, *going concern*. The aim of this revision is to provide more transparent audit reports. These standards, among others, include reporting key audit matters (KAM) and the name of the audit partner engaged by the listed firms. The new standards also focus on disclosing improved information about a firm's capability to carry on as a going concern. These revised standards are useful for audits of financial reports in Malaysia from periods ending December 15, 2016.

2.3 Audit Opinion (ISA 700)

The audit function acts as a mechanism to monitor the role and behavior of the corporate management, and is recognized as a mode of social control to ensure the credibility of financial statements. Flint (1998) contends that audit practices exist because the financial statement users are not in a position to confirm the reliability of the information available to them. Auditors must report any incidences in the financial reporting system which entail mismanagement, misuse or scam, and validate the efficiency of the firm's internal controls. After auditing the financial records, the auditor gives a formal opinion which can be modified or unmodified.

The ISA 700 stipulates the format for the auditor, to form an opinion concerning the audited financial statements. This format consists of three parts: first, the introductory paragraph which explicates the scope of the audit; second, the paragraph for management liability; and third, the opinion paragraph. There are four common types of independent auditor reports: each one shows the different conditions that confront the

auditors during the audit process. An audit opinion is held to be unmodified or clean, when the auditor concludes that financial report gives a true and fair view of the company's position. It also confirms that the report is in accordance with the financial reporting framework used for the preparation and presentation of the statement. The auditors issue a clean opinion when they do not have any concerns with items recognized and disclosed in the financial statements. An unmodified audit report could also be with an additional paragraph on Emphasis of Matter (EMP). The EMP paragraph has been defined in ISAs as "a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements".

2.3.1 Modified Audit Opinion (ISA 705)

The auditor issues a modified audit opinion when a standard unmodified opinion is no longer suitable. The ISA 705 (revised 2015) explains that "The auditor shall modify the opinion in the auditor's report when: (a) the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement (Ref: Para. A2 - A7); or (b) the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement (Ref: Para. A8 - A12)". According to the ISA 705, there are three categories of modified audit opinion:

- Qualified Audit Opinion
- Adverse Audit Opinion
- Disclaimer Audit Opinion

Firstly, a qualified audit opinion is issued when the falsification of the financial statements independently or collectively, is material but not pervasive, whether or not the auditor has sufficient audit evidence. In this case, the auditor affirms that with the exception of a particular item, everything in the audit is reasonably presented. Secondly, the auditor issues an adverse opinion when the falsifications independently or collectively, are both material and pervasive, and enough suitable audit evidence is attained. This is the worst kind of modified audit opinion. Next, the disclaimer opinion is issued if the auditor is not able to obtain enough suitable evidence and there is likelihood that falsifications might be both material and pervasive. Further, disclaimer opinion is given when auditors are unable to construct an opinion because of the numerous uncertainties and their potential cumulative consequences on the financial reports. The matter which causes the modification helps auditors to decide the suitable type of modified opinion.

Table 2.1 *Reasons of issuing modified audit opinion*

| Nature of matter giving rise to the modification | Auditor's judgment about the pervasiveness of the effects or possible effects on the financial statements | |
|---|---|------------------------|
| | Material but Not Pervasive | Material and Pervasive |
| Financial statements are materially misstated | Qualified opinion | Adverse opinion |
| Inability to obtain sufficient appropriate audit evidence | Qualified opinion | Disclaimer of opinion |

Source: ISA 705 (revised 2015)

The authority of the auditor is very important to ensure the high quality financial statements in the audit process (Johl et al., 2007). To convey the quality of financial information to the relevant users, the audit report is the only report which auditors can employ (Porter, Simon, & Hatherly, 2003). If the auditor is unable to acquire sufficient

verification that financial reports are not free from material misstatements or are not in full conformity with the GAAPs, they would be unable to provide a clean audit opinion (Chen et al., 2016). Financial statements users consider the audit report as an essential indicator of the reliability of a firm's financial reporting or internal control procedures (Hope & Langli, 2010). The audit process provides assurance to the financial statements users concerning the quality of financial reporting, as depicted in the Figure below:

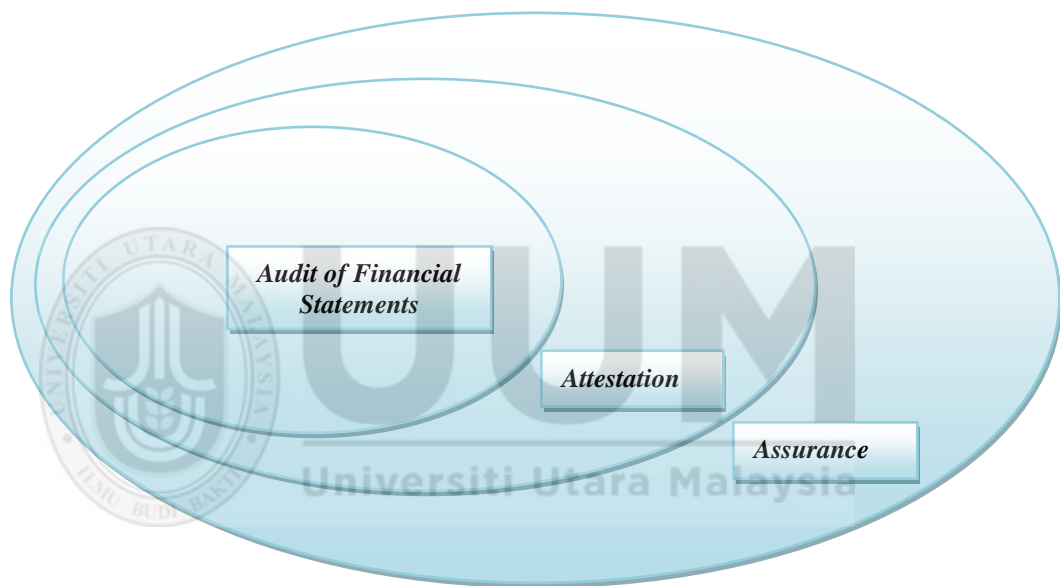


Figure 2.1 Scope of audit process

Source: Knechel and Salterio (2016)

According to Balsam, Krishnan, and Yang (2003), the financial reporting process involves presenting the financial particulars to the users and the quality of financial reporting depends on the extent of those particulars. It can be inspected through auditor litigation, enforcement actions, analyst rankings and earnings quality. This study argues that financial reporting quality could also be observed through type of the audit opinion, because the audit opinion is an evidential judgment of the financial reporting quality and

a crucial piece of information for financial statement users (Butler, Leone, & Willenborg, 2004). Chen et al. (2016) advance that financial reporting quality can be reflected by the properties of earnings, i.e., discretionary accruals, or by the external indicator of earnings, e.g., modified audit opinion.

Auditing standards require auditors to examine the financial reporting quality and not just its acceptability (SAS, 90). The auditor's liability includes providing assurance of financial reporting quality, and identifying GAAP violations. DeFond and Zhang (2014) contend that there is better assurance of financial reporting quality if higher quality auditing practices are engaged. Audit quality enhances the reliability of the financial reports, which subsequently enhancing the financial reporting quality. This is recognized that audit quality is an important part of the overall quality of financial reporting.

The performance of a firm depends on its financial information quality, so, to accomplish high quality information, the auditor's role is very crucial (Lynda, 2016). High quality auditors are more likely to notice misdeeds in the accounting books and issue modified audit opinion as a consequence (Farinha & Viana, 2009). Chen et al. (2015) explicate that modified audit opinion is an indication of low quality financial reporting by the lenders and in result they adjust relative use of covenants. When financial statements are prepared in compliance with the standards, an unmodified or clean audit opinion is given by the auditor (Ozcan, 2016).

The integrity of a firm's financial reports is based on its financial reporting system. When a firm receives a modified audit opinion, it raises concerns about the integrity of

financial reporting and may lead firm to get delisted from exchange. The SEC assures financial reporting quality by imposing penalties for misreportings and mandating GAAP compliance (Cipriano, Hamilton, & Vandervelde, 2016). Better quality financial reports minimize the firm's cost of capital and information asymmetry (Francis, Nanda, & Olsson, 2008).

This study examines modified audit opinion as an appropriate proxy of financial reporting quality, in line with existing research (Chen et al., 2001; Sanchez-Ballesta & Garcia-Mecca, 2005; Caramanis & Spathis, 2006; Firth et al., 2007; Pucheta-Martinez & Fuentes, 2007; Johl et al., 2007; Farinha & Viana, 2009; Chen et al., 2013; Sundgren & Svanström, 2014; Tsipouridou & Spathis, 2014; Ji & Lee, 2015; Goodwin & Wu, 2016; Mendez et al., 2016; Pucheta-Martinez et al., 2016; Chen et al., 2016). Different types of modifications transmit different warning signs to the financial reports users. Hence, this study does not categorize the different types of modified audit opinion and evaluates modification as a dichotomous variable (Sanchez-Ballesta & Garcia-Mecca, 2005; Pucheta-Martinez & Fuentes, 2007; Farinha & Viana, 2009; Mendez et al., 2016; Pucheta-Martinez et al., 2016; Chen et al., 2016). A binary variable is a sub-category of the dichotomous variable; so a value of „1“ is allocated if the opinion is modified and otherwise „0“.

2.4 Theoretical Background

Research on the influence of management in the governance process and association with modified audit opinion is very limited. Theories suggest that managerial power can be used to influence the performance of other players of the corporate governance

mosaic. To ensure financial reporting quality, management has the primary responsibility along with the audit committee and independent external auditors. The underpinning theories related to these players of the corporate governance mosaic are explained here:

2.4.1 Power Theory

In the scope of social sciences, power is the aptitude to manipulate or influence the actions or behavior of people (Finkelstein, 1992). Power is commonly perceived as social behavior which can be immoral or unfair. In business, power is normally declared as being “upward” or “downward”. When companies wield upward power, it is the employees who persuade the business decisions, and alternatively, downward power is observed when a company’s superiors have enough control over decisions and employees just follow them. French, Raven, and Cartwright (1951) shaped a schema of power resources to evaluate how power works in a particular affiliation. They stated that “power must be distinguished from influence in the following way: power is that state of affairs which holds in a given relationship, A-B, such that a given influence attempt by A over B makes A’s desired change in B more likely”.

There is a possibility that top management uses their power to influence the decisions or actions of others to work in their own interests rather than that of shareholders. The separation of ownership and control poses a risk in that those who control the company may not have the same interests as those who own the company. Bebchuk and Fried (2004) argue that “when CEOs have more power over the board of directors, they will be better positioned to negotiate for compensation arrangements that serve their own

interests". Baker, Jensen, and Murphy (1988) argue that executives are more interested in short term compensations rather risky arrangements. It is believed that corporate directors carry out the tasks which benefit the shareholders but Bebchuk and Fried (2004) doubt the legitimacy of this belief, taking into consideration the influence of powerful management.

The powerful CEOs can minimize the monitoring role of the board in numerous ways, for example, when they are involved in the selection process of directors (Main, O'Reilly, & Wade, 1995), they choose directors on the basis of their friendship, collegiality and loyalty because they are less likely to confront them (O'Reilly & Main, 2010). The CEO's influence on board through participation in the compensation process can also reduce the independence of directors. Cormier et al. (2016) provide some justification about the power characteristic and find that companies are more likely to be involved in financial statement frauds or misreporting when the CEO is more powerful. This study, contribute to the literature on the power theory.

2.4.2 Upper Echelon Theory

The upper echelon theory argues that an executive's personal attributes, such as age, gender, experiences, values, etc., influences organizational performance and accounting outcomes. The theory was initially presented by Hambrick and Mason (1984) as they stated that, "the manager's eventual perception of the situation combines with his/her values to provide the basis for strategic choice". The first assertion of the theory is that top executives exert influence on organization's strategic choices and outcomes (Finkelstein & Hambrick, 1990). The complex choices are mainly the result of

behavioural factors rather than a mechanical chase for economic optimization (Cyert & March, 1963). The second assertion of upper echelons theory is that, if strategic choices have a large behavioural component, it reflects the decision maker's cognitive biases and values.

Over time, several studies have empirically examined the relationship between CEO attributes and firm level outcomes (Ireland et al., 1987; Mudrack, 1989; Hambrick, 2007; Troy, 2011; Huang et al., 2012; Li, Low, Makhija, 2017; Belot & Serve, 2017). Byron and Post (2016) argue that the directors' cognitive frames due to their prior knowledge, experience and values inform strategic decision making, and ultimately, corporate strategy. In Malaysian context by considering the cognitive frame of Muslim CEOs, Alazzani et al. (2019) argued that CEO religiosity and female directors will bring different knowledge, experiences and values to the board deliberations. Huang et al. (2012) find negative association between CEO age and financial reporting quality. The current study adds to the body of knowledge on this important management theory by examining various characteristics of top executives.

2.4.3 Agency Theory

The divergence of ownership and management of a firm creates difficulties or costs for the shareholders to monitor the action of management. Jensen and Meckling (1976) state that, "An agency problem arises due to the conflict of interests of the principal (owner) and those of the agent (manager)". So, the difference of interests and information asymmetry may lead to lack of trust between each group of stakeholders in the company and raise questions about the credibility of the information provided to the shareholders.

It can be argued that information asymmetry can be reduced by increasing the financial reporting quality of the company (Brown, Hillegeist, & Lo, 2004). Healy and Palepu (2001) and Francis et al. (2008) suggest that higher quality financial reports and disclosure are helpful in decreasing the information asymmetry between stakeholders. Further, in emerging countries like Malaysia type II agency problems also known as principal-principal problems prevail due to concentrated or family ownership structures. Controlling shareholders have the motive to pursue own interests at the expense of non-controlling or minority shareholders (De-Cesari, 2012).

Previous studies have suggested different indicators of financial reporting quality and one of those is the type of audit opinion. Audit opinion is disseminated by the external auditors who audit the financial statements of the firm. Arguably, the reliability of reporting process and the integrity of financial information depend on the audit opinion type (Adiloglu & Vuran, 2011). Accordingly, audit opinion issued on the financial reports is helpful for reducing information asymmetry between management and shareholders, which in turn, can reduce the divergent interests between shareholders and managers (Elfouzi & Zarai, 2009; Stanley, DeZoort, & Taylor, 2009). According to the agency theory, the audit opinion issued by the auditor is an independent assurance of the quality of information provided to the users of the firm's financial reports (Jensen & Meckling, 1976; Carcello & Neal, 2000; Hope & Langli, 2010).

Specifically, the users of financial information, including shareholders, will be concerned with the modified audit opinion, which indicates that the quality of financial reporting is low (Chen et al., 2001; Pucheta-Martinez & Fuentes, 2007; Farinha &

Viana, 2009; Haji-Abdullah & Wan-Hussin, 2009; Mendez et al., 2016; Pucheta-Martinez et al., 2016; Chen et al., 2016). Modified audit opinion is given by the external auditors when they find that the financial report is not prepared according to the GAAPs or misstated or involves various uncertainties (ISA 705). Thus, it can be argued that the modified audit opinion is an indication of low quality of financial reporting (Farinha & Viana, 2009), and may indicate the presence of an agency problem, a concern that is central to the financial statements users (Sanchez-Ballesta & Garcia-Mecca, 2005).

To reduce the agency cost by providing high quality financial information, agency theorists have prescribed various governance mechanisms (Walsh & Seward, 1990; Davis, Schoorman, & Donaldson, 1997). Corporate governance involves overseeing and controlling the management to ensure their activities are in line with all shareholders' interests (Hill et al., 2016). The agency theory is very much related to corporate governance monitoring functions, and this is because corporate governance focuses on dealing with the problems brought about by the issue of separation of ownership from the control of business (Okpala, 2012; Maijoor, 2000). Hence, to protect shareholders' interests by solving agency problems, corporate governance is arguably an important mechanism.

Previously, researchers have focused more on the board and audit committee as the main players of corporate governance to oversee the quality of financial reporting. Carcello et al. (2011) and Cohen et al. (2004) explain the role of other players which can influence the governance system or financial reporting process, including external auditor and management. This is because external auditors play an essential role and certify that the

financial reports are in conformity with the GAAPs. Hence, a well-structured corporate governance system is likely to advance and increase financial reporting quality (Cohen et al., 2002, 2004; Carcello et al., 2011; Johl et al., 2012).

2.5 Corporate Governance Mosaic and Financial Reporting Quality

Corporate governance is a legitimate system which examines management's conduct towards corporate accountability. The agency theory postulates that those who are being monitored, like management, should be independent from those who are executing the monitoring task, like the board and the audit committee. According to the POB (1993), corporate governance refers to "those oversight activities undertaken by the board of directors and audit committee to ensure the integrity of the financial reporting process" (Cohen & Hanno, 2000). If there is a proper level of monitoring, governance in the company will be effective (Cadbury, 1997). Further, Tsui and Gul (2000) contend that the corporate governance system improves the accuracy of information and keeps managers on track to comply with accounting standards. In other words, to preserve the shareholders' interests, the corporate governance system must be accountable to oversee management.

Corporate governance plays a decisive role in ensuring the quality of the reported financial information by improving the performance of the financial reporting process (Farinha & Viana, 2009). The "strong corporate governance mechanisms are likely to lead to better quality accounting information" (Johl et al., 2012). Further, the type of audit opinion rendered could be extensively influenced by the corporate governance structure (Pucheta-Martinez & Fuentes, 2007). Auditors depend hugely on the audit

committee to prepare their audit opinion. In short, it could be argued that good quality audit is correlated with the governance structure of firms.

In determining the stability of the corporate governance structure, Cohen et al. (2002) argue that there is a lack of knowledge on how and which governance components need to be focused on to ensure financial reporting quality. Larcker and Richardson (2004) affirm that “the typical structural indicators used in academic research and institutional rating services have very limited ability to explain managerial behavior and organizational performance”. In this regard, Cohen et al. (2004) suggest that limiting corporate governance to just monitoring management may be an underestimation of its effectiveness.

The inclusive research framework related to corporate governance is more appropriate to study financial reporting quality. Cohen et al. (2004) and Carcello et al. (2011) recommend that the firm’s management, audit committee and external auditor, are the core components of the corporate governance mosaic, to make sure of the quality of financial reporting. The Figure below depicts the financial reporting triangle of the corporate governance mosaic:

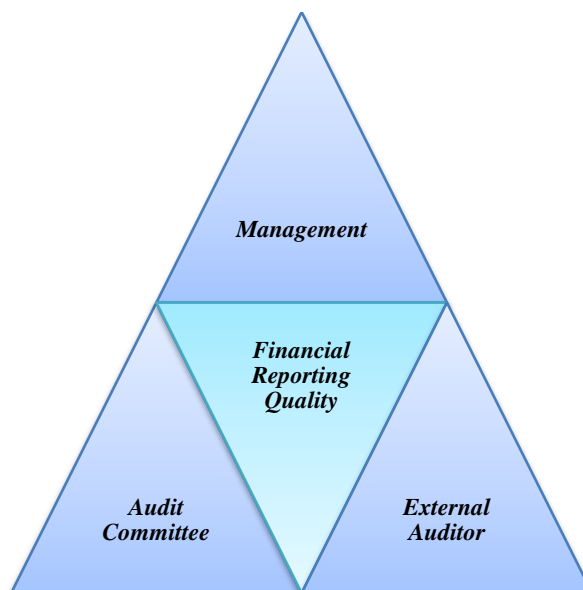


Figure 2.2 Triangle of financial reporting quality on the basis of Cohen et al. 2004

The external auditors is an important factor of a firm's monitoring structure as consistency of accounting information is linked with the performance of auditor (Watts & Zimmerman, 1983; Cohen et al., 2004). To form an audit opinion on the financial statements is the prime responsibility of auditors. Bamahros and Wan-Hussin (2015) conclude that shareholders believe auditors are proficient enough to notice irregularities in the financial statements and can report these irregularities autonomously. The agency theory also recommends that the efficacy of financial reporting process depends on the monitoring role of external auditors; consequently, they must integrate with the other stakeholders in the governance mosaic (Beasley & Salterio, 2001).

Cohen et al. (2002) show that to make sure that shareholders and investors obtain high quality financial reports, auditors' responsibility toward the other actors of the corporate governance mosaic is important. For example, auditor's interaction with the

management and the audit committee of the firm in the governance process is very significant. The board also influences the audit planning decisions and risk control estimations (Cohen et al., 2007). It is the obligation of the independent auditor that financial reporting is reasonable and legitimate in all material respects (Choi & Wong, 2007). So, the preceding arguments validate the monitoring role of external auditors in the corporate governance system.

In addition, management is an important stakeholder of the corporate governance mosaic. Cohen et al. (2004) argued that according to the auditor's observation, the most important driver of corporate governance is management. The management can drive both accounting/auditing outcomes and governance characteristics but in the most studies, management has not been incorporated into the analysis. Carcello et al. (2011) question whether it is appropriate to eliminate management while associating the governance characteristics with the accounting/auditing outcomes. The responsibility and performance of management in the governance mosaic to improve shareholder value must not be underrated. The responsibility and role of the corporate governance system for the firm's financial reporting quality cannot be realized fully without the integration of the management component (CSO, 1992).

The role of audit committee in corporate governance mosaic is important to protect shareholders value. The audit committee is responsible to oversee both internal and external audit function of the firm (Carcello & Neal, 2000; Yasin & Nelson, 2012). Audit committee also plays part in resolving the disagreements between management and external auditors regarding the merits of financial statements. In Malaysia the

corporate governance policies and practices are comparable to developed markets like UK, USA (Liew, 2007; Haat, Rahman, & Mahenthiran, 2008) however, considering the institutional setting of emerging markets the factors which leads to more effective audit committee in Malaysia are unresolved. Bliss et al. (2011) argued that aspects which increase the usefulness of audit committee in the governance system still remain unsettled.

Due to the understanding that an improved corporate governance system can lead to enhanced quality of financial reporting, there is a need to determine what components of corporate governance are more effective. In the wake of recent concerns firm's management, auditors and audit committee are equally responsible to develop better financial reporting process (Carcello et al., 2011; Hasnan et al., 2013; Tee, 2019). This study examines the effect of these three stakeholders of the corporate governance mosaic on the financial reporting quality. Table 2.2 below list few of the important studies related to the financial reporting quality and corporate governance.

Table 2.2 Summary of some important studies related to financial reporting quality

| Author | Data Sample | Independent Variables | Dependent Variables | Estimation Method | Results |
|-------------------------|----------------------|--|---------------------|---------------------|--|
| Mollik et al. (2020) | 2006-09 Australia | Big 4 AC Independence AC Expertise | Earnings Management | Fixed Effects | Findings show that audit quality, in terms of being audited by Big4 auditors, constrains earnings management during the pre-crisis period, but not during the global financial crisis. Audit committee independence has a significant mitigating effect on firms' earnings management, while audit committee members' accounting and finance expertise do not constrain earnings management. |
| Oussii and Klibi (2020) | 2012-18 Tunis | AC Financial Expertise External Auditor's Size | IFRS | Logistic Regression | Results show that the proportion of financial experts who sit on the audit committee positively associated with the de facto use of IFRS. Besides, the association between audit committee members' financial expertise and the voluntary use of IFRS is more pronounced when the company is audited by at least one BIG4 audit firm. |
| Al-Absy et al. (2019) | 2013-15 Malaysia | ACC Tenure ACC Age ACC Gender ACC Ethnicity | Earnings Management | OLS | Find that audit committee chair tenure, gender and ethnicity are associated with discretionary accruals. |

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|-------------------------|---------------------|--|---------------------|---------------------|---|
| | | ACC Expertise ACC Directorship | | | |
| Harris et al. (2019) | 1992-14 USA | CEO Gender CEO Equity Incentive | Earnings Management | 2SLS | Find that female CEOs manipulate earnings to a lesser degree than their male counterparts. In order to amplify the value of their equity based incentives both male and female CEOs manipulate earnings. |
| Norziaton et al. (2019) | 2008-10 Malaysia | Politically Connected Firms Institutional and Managerial Ownership Firms Family Ownership Firms AC Independence AC Diligence AC Expertise | Audit Fee | OLS | Study finds that politically connected firms pay higher audit fees than institutional and family owned firms. Further, audit committee independence, diligence, and expertise association with audit fees is positive and significant for politically connected firms. |
| Omer et al. (2019) | 2004-14 Global | Audit Committee Connectedness | Irregularities | Logistic Regression | Study finds that firms with well-connected audit committees are less likely to misstate annual financial statements. Study also demonstrates that audit committee connectedness through director networks moderates the negative effect of board interlocks to misstating firms on financial reporting quality. |

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|--------------------|---------------------|--|--|--------------------------------|---|
| Reid et al. (2019) | 2011-14 UK | New Reporting Regime | Abnormal Accrual Meet or Beat Analyst Forecast Cumulative Returns Audit Fee Audit Report Lag | OLS Logistic Regression | Study finds that the United Kingdom's new reporting regime is associated with an improvement in financial reporting quality as proxied by significant decreases in absolute abnormal accruals and the propensity to just meet or beat analyst forecasts, and a significant increase in earnings response coefficients. As for audit costs, study did not find a significant change in audit fees or audit delay surrounding the implementation of the new reporting regime. |
| Tee (2019) | 2002-15 Malaysia | CEO Power | Audit Fees | OLS | Find that CEO power is associated with lower audit fees. However, this relationship is weakened by the political connections and family ownership. |
| Zhang (2019) | 2006-13 USA | Team Homogeneity Team Experience Team Size | Restatements Earnings Management | Logistic Regression OLS | Study results indicate that firms with top management teams that have more similar backgrounds and longer experience working together are more likely to misreport their financial statements. It is also documented that these firms also engage in more accrual and real earnings management when |

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|--------------------------|---------------------|--|----------------------------------|------------------------|--|
| | | | | | they face income increasing earnings management incentives. |
| DeBoskey et al. (2018) | 2008-13 Global | CEO Power Board Oversight | Earnings Announcement Tone | Fixed Effects | Finds that tone of earnings announcement is positively associated with the CEO duality. |
| Lai et al. (2018) | 2010-13 Malaysia | Audit Partner Busyness | Accruals | OLS | Audit partner busyness is confidently associated with lesser earnings quality proxied by discretionary and total accruals. |
| Ocak (2018) | 2010-16 Turkey | Auditor Education Auditor Busyness | Modified Audit Opinion | Logistic Regression | Busy audit partner associated with low audit quality. Auditor formal education level minimizes the negative effect of auditor busyness on auditor quality. |
| Wan-Hussin et al. (2018) | 2013 Malaysia | Audit Partner Workload Partner-client Tenure | Audit Report Lag | OLS | The busy auditors are observed to prolong audit lags, and the effect is more acute for non-Big 4 clients, busy season clients and short partner tenure. |
| Belot and Serve (2017) | 2012-13 France | CEO Gender CEO Age | Earnings Management | OLS | Find that older CEO's are associated with low earnings quality. Female-run firms engage in less earnings management than do male-run firms. |

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|-----------------------------|-----------------------|--|--------------------------------------|------------------------|---|
| Ghafran and Yasmin (2017) | 2007-10 UK | ACC Financial Expertise ACC Experiential Expertise ACC Monitoring Expertise | Audit Report Lag | 2SLS | Find that the experiential and monitoring expertise of audit committee chairs have a significant negative association with the delay in the audit report lag period. |
| Haji-Abdullah et al. (2017) | 1999-2009 Malaysia | Non-Audit Services Audit opinion Affiliated Directors Bumiputra Directors | Fraudulent Financial Reporting | Logistic Regression | Study reveals that joint provision of audit and non audit service is significantly positively associated with fraudulent financial reporting. With regard to audit opinion, affiliated directors, and bumiputra directors there is a significant association with fraudulent reporting. |
| Sun et al. (2017) | 2000-14 China | Older CFO Female CFO CFO Education Level | Fraudulent Financial Reporting | Logistic Regression | Study finds that fraudulent financial reporting is higher when CFOs are younger, male, and have lower education backgrounds. Also demonstrate that CFOs with higher education levels are associated with more inflated earnings. |
| Cormier et al. (2016) | 1995-09 Canada | CEO Power CEO Hubris | Financial Misreporting | Logistic Regression | The CEO power and hubris is robustly persuaded the directors and lead companies to charge in misreporting or misstatement; governance mechanism is impotent in supervising the financial reporting integrity in |

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|-------------------------------|----------------------|---|---|----------------------------|--|
| | | | | | the attendance of powerful CEO. |
| Chen et al. (2016) | 2003-2009 China | Financial Analyst Coverage | Modified Audit Opinion | Probit Regression | Find that analyst coverage, which serves as an external governance mechanism, helps to enhance the financial reporting quality of Chinese listed firms. |
| Kalelkar (2016) | 2006-12 Global | Audit Engagement | AC Meet | OLS | Audit committees meet more frequently in the first year of audit engagement with new audit partner. |
| Mohammad-Rezaei et al. (2016) | 1999-10 Iran | Audit Market Liberalization, Auditor Type | Audit Opinion | Probit Regression | Find that modified audit opinions have decreased following the liberalization of the audit market in Iran, and compared to private auditors, state auditors have issued fewer modified audit opinions. |
| Goodwin and Wu (2016) | 1999-10 Australia | Audit Partner Busyness | Discretionary Accruals, Incidence of Small Profits, Going Concern Opinion | OLS Logistic Regression | Audit partner busyness is not extensively connected with the audit quality surrogates, mainly after controlling the apparent time of equivalent partner quality. |
| Paananen (2016) | 2011 Finland | Profitability Solvency Liquidity AR Lag AF Size | Modified Audit Reports | Logistic Regression | Big N audit firm, large client and extended audit report lag enhance the possibility of the auditors to issue modified audit opinion. |

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|--------------------|--------------------|--|---------------------------|------------------------|--|
| Fung et al. (2016) | 1994-12 Global | Client Importance Big-N Auditor Multinational Client Legal Regime | Modified Audit Opinion | Logistic Regression | Find that auditors are more likely to issue modified opinions to their economically important clients relative to other clients. This association is stronger for Big-N auditors, multinational audit clients, and in countries with stronger legal regimes. |
| Lynda (2016) | 2002-11 France | Profitability Liquidity Debt Loss Inventory Turnover Receivable Turnover Identity of Auditor Previous AO Audit Fee Company Size | Audit Opinion | Logistic Regression | Find that the analysis of the conditions of receiving a modified audit opinion is determined by: the variables of the financial health of the company, the inventory receivables which indicate the complexity of the audited firm and the characteristics of the audit. |
| Adebiyi (2016) | 2005-13 Nigeria | Managerial Ownership, Institutional Ownership, Foreign Ownership, Bank Size | Discretionary Accrual | OLS | The quality of financial reporting is affected by the firm's ownership structures; specifically the managerial ownership enhances the quality of financial reports. |
| Du et al. (2018) | 2008-10 China | Environmental Performance, Internal Control, Green Washing | Modified Audit Opinion | Logistic Regression | Find that firm's environmental performance is significantly negatively associated with modified audit opinions, suggesting that auditors applaud |

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|--------------------------------|------------------|---|--|--|---|
| | | | | | environmentally friendly firms. |
| Mendez et al. (2016) | 2004-11 Spain | Busy Directors Overlap Directors | Executive Remuneration, Audit Opinion, Earnings Management | Pooled OLS, Panel Fixed and Random Effects, Logit Regression | Find that firms with busy directors offer low executive remuneration and present a low probability of a qualified audit opinion. Further, firms with overlap directors exhibit a higher probability of receiving a qualified audit opinion. |
| Pucheta-Martinez et al. (2016) | 2004-11 Spain | AC Female Directors, AC Independent Female Directors, AC Chaired by Women | Audit Opinion | Logistic Regression | The percentage of female directors in the audit committee reduces the possibility of qualifications related to the other matters except going concerns. But the chances of qualifications due to going concern is positively associated with the percentage of audit committee female and independent female directors and also with the audit committee chair if hold by female directors. |
| Tanyi and Smith (2015) | NA | ACC Busyness ACC Expertise | Accruals | OLS | Finds significant association between audit committee chair busyness and abnormal accruals. |
| Bamahros and Wan-Hussin | 2009 Malaysia | Non-audit Services Audit Firm Tenure | Accruals | OLS | Find that longer audit firm tenure reduces earnings management. But the magnitude |

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|---------------------------------------|---------------------|---|-------------------------------------|---------------------------------------|---|
| (2015) | | | | | of non-audit fees increases the earnings management. |
| Sakka and Jarboui (2015) | 2006-13 Tunis | Audit Committee, Board Size, Outside Directors, CEO Duality, Ownership Concentration, Institutional Ownership, External Auditor Reputation | Timely Disclosure, Audit Opinion | GLS, Logistic Regression | The corporate governance mechanisms consists of large board size, independent directors, CEO as board chair as well as ownership structures extensively influence audit quality. |
| Ji and Lee (2015) | 2001-11 Global | Managerial Overconfidence: Excess Investment, Net Acquisition, Debt to Equity Ratio, Risk Debt, Dividend Yield | Going Concern Opinion | Logistic Regression | The prospect of issuing a first time going concern modified audit opinion is positively related with the managerial overconfidence, implying that overconfident management is negatively perceived by auditors in the financial distressed organizations. |
| Blandon and Argiles (2015) | 2002-09 Spain | Audit Firm Tenure | Audit Opinion | Multinomial Logistic Regression | Find that auditors seem willing to sacrifice independence in lengthy engagements, but only for non going concern modified opinions. |
| Vichitsarawong and Pornupatham (2015) | 2004-08 Thailand | Audit Opinion | Earnings Persistence | OLS | The firms with modified audit opinions have lesser earnings persistence in comparison with firms receiving unqualified |

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|-------------------------------|------------------|--|--|---|---|
| | | | | | opinions, and the level of earnings persistence fluctuate between types of audit opinion modifications. |
| Sundgren and Svanstrom (2014) | 2009 Sweden | Auditor Assignments, Auditor Age | Going Concern Opinion | Logistic Regression | The amount of audit engagements and auditor age are adversely allied with the probability of a going concern opinion. |
| Chang et al. (2017) | 2007 China | AC Diligence, AC Independence, AC Financial Expertise | Earnings Management, Audit Fees, Audit Opinions, Delayed Filings | Treatment Effects, Probit Regression | The firms with efficient audit committees are linked with low earnings management and lesser audit fees, and limited chances to have modified opinions and delayed filings. Independent accounting expert directors, extra paid supervisors, huge chairman ownership, larger total assets, and Big 4 auditors are most likely to have efficient audit committees; firms with a considerable subsistence of the principal shareholder and varied share ownership are less possibly to have effectual audit committees. |
| Chen et al. (2013) | 2001-08 China | Executive Integrity, Modified Audit Opinion | Financial Frauds | Logistic Regression | Find that firms with lower executive integrity are associated with higher propensity of regulatory enforcement actions against |

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|--------------------------------|-------------------|---|--|---------------------|---|
| | | | | | corporate fraud in the subsequent year. This effect is moderated by the issuance of modified audit opinion report by the auditors. |
| Cohen et al. (2013) | 2001-07 Global | Accounting and Supervisory Expertise, Audit Committees and Industry Expertise | Restatements, Accruals, Audit Fees, Non-audit Fees | OLS, 2SLS | The members of audit committees who have both accounting and industry expertise execute better in compare of those who only accounting experts, in definite instance members with supervisory expertise who also industry expertise execute better than supervisory experts only. Industry and accounting expert members can boost the efficiency of audit committee which direct to less likelihood of earnings management and restatements. |
| Tsipouridou and Spathis (2013) | 2005-11 Greece | Discretionary Accruals | Audit Opinion | Logistic Regression | Bad financial performance in the recent fiscal year, preceding year losses, type of audit opinion recognized in the preceding year, little firm size and larger audit effort result in a high prospect of getting a going-concern opinion. The going-concern modification choice is not correlated to the intensity of discretionary |



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| | | | | | accruals. |
| Hasnan et al. (2013) | 1996-07 Malaysia | Prior Violations, Related Party Transactions, Founders on Board, Financial Distress, Family Ownership, Foreign Ownership, Political Connection, Lack of Independent Board, Multiple Directorship, Audit Quality, Earnings Management | Fraudulent Financial Reporting | Logistic Regression | There is an important and positive relationship among earnings management and founders on the board with the incidence of fraudulent financial reporting. Also the results demonstrate that firms with high party related transactions have lesser incidences of fraudulent financial reporting. |
| Huang et al. (2012) | 2005-08 Global | CEO Age | Analysts Earnings Forecast, Financial Restatement | Logistic Regression | The CEO age is considerably and negatively correlated with the low financial reporting quality; pointed out by the restatements and meet or beat of analysts forecast. |
| Barua and Yan (2011) | 2005 USA | New CEO New CFO | Material Weakness | Logistic Regression | The results demonstrate that unfavorable SOX 404 reports are more possibly at firms that appoint a new CFO. |
| Geiger and North (2011) | 1995-02 USA | CEO Turnover PFO Turnover | Discretionary Accruals | OLS | Appointment of both new CEO and PFO or CFO in the same period report noticeably boosts the discretionary accruals in the succeeding reporting period and for the combined two years |

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| | | | | | surroundings the joint appointments. |
| Firth et al. (2011) | 2000-05 China | Stock Returns, Cost of capital, Bid-ask Spread, Modified Audit Reports, CEO Turnover | Falsified Financial Statements | Probit Regression | The corporations with lofty debt are more expected to maneuver their earnings in following restated financial reports. Restating firms experience adverse abnormal stock returns, wider bid-ask spreads, enlarged in their cost of capital, a higher incidence of modified audit opinions, and higher CEO turnover. |
| Dhaliwal et al. (2010) | 2004-06 Global | AC Accounting Expert, AC Financial Expert, AC Supervisory Expert | Accruals Quality | Cross-sectional Regression | The accounting experts of audit committee, who are also independent, have a short tenure in their firms and hold less number of directorships, have a reflective positive impact on accruals quality. |
| Chen et al. (2010) | 1995-04 China | Quick Ratio, Accounts Receivables, Leverage, Turnover Ratio, ROA, Loss, Company Age, Total Assets, Stock Returns, Earnings Management, | Modified Audit Opinion | Logistic Regression | The auditors in China are more inclined to issue modified audit opinions to those clients who are facing financial difficulties, despite of their compliance with GAAP. Secondly increase in earnings management is an imperative cause underlying modified audit opinion, weak corporate governance is also a contributing reason for the vast |

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| | | Audit Firm Market Share, Auditor Partner Expertise | | | numbers of audit opinion modification. |
| Farinha and Viana (2009) | 2002-05 Portugal | Board Size, Board Diligence, Board Independence | Modified Audit Opinions | Logistic Regression | The diligence of board and independence have an adverse affect on that possibility of getting modified audit opinion, though size of board do not have a considerable influence. |
| Shafie et al. (2009) | 2002 Malaysia | Audit Firm Tenure | GC Audit Opinion | Logistic Regression | There is positive significant association between long audit firm tenure and auditor reporting decision. |
| Haji-Abdullah and Wan-Hussin (2009) | 2002-03 Malaysia | AC Size, AC Independence, AC Meetings, AC Financial Expertise, Number of Directorships | Annual Awards | Logistic Regression | Find that the desirable characteristics which the policy makers believe would enhance the effectiveness of the audit committee in carrying out its financial oversight responsibilities do not seem to yield the intended consequence. But find an association between financial distress and financial reporting quality. |
| Larcker et al. (2007) | 2002-03 USA | Board Variables, Stock Ownership Variables, Activist Variables, Debt Variables, Compensation Mix | Accruals, Restatements, ROA | PCA, OLS, Logistic Regression | The study proposed fourteen dimensions of corporate governance using thirty nine structural procedures, for example board characteristics, institutional ownership, stock |

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| | | Variables, Anti-takeover Variables | | | ownership, activist stock ownership, mix of executive compensation, existence of debt holders, and anti-takeover variables have varied relationship with abnormal accruals, small relation with restatements, and some capacity to elucidate future excess stock returns and future operating performance. |
| Firth et al. (2007) | 1998-03 China | Shareholding Concentration, Shareholder Type, Supervisory Board, Board of Directors, Audit Firm | Accounting Earnings, Stock Returns, Discretionary Accruals, MAO | OLS | The ownership concentration, the percentage of trade-able shares, the presence of foreign shareholders, the supervisory board, the type of dominant shareholder, and independent directors significantly influence the discretionary accruals, earnings response coefficients and the incidence of modified audit opinions. |
| Johl et al. (2007) | 1994-99 Malaysia | Abnormal Accruals, Audit Quality | Audit Opinion | Logistic Regression | The Big 5 audit firms in Malaysia seem to modify more than their non Big 5 equivalents and when more frequency of abnormal accruals are there, yet the interaction among external auditor industry specialization and abnormal accruals is not symbolic in forecasting the |

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| | | | | | frequency of qualification. |
| Pucheta-Martínez and Fuentes (2007) | 1999-01 Spain | AC Existence, AC Effectiveness, AC Size AC Independence | Audit Opinion | Logistic Regression | Find that ACs size, the percentage of independent members in ACs, company size, losses reported in either or both of the previous two years, receiving the same qualified audit opinion as in the previous year and ownership concentration affect the likelihood of receiving error or non-compliance qualifications. |
| Caramanis and Spathis (2006) | 2001 Greece | Audit Firm Characteristics, Auditee Financial Information | Qualified Audit Opinion | OLS, Logistic Regression | The type of audit firm and audit fee do not influence auditors' partiality to qualify the opinions, as an alternative the incidence of audit qualifications is allied with financial metrics like as the current ratio and operating margin to total assets. |
| O'Connor et al. (2006) | 1996-04 USA | CEO's Stock Option, Board of Directors Stock Options, CEO Duality | Fraudulent Financial Reporting | Logistic Regression | The growing CEO stock options lead firms to the minimized incidence of fraudulent financial reporting if the CEO was also chairman of the board and the firm's board of directors has stock options, or if the CEO was not chairman and the board had no options. The CEO age and the audit committee meetings frequency are adversely allied |

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| | | | | | with fraudulent reporting. |
| Sanchez-Ballesta and Garcia-Meca (2005) | 1999-02 Spain | Shares Ownership, Family on Board, Board Size | Audit Opinion | Logistic Regression | Find that higher insider ownership provides better corporate governance structure leading to higher quality of financial reporting and, therefore, less likelihood of receiving qualified audit reports. On the other hand, the presence of family members on the board increases the possibility of obtaining a qualified report. |
| Uzun et al. (2004) | 1978-01 USA | Board Composition, Board Size, Board Chair, Committee Structure, Board and Committee Meetings, | Financial Fraud | Logistic Regression | In general findings advocate that composition and structure of the board's lapse committees are considerably interrelated with the occurrence of corporate fraud. Mainly the existence of audit and compensation committees and the independence of these committees have drastically negative impact on the prevalence of fraud. |
| Abbott et al. (2004) | 1991-99 USA | AC Independence, AC Size, AC Expertise, AC Meetings | Restatements | Logistic Regression | The independence and level of activity of the audit committee demonstrate an important and adverse association with the incidence of restatement. Audit committee members financial |

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| | | | | | expertise also has a considerable negative relationship with restatements. |
| Lennox (2003) | 1995-98 Global | Executive Affiliation, Executive Turnover | Audit Opinion | Logistic Regression | The affiliated executives of who are CPAs with audit firm's before considerably more expected to receive clean audit opinions than companies with unaffiliated executives. And the executive turnover is also drastically lesser if they are affiliated. |
| Ireland (2003) | 1998 UK | Total Assets, Quick Ratio, Debt, Loss, Contingent Liabilities, Big 6, Audit Fees, Non-audit Fees, AR Lag, Previous AO | Audit Opinion | Multinomial Logistic Regression | The determinants of audit opinion modifications differ towards modification types, with the exclusion of the audit report lag and the preceding year audit report. As well companies who paying lofty audit fees are less expected to receive going concern related modifications. |
| Defond et al. (2002) | 2001 USA | Audit Fees, Non-audit Fees, Total Fees | Going Concern Opinion | Logistic Regression | The study not find considerable relationship among non-audit service fees and prejudiced auditor independence, the results are consistent with market base incentives, such as loss of reputation and litigation costs. |

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| Johnson et al. (2002) | 1986-95 USA | Audit Firm Tenure | Accruals | OLS | The study finds no significant evidence that longer audit firm tenures reduced financial reporting quality. |
| Chen et al. (2001) | 1995-97 China | Earnings Management, Profitability | Modified Audit Opinion | Logistic Regression | There is significant association between receiving MAOs and reporting profits marginally above the target levels specified in stock de-listing and rights offering regulations. Study findings are consistent with the notion that asymmetric profitability requirements exacerbate managers' propensity to engage in earnings management, which in turn is positively associated with receiving MAOs. |



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2.5.1 Management Characteristic

In view of providing better quality financial reports to stakeholders, management is principally liable to manage the financial reporting system of the company (Cohen et al., 2004; Bebcuk & Fried, 2004; Carcello et al., 2011). When accounting standards are less precise, management may be more assertive in the financial reporting system (Nelson, Elliot, & Tarpley, 2002). Section 302 of the SOX Act states that, “appropriateness and fairness of financial reports and related disclosures must be certified by the management of listed firms”. Financial reporting quality has a significant effect on management interaction with the other players of the corporate governance mosaic.

A study based on the interviews of auditors has revealed that the financial reporting process is significantly influenced by the management (Cohen et al., 2002). Most of the auditors responded in this study argue that “if management does not want to be governed, they can’t be”. Further, management may appoint compliant directors on the board who are reluctant to confront management in their decisions regarding accounting disclosures as long as they satisfy regulatory requirements. Harris et al. (2019) argues that CEOs have vested interests in the financial reporting activities because these reports articulate information about performance that is often considered as a reflection of management abilities and efficacy. Forbes magazine reveals that top management was involved in most of the financial statement frauds that happened in the last decade (Forbes, 2016).

Prior studies have examined the different impacts of management behavior on financial reporting. For instance, Ji and Lee (2015) observe how auditors recognize management's overconfidence in the likelihood of issuing a modified opinion; they find that managerial overconfidence is associated positively with going concern modification. The finding suggests that overconfident managers are more involved in accounting discrepancies and auditors adversely value the overconfidence of managers. Schrand and Zechman (2012) argue that overconfident executives misstate financial reports to gain some personal benefits.

Consistent with the above arguments, it can be said that overconfident CEOs are more involved in financial reporting frauds. Chen et al. (2013) argue that there is a higher number of enforcement actions against financial frauds when the integrity (indicated by earnings manipulation) of the firm's executives is low. The study implies that executives will be less likely to commit fraud if auditors challenge their integrity and impose a warning on them. Herbohn and Rangunathan (2008) suggest that inherent uncertainty modifications have a greater effect on earnings, and propose that managers make policy choices which better forecast the firm's future earnings.

Beams et al. (2016) shed light on the link between top management resignations and going concern audit opinions. They find that going concern audit opinion is positively linked to the resignations of the top management in the subsequent year. Geiger and North (2011) evaluated the relationship between corporate financial reporting and engagement of new CEO, and find that firms that appoint a new CEO or CFO (the "big

bath”) are adversely correlated with discretionary accruals in the succeeding reporting year.

Ownership has a significant effect on the financial reporting quality of the listed firms (Adebiyi, 2016), specifically, managerial ownership improves the quality of the financial reports. Erickson, Hanlon, and Maydew (2006) find no reliable evidence to support the argument that executives’ vested stock or total equity and stock options influence the probability of increased accounting fraud. The results suggest that there is no significant difference in terms of management stock options for fraud and non-fraud firms. Brochet, Faurel, and McVay (2011) describe that experienced executives are more conscious of their reputation in the market during the mergers and acquisition processes, and this mitigates the effect on their propensity to report timely and informative goodwill impairments.

In Malaysia ownership structure is a matter of concern due to the concentrated ownership and control by family or institution. According to the agency theory, it is considered fail that entrenchment effect occurs between majority shareholders and minority shareholders. Morck and Yeung (2003) argued that majority owners tend to exploit minority shareholders rights, also known as “owner opportunism”. Hasnan et al. (2013) find that fraudulent financial reporting is positively associated with founders on board; suggesting founders encourage a culture of fraudulent financial reporting in Malaysia. They also find that the institutional and external audit environment in the emerging economies like Malaysia has significant implications for fraudulent financial reporting. Cormier et al. (2016) argue that signals and indications of good governance

need to be given more attention to reduce the propensity of financial misreporting. They conclude that CEOs with strong power and a hubris nature are positively associated with financial misreporting. The CEOs with hubristic tendencies may control the formal governance process as independent boards do not seem to be effective in preventing financial misreporting.

Lennox (1998) shows that reduced executive compensation is significantly influenced by unfavorable audit reports, and is particularly more strong when modification is issued due to going concern uncertainties. The study further finds a weak but positive association between CEO turnover and modified audit opinion, suggesting that modified audit opinion is costly to company executives. In this regard, Beasley, Carcello, Hermason, and Neal (2009) posit that to some extent, the audit committee can rely on external auditors as they are a significant source of information for them. But auditors' judgment of internal controls also depends on the information presented by the management. By using historical analysis of fraudulent financial reporting, Lee, Clarke, and Dean (2008) highlight how the work of auditors is obfuscated by the dominant senior managers, which appears to be a persistent fixture in fraud cases. Eventually, the financial reporting quality relies on information which management provides to the audit committee and auditors.

Previous research has also argued that the flow of information to the directors is controlled by the CEO and management of the company. For instance, Adams and Ferreira (2007) argued that managers are less willing to share information with directors which may relate to finances of the company. Harris and Raviv (2008) also contend that

the advantages of having an independent audit committee to examine financial reporting process will be reduced if management withholds information. There is a greater prospect of fraudulent financial reporting in the firms with a CEO who is also the chairperson of the board with more stock options (O'Connor et al., 2006). Financial reporting quality is also associated with age of CEO as Huang et al. (2012) discover that there is a negative relationship between financial restatements and earnings forecasts and CEO age.

As management is considered an essential player in the corporate governance process (Cohen et al., 2002, 2004; Carcello et al., 2011; Cormier et al., 2016; Tee, 2019), this study contributes into the literature related to agency and power theory perspective. To date, few studies have empirically examined how management influences the possibility of receiving modified audit opinion. Some of the management characteristics discussed above have been linked with the quality of financial reporting in previous research (O'Connor et al., 2006; Lee et al., 2008; Harris & Raviv, 2008; Beasley et al., 2009; Geiger & North, 2011; Huang et al., 2012; Schrand & Zechman, 2012; Ji & Lee, 2015; Cormier et al., 2016; Belot & Serve, 2017; DeBoskey, Luo, & Zhou, 2018; Tee, 2019; Harris et al., 2019). Further, Malaysia has its own unique feature of family and managerial ownership which is a source of power for managers. Prior studies showed concerns that managerial ownership needs to be restricted because high managerial ownership results in managers having high personal interests, so that managers do not act in the best interest of the company, but for their self-interest (Setiadi et al., 2016; Tee, 2019).

This study extends the literature in line with prior studies by examining management characteristics related to the power, upper echelon and agency theories which can potentially impact financial reporting quality. The focus on senior management is because of the importance of the COSO report (Beasley et al., 2010), which states that CEOs assist in setting the “ethical spine” that pervades all other corporate governance mechanisms. Further, CEOs have been involved in some of the biggest frauds in recent times, which have affected the quality of financial statements (Peltier-Rivest, 2002; Global Economic Crime and Financial Fraud Survey of PWC, 2020).

2.5.1.1 CEO Age

An individual’s preferences, values, actions and interpretations are affected by the situation in which these choices happen (Hambrick & Mason, 1984). The age of the CEO is a noticeable attribute which might affect the company’s policies and financial outcomes. Hambrick (2007) suggests that age differences affect top managers’ beliefs about the firm’s right strategic direction. The experience of the CEO impacts the strategic decisions of the firm (Ireland et al., 1987). Further, Mudrack (1989) state that age is an important predictor of CEO’s ethical behavior. In terms of financial reporting, it is argued that age-based differences of CEOs have significant implications for the credibility of information (Huang et al., 2012).

Prior research on age-based differences in the accounting and management area has been mainly presented in two aspects. Prendergast and Stole (1996) argue that in comparison to older managers, the younger managers undertake more risky investment strategies to show their talent and capabilities. Li, Low, and Makhija (2017) document an inverse

association between CEO age and firm's risk taking. Troy (2011) argues that younger CEOs with less experience are more likely to commit accounting frauds as compared to the older ones.

Huang et al. (2012) find that CEO age is negatively associated with meeting or beating analyst earnings forecasts and financial restatements. The study concludes that CEO age is positively linked to the financial reporting quality. Belot and Serve (2017) find that earnings quality is less with older CEOs, as the extent of discretionary accruals is negatively related to CEO age. A recent study by Haider (2019) also suggests that younger individuals are less ethical and risk-averse than older individuals. The result shows that analyst forecast accuracy increases with CEO age as the earnings and other related information provided to analysts improve.

Dechow and Sloan (1991) examined the probability that in the last years of service, CEOs are more likely to manage short-term earnings. This is due to the career horizon problem for CEOs close to retirement age, whose profit based benefits are a big portion of the total compensation. Davidson et al. (2007) find that companies document huge discretionary accruals in the year earlier to CEO turnover (as they approach to the age of retirement). If older and more experienced CEOs improve company's performance, they possibly use lesser discretionary accruals. Zhang et al. (2008) also conclude that CEOs with long tenure are motivated by short term economic gain.

Consistent with the horizon problem, Ali and Zhang (2015) find that earnings overstatement is considerably larger in the final year of departing CEOs. Further, by

using empirical research methods, Khuong and Xuan-Vy (2017) report a significantly negative relationship between CEO age and the timeliness of financial reporting quality. Market participants perceive the quality of financial statements by the CEO's attributes, including age (Zhang & Wiersema, 2009). The current study investigates the impact of CEO age on the tendency to receive modified audit opinion (a proxy of low financial reporting quality). To date, no study has been found which has explored the relationship between CEO age and audit opinion modification, especially in the Malaysian setting. Serfling (2014) argues that CEO age remains relatively an under-researched issue with mixed results.

2.5.1.2 CEO Founder

The power theory implies that CEO influence limits the monitoring role of board in the reporting process. In this regard, Cohen et al. (2012) find that firms with excessively powerful CEOs are expected to have directors who are subservient to management. One of the main sources of CEO power is the ownership which comes from the status of the founder (French, Raven, & Cartwright, 1951). CEOs who are founders or relatives of the firm's founder could gain power through long-term connections with the board and they use their unique position to control or influence the board members (Finkelstein, 1992). Ownership power accrues to executives in their capacity as shareholders' agents and acting on behalf of them. It might be easy for the CEOs to implement their agendas more convincingly if they have ownership power.

Lisic, Neal, Zhang, and Zhang (2016), Adams and Ferreira (2007), and Harris and Raviv (2008) support the argument that powerful CEOs give minimum or misleading

accounting information to the audit committee, which in turn, raises the chances of restatements in the firm. Cormier et al. (2016) suggest that governance mechanisms become less effective in preventing or detecting financial misreporting if the CEO is more powerful. The study finds a significantly positive relationship between founder CEO and misreporting. Independent directors seem ineffective in preventing financial irregularities under the formal governance system, which strong CEOs influence. Further, a recent study from the auditor's perspective, argues that CEO power is significantly connected to lower audit fees (Tee, 2019).

By presenting a governance-based contracting model, Albuquerque and Miao (2013) premise that CEOs are the primary supporters of governance change. Different CEOs prefer different governance structures to suit their compensation packages. They assume that there is no agency conflict between the board of directors and shareholders and focused on the agency conflict between shareholders and the CEOs. The study further argues that the CEO will expend more effort to control the board, in the absence of effective governance system. Bebchuk and Fried (2004) also argued that powerful CEOs can massively sway over boards to establish overly generous CEO contracts.

To sum up the studies discussed above, the involvement of top management in determining financial reporting quality still remains unexplained to a large extent (Petit & Bollaert, 2012). In the context of financial reporting manipulations, personalities and personal weaknesses of CEOs are difficult to infer. There is very little research on CEO ownership power in relation to financial reporting quality, specifically modified audit

opinion. This study extends the literature related to CEO ownership power (founder) and the modification of audit opinion.

2.5.1.3 CEO Duality

The firm's hierarchical structure determines how the roles and responsibilities are assigned, controlled and coordinated among individuals. In this regard, the CEO's power depends on his or her influence within the firm's hierarchy (Brass & Burkhardt, 1993; Daily & Johnson, 1997). It is argued that CEO who is also chairperson of the board, have more power over other directors of the company (Finkelstein, 1992; Malmendier, 2012). Prior research has suggested that CEO structural power intensified when he or she serves in a dual leadership role (Ginesti et al. 2017; DeBoskey et al., 2018). The dual position gives CEOs structural power and more control to influence company's policies and individuals. In the presence of severe agency problems, CEO structural power undermine the monitoring role of board (Baldenius, Melumad, & Meng, 2014) and can be harmful for the effective corporate governance.

With regards to quality of financial reporting, DeBoskey et al. (2018) report that tone of the earnings announcement is positively linked to CEO duality. The study argues that companies with powerful executives use more aggressive tones in their earnings announcements, and the affirmative relationship between CEO power and tone of earnings announcements is weak for companies with strong boards that are more diligent and independent. Further, Zhao and Chen (2008) reveal that fraud firms with CEO duality show weaker governance. Wan-Abdullah et al. (2008) also demonstrate that the

non-independent directors' ownership and CEO duality have an inverse connection with audit quality but not significant.

It is considered that if nomination process of directors on the board is controlled by the shareholders, it restrains the domination tendency of CEO (Baldenius, Melumad, & Meng, 2014). Instead, if a powerful CEO controls the nomination process and appoints directors, the integrity of the board to protect shareholders interests become controversial (Edlin & Stiglitz, 1995). Coles, Daniel, and Naveen (2014) find that CEO power is inversely related to the monitoring intensity of directors. Aktas et al. (2018) argue that CEO duality is linked to lessening in industry adjusted investment and this undesirable impact exists only in firms which face high agency problems. Bliss et al. (2011) provide evidence that politically connected companies that have CEO duality are perceived by audit firms as being of higher risk than CEO duality firms without political connection.

On the other hand, O'Connor et al. (2006) present another view related to CEO duality and power. The study argues that CEOs who serve as board chairpersons' gain influence over the board through members' nominations, compensation plans, etc. This power enables CEOs to shape the governance processes to their own liking. So, the structural power could make it easier for them to ensure the shareholders' interests as per the agency theory's argument. The results reveal that CEO duality moderates the association between CEO's stock options and lesser incidence of fraudulent reporting. The current study ascertains the connection between CEO duality and modified audit opinion as

prior literature has not shown clearly whether or not structural power influences financial reporting quality.

2.5.1.4 CEO Ownership

The aim of CEO ownership is to lessen agency problems by combining the interests of managers and shareholders. Core and Guay (1999), and Murphy (2013) argue that equity-based compensation serves as a governance system and provides strong incentives to management to give value to shareholders. The firm's CEO is the most influential person in the overall management of the company (Cohen et al., 2004; Cormier, 2016). Most of the decisions related to investments, mergers or financial reporting, are under the purview of CEOs. It has been argued that companies with high executive equity ownership have high market valuations and superior long-term stock market returns.

In support of the agency theory, O'Connor et al. (2006) find that probability of fraudulent financial reporting substantially decreases with the CEO's stock options. Al-Duais et al. (2019), report that managerial ownership restrains the utilization of both real and absolute earnings management. Denton et al. (2017) conclude that equity incentives serve as a means to align managers' interests with the shareholders to prevent possible agency problems. The study finds that outside shareholders are inclined to endorse compensation packages which are more responsive to changes in stock price. Liu and Liu (2017) demonstrate that sensitivity of CEO equity portfolio to stock price has a positive impact on company's promptness in avoiding material weaknesses.

However, the counter-argument is that equity ownership provides instantaneous financial incentives to CEOs to inflate short-term financial performance at the cost of long-term benefits. To justify this argument, Bergstresser and Philippon (2006), and Daniel and Naveen (2006) assert that equity ownership could also provoke undesirable behaviors, including earnings manipulation, excessive risk-taking and insider trading. Using the coincident method of equations, Alam et al. (2015) find a negative association between CEO equity incentive and earnings quality, suggesting that executives have enticement to decrease earnings quality. Harris et al. (2019) find that in order to amplify the value of their equity-based incentives, CEOs manipulate earnings.

Moreover, using auditor industry expertise, Jayaraman and Milbourn (2015) conclude that CEO equity incentives are certainly linked to misreporting when auditors' expertise is low. The study implies that auditor's expertise lowers the cost of granting equity-based incentives. Similar to this, the current study examines the relationship between CEO ownership and modified audit opinion issued by external auditor as the overall prior evidence discussed in the literature above is inconclusive and still remains controversial and under-researched (Jayaraman & Milbourn, 2015; Denton et al., 2017).

2.5.1.5 CEO Overconfidence

A psychological or cognitive bias of overestimating the future outcomes of current events is described as overconfidence. Svenson (1981) describes overconfidence is a tendency of humans to think that they are special or "above average". In the same context, corporate policies or financial reporting decisions could be negatively affected by the overconfident or overoptimistic CEOs. Park, Kim, Chang, Lee, and Sung (2015)

establish a negative effect of hubristic or overconfident CEOs on corporate financial performance which is exacerbated if the CEO is powerful. They further suggest that overconfidence creates more entrenchment problems when CEO power is greater, but if the board of directors is more vigilant, this affect is reduced.

Previously, several studies have examined different aspects of CEO overconfidence. For example, overconfident managers are more prone to show an optimistic partiality, and accordingly, are more likely to start down a slippery slope of misstatements (Schrand & Zechman, 2012). Presley and Abbott (2013), report that chances of restating financial statements are higher in the firms managed by highly overconfident executives. Lee (2016) suggests that financial reporting system is impacted by the weakness of internal control, and find a positive association between overconfident CEOs and internal control weakness of the firm.

Studies have also looked into the implications of managerial overconfidence to earnings forecasts (Hribar & Yang, 2016; Libby & Rennekamp, 2012). Using a press-based measure of overconfidence, Hribar and Yang (2016) provide evidence that higher scores of CEO overconfidence are connected with a greater likelihood of optimistic earnings forecasts. They also find that optimistically biased forecasts are more likely to be issued by the overconfident managers because they overrate their aptitude to control the financial consequences or underrate the outcomes.

Several decisions related to finance and risk management of the company are also affected by managerial overconfidence (Adams et al., 2011). Ahmed and Duellman

(2012) contend that overconfident managers are inclined to holdup loss recognition and overestimate the future returns of the firms' investments. This can lead to the misstatements in the financial reporting. Their findings add to the notion that overconfidence influences financial reporting performance of the firm.

Malmendier (2005) finds that corporate investment policies are distorted by the personal characteristics of the CEOs, and overconfident CEOs overestimate the future returns of their companies. Hwang (2014) also links managerial overconfidence to the investment decisions of the firms. He finds a negative association between accounting conservatism and CEO overconfidence. Further, the study states that overconfident CEOs are inclined to hinder loss recognition and utilize less conservative accounting proceedings. The CEOs overconfidence or hubris has substantial practical consequences and could be devastating for the firms (Hayward & Hambrick, 1997).

There are two conventional justifications for investment distortions: one is the incorrect information between the capital market and the corporate insiders (Myers & Majluf, 1984), the other is the mismatch of managerial and shareholders' interests or concerns (Jensen & Meckling, 1976). Overconfident managers overvalue their capability to produce returns as they recognize new projects as value-increasing and commence value devastating mergers (Malmendier & Tate, 2008). This is according to the agency view that managers might overinvest to obtain personal perks and privileges.

It is considered that effective board oversight helps to mitigate the concerns of CEO overconfidence. Banerjee, Humphery-Jenner, and Nanda (2015) find that to some extent

CEO overconfidence benefit the shareholders in terms of profit and its negative effect could be minimized through board. Further, Bollaert and Petit (2010) suggest that an intense hubristic nature may pose a risk to organizations and to their status, and is therefore, an important corporate issue to study. Brennan and Conroy (2013) call for more research into hubristic or overconfident CEOs.

2.5.2 Audit Committee Characteristics

The committee of the board which is responsible for overseeing the process of financial reporting and making sure of proper audit of financial reports is the audit committee. According to SOX Act (2002), the role of audit committee continues to evolve; and with that, the significance of the audit committee chairperson also increases. The establishment of audit committee in Malaysia is mandated for listed firms by Paragraph 15.09 of Bursa's Listing Requirements. Audit committees oversee the financial reporting process and evaluate internal and external audit processes (Lee, Mande, & Ortman, 2004; Bedard, Chtorou, & Courteau, 2004). It helps the board to fulfill its corporate governance responsibilities of overseeing and providing advice and recommendations in relation to the firm's financial reporting, internal control and external audit functions. The requirements of an audit committee differ from country to country, depending on the political and economic conditions.

In public firms, financial reports are typically reviewed by the audit committee annually or sometimes quarterly. Application of latest accounting principles and other regulations are included in the agenda of audit committee meetings. Complicated accounting estimates and judgments formulated by the management are also discussed by the

members of the audit committee with the senior management of the company, like the CFO or CEO. External auditors must also report to the audit committee about different issues, like disagreement with management, accounting adjustments arising from audits, management's choice of accounting principles and any identified fraud or illegal acts. Mollik et al. (2020) argued that audit committee independence has a significant mitigating effect on firms' earnings management.

Previous researchers have explored various factors of audit committee with regards to accounting outcomes. Chang et al. (2017) finds that an effective audit committee is associated with chairperson ownership, members accounting expertise, supervisors, Big-4 auditors, and total assets. In addition, they argued that an ineffective audit committee exists due to the diverse share ownerships and presence of substantial shareholders in the firm. Cohen et al. (2013) suggest that the performance of an audit committee with only accounting expertise is lesser than the performance of a committee with both accounting and industry expertise. They also found that members with supervisory and industry expertise perform better as compared to only supervisory expertise. They concluded that efficacy of the audit committee in overseeing the financial reporting process could be increased if the audit committee members have accounting expertise as well as industry expertise.

Further, Dhaliwal et al. (2010) find that accruals quality is influenced by the audit committee accounting experts who hold few directorships, make independent decisions and have shorter tenure in the firm, and vice versa. They suggest that effective audit committees not only have members with accounting expertise, but who are also

independent. Abbott et al. (2004) find a significantly negative association between the activity level and independence (proxies for diligence) of the audit committee and the prevalence of restatement. They also document that an audit committee with at least one financial expert, is inversely correlated to restatements. The results endorse the BRC's recommendations.

In Malaysian perspective, Haji-Abdullah & Wan-Hussin (2009) conclude that financial distress and audit committee size adversely affect the financial reports quality. Bliss et al. (2011) concluded that role of independent audit committee directors in Malaysian politically connected firms is consistent with the perspective that audit committee independence enhance the effectiveness of corporate governance. Norziaton et al. (2019) find that mandatory regulations related to audit committee including independence and diligence are positively associated with higher audit quality. On the contrary, Wan-Muhammad and Wasiuzzaman (2019) fail to associate the role of audit committee independence in curtailing earnings management activities.

The MCCG (2017) accentuates that the chair of the audit committee is more important as the efficacy of the audit committee often hinges on the role of the chair. The role of audit committee chair is crucial in providing vision and leadership to the other members. The agenda of the audit committee meetings is also managed and set by the chair of audit committee. The audit committee chairperson must be independent and possess financial expertise for proper functioning of the audit committee. Sori, Hamid, Nassir, and Mohamad-Z (2001) argue that audit committee chairman can play an effective role to ensure continuous interactions between the board and external auditors in Malaysian

setting. The ability of audit committee members and chairperson to practice their judgments in an informed and impartial manner is important for the fulfillment of its mandate.

As noticed above, previous studies have used various characteristics of the audit committee with different measures of financial reporting quality but very few have linked these with audit opinion. By having an efficient allocation of resources, an audit committee may effectively manage the control environment, and help in the proper coordination of internal and external audit activities (Sakka & Jarboui, 2015). Li-W and Li-Q (2007) find that competence of audit committee is adversely linked to audit opinion modification. They consider that independence, working procedures and members' expertise determine the extent of efficiency of the audit committee. Chang et al. (2017) find that firms which have an efficient audit committee are less expected to get modified audit opinion. Considering the importance of audit committee in corporate governance, the current study explored the following features of audit committee members and chair in Malaysian setting.

2.5.2.1 Audit Committee Chair Expertise

Regulatory bodies consistently mandate new regulations for the audit committee to ensure the independence and expertise of the members, in response to the increasingly large accounting scandals. For example, by highlighting the significance of the committee's expertise, the SOX Act (2002) requires that all listed companies should have financial experts in the audit committee. Further, the report of the BRC (1999) recommends that to better detect earnings management, financially experienced audit

committee members are more capable. Xie, Davidson, and DaDalt (2003) endorse the recommendations of the BRC and find that firms that have lesser discretionary accruals are linked to an audit committee with financial or industry expert members. The primary objective of the SOX Act and BRC is to enhance financial reporting quality, primarily via audit committee composition and expertise. In Malaysia, the regulators also emphasize on audit committee members accounting and financial expertise. According to listing requirements, an appropriate level of expertise, experience and commitment amongst members is essential to the fulfillment of the committee's mandate (BMLR Paragraph 15.09).

Various studies have previously confirmed that different kinds of expertise, specifically accounting and financial expertise, lead to firms having an effective audit committee, and a positive relationship with quality of financial reporting (Felo, Krishnamurthy, & Solieri, 2003; Bedard et al., 2004; Krishnan & Visvanathan, 2008; Carcello et al., 2011; Kim et al., 2015; Abernathy et al., 2015). Krishnan and Visvnathan (2008) find that financial expert members of audit committee improve accounting conservatism since they have superior monitoring capacity that is driven by their knowledge. Further, the findings also suggest that weak governance mechanisms affect the role of accounting and financial experts in promoting conservative accounting.

Bedard et al. (2004) assert that in limiting earnings management audit committee with financially expert members is more efficient. Further, they suggest that members of the audit committee, who have more expertise, particularly in finance, are more competent in constraining accruals. Through examining the relationship between audit committee

members' financial expertise and earnings management, Carcello et al. (2011) find lesser earnings manipulation when the audit committee members have financial or accounting capabilities. There are also a number of indications that audit committee's with financially expert members support the auditors in accounting disputes with the management more efficiently (DeZoort & Salterio, 2001).

The SOX Act (2002) mandates that all companies should have financially expert members in the audit committee, but some studies have stated that to ensure the competence of audit committee, having only financially expert members is not enough. Financial experts with accounting knowledge perform better in the audit committee than the non-accounting financial experts. Kim, Kwak, Lim, and Yu (2015) are of the view that accounting experts in the audit committee endow more useful internal control system in result auditors efforts reasonably reduced. Further, they observe that chances of deploying high quality auditors, for instance Big-4 or auditors with industry expertise are significantly dependent on the accounting expertise of the members. However, the results are influenced by the moderating effect of CEO power.

The notion that members with accounting expertise should be considered as "financial experts" is an important topic for discussion in the regulatory, academic and investor communities. The US SEC rules (2003) state that persons with either accounting or non-accounting financial expertise can be nominated as "financial experts" for audit committees. By looking at such perspective of expertise, Cohen et al. (2013) recommend that audit committee members who have industry expertise can enhance audit committee efficacy. They posit that control of the external auditor, accounting guidance and

estimates, are often linked to firm's operations within a specific industry, and thus, audit committee members' industry knowledge is valued.

In contrast, the aim of regulators to improve financial reporting quality by imposing new regulations for the listed companies to have financial experts in the audit committee, might result in lower status of audit committee members. That is because the new regulations can lead to the appointment of a person who would not otherwise be considered or appointed for director positions (Erkens & Boner, 2012). Personal attributes, ability to influence outcomes and controlling power of individuals or groups, are the aspects of status (Fischer & Pollock, 2004; Pollock, Chen, Jackson, & Hambrick, 2010). Badolato, Donelson, and Ege (2014) argue that regulatory pressure to include members with financial expertise can decrease the capability of some audit committees to discourage earnings management due to the lack of status. The findings recommend that earnings management decreases when audit committee members hold both status and financial expertise.

The current study argues that financial reporting will be of higher quality if the chairperson of the audit committee has enough financial and accounting knowledge. The significance of the audit committee chair is increased because it provides leadership in setting the overall committee's tone, its agenda and work style. It is vital to ensure the committee's effectiveness and accountability. The MCCG (2017) also asserts that efficacy of the audit committee often hinges on the role of its chair, as the chairperson has the capability to direct deliberations and discussions, and eventually be satisfied that the end result reasonably reflects the understanding of the audit committee. Further, the

most effective audit committee chairs ensure that the right resources are being employed to support financial reporting quality; they set clear expectations for committee members, management and auditors.

In this view, Abernathy et al. (2015) studied the relationship between audit committee chair's accounting expertise and financial reporting timeliness. The finding shows that to resolve the timeliness of financial reporting, accounting expertise of the audit committee chairperson and members is important. Similarly, Baatwah et al. (2019) find that audit committee chair financial expertise is associated with a reduction in audit delay in Oman. The current study examine accounting expertise of audit committee chair in ensuring high quality financial reporting (proxied by modified audit opinion), by keeping in view that audit committee's chair is vital for interactions with management and for effective external and internal audit processes (Bromilow, 2010).

2.5.2.2 Audit Committee Chair Duality

The process of financial reporting is monitored by audit committees on behalf of the firm's shareholders. KPMG (2018) recommends that effectiveness of the audit committee relies heavily on personal attributes of its chair. It is considered that to build and maintain an effective working environment, strong personal skills matter a lot. The role of the chair is different from other audit committee members and crucial for the success of the audit committee (Turley & Zaman, 2007; Hanen, 2019). Beattie et al. (2014) argue that the audit committee chair plays a gate-keeping role.

The audit committee chair must be clear about the responsibilities and duties of the committee to provide effective leadership (Kallamu & Saat, 2015). The chair's ability in handling the audit committee agenda and communicating with the management and board increase the ability of the audit committee in exercising constructive top-down pressure. Management and other members of the committee must recognize the vision and leadership role of the chair in setting the overall tone of the audit committee. To take a "deep dive" into the important accounting policies, estimates or judgments, many audit committee chairs set aside time at each meeting, and some chairs request a summary before the meeting about the company's key accounting estimates and judgments. Ensuring both the timeliness and quality of pre-meeting materials are important functions of the audit committee chair. Akhigbe and Martin (2006) find that audit committee chair independence is positively associated with the quality of financial reporting and lower probability of fraudulent financial reporting.

The usefulness of the audit committee and its chair is reduced when the CEO is more influential (Carcello et al., 2011). Prior literature on duality suggests that CEOs who are also board chair circumvent the governance process in an attempt to shape their firms to their liking (O'Connor et al., 2006). CEO duality has been consistently recognized as a conflict of interest in corporate governance because of the agency costs (Finkelstein, 1992).

Further, audit committee members and its chair control, ensure compliance and monitor the process of financial reporting, to protect the shareholders' interests. Similar to CEO duality power, the audit committee chair also gains structural power by holding the

position of the board chair. The board chair is also a leader who keeps all board members focused on the firm's vision and strategic direction (Barlow, 2016). A powerful audit committee chair will positively affect the financial reporting quality as suggested by the agency theory. There is no prior empirical evidence which has examined audit committee chair duality; however, Yeh et al. (2011) argue that independence improves the power of the audit committee chair to better perform his or her responsibilities. This study contributes to the power theory literature in the perspective of audit committee chair. The strong leadership role of audit committee chair is critical as it urge other members in handling their tasks effectively (Chambers, 2016).

2.5.2.3 Audit Committee Chair Busyness

The chair of the audit committee is being called the hot seat in recent times. In an interview, Alan Ferguson, the audit committee chairman of four companies, states that "the role of the audit committee chair has changed substantially over the years; it is more challenging and high profile than it was 15 years ago, and that's appropriate" (Wilson, 2015). The KPMG Global Audit Committee Survey (2015), which is based on 1,500 audit committee members, reveals that 75% of participants said that to carry out audit committee responsibilities, the amount of time required has increased moderately over the past two years. The survey informs that cyber security, environmental issues, bribery, labor practices and corporate reputation, consume a lot of time and effort of most audit committees. Consequently, the responsibilities and stress rest on the audit committee chair and its members have significantly increased over the time (Bodine & Heid, 2016).

Prior literature on workload has suggested that efficiency of the audit committee could increase through evaluating its chair's busyness (Jaafar et al., 2016). By empirically examining the chair's busyness and financial reporting quality, Tanyi and Smith (2015) find a strong and positive relationship between the number of audit committee chair positions and abnormal accruals. Further, the study argues that firms with busy audit committee chairs are more prone to meet or beat earnings benchmarks. A recent study in Malaysia by Al-Absy et al. (2019) shows that audit committee chair tenure, gender and ethnicity are linked to earnings management; however, the result for number of directorships is not significant. Though chair busyness is an important factor of audit committee effectiveness, to date, little research has been done with the exception of Wan-Hussin, Fitri and Salim (2021). They find that audit committee chair who sits on other board monitoring committee is associated with poor internal auditing practices. The current study explores the relationship between audit chair busyness and modification of audit opinion.

2.5.2.4 Audit Committee Independence

The SOX Act and the Corporate Oversight Bill (2002), accentuate more on the viability and independence of the audit committee and the board (Person, 2005). The audit committee independence assures that management is responsible and will be liable to stakeholders (TWC, 1987; Cadbury Committee, 1992; BRC, 1999). It is argued that the members of the audit committee, who are independent, are more likely to find misappropriation in the firm's financial reporting (Abbott et al., 2004). It is also required by the Bursa Malaysia Listing Requirements Paragraph 15.09 (1) (b) that audit committee should comprise of non-executive directors with mostly being independent.

Many earlier studies have analyzed the effectiveness of the audit committees in alleviating the probability of fraud with different outcomes. Abbott et al. (2004) confirmed that there is significant negative relationship between audit committee independence and fraudulent financial reporting. The study argues that the extent of independence is an appropriate measure of effective oversight of audit committee. The results affirm that audit committee independence and meetings are negatively linked to false or deceptive reporting. Another study by Abbott et al. (2004) has found that independence and action level (proxy for audit committee diligence) of the audit committee has a critical and negative relationship with the incidence of restatements.

Accounting irregularities and concerns with the quality of financial statements have prompted many calls for increasing the efficacy of the audit committee. Bronson, Carcello, Hollingworth, and Neal (2009) analyzed whether or not the requisite for totally independent members is important to play an oversight role. Judith et al. (2019) argue that the audit committee's independence considerably contributes to the success of overall corporate governance performance. Pomeroy and Thornton (2008) conducted a meta-analysis on the affiliation between independent audit committee and financial reporting quality, using various financial reporting quality measures and find different results across different models.

In contrast, Lin, Li, and Yang (2006) do not find a considerable impact of audit committee independence on the reported earnings quality. Kusnadi, Leong, Suwardy, and Wang (2015) also do not find support that increased independence of the audit

committee improves financial reporting quality, since the audit committee already comprises mostly independent directors. Felo et al. (2003) examined the connection between two audit committee attributes, i.e., the size and independence of the audit committee with quality of financial reporting, and find some evidence of a positive connection between the size of the audit committee and financial reporting quality, but in the case of audit committee's independence, they do not find any significant association.

In the context of Malaysia, evidence has shown that increasing the number of independent directors fails to improve board monitoring (Germain et al., 2014). Many independent directors sit on the board of several other companies and devote limited time to strenuous audit tasks unless the directorship is within the same industry (Clements et al., 2015). Also, despite the stringent listing requirement for audit committee to be comprised of independent directors, empirical studies suggest that audit committee independence is unlikely to result in audit committee efficacy unless it is supported by the existence of active audit committee members or industry specialist auditor (Menon & Williams, 2004). Findings on audit committee independence in assuring the quality of financial reporting are not conclusive especially in different corporate governance settings. The current study adds to the body of knowledge on audit committee independence.

2.5.2.5 Audit Committee Meetings

The main function of the audit committee of a firm is to evaluate the process of financial reporting (Larcker et al., 2007). Besides, compensation, appointment and supervision of

auditors are also the responsibility of the audit committee. The external auditors report directly to the audit committee of the firm instead of the CEO. The agenda of the audit committee meetings include the timings, objectives and specific actions that must be performed with regards to the financial reporting and audit processes. It is recommended in the listing requirements that there should be no less than four meetings of audit committee held during the year; and the listed firms ensure that directors and employees only attend meetings on invitation (BMLR, Paragraph 15.13). Due to the functions audit committees perform, previous researchers have considered the frequency of audit committee meetings as a measure of effort and diligence (Menon & Williams, 1994; DeZort et al., 2002; Kalelkar, 2016).

By using an activity-based approach, Collier and Gregory (1999) find that audit committee meeting frequency is a suitable measure of directors' monitoring activities. Chariri et al. (2018) assert that the frequency of audit committee meetings positively influences level of integrated financial reporting. The corporate governance performance index is also positively influenced by audit committee meeting frequency (Judith et al., 2019). The financial statements users perceive the efficacy of the audit committee by its reports and quarterly meetings (Sori et al., 2006). Further, Qamhan et al. (2018) examined the relationship between earnings management and directors' attendance at the audit committee meetings. They find that there is less earnings management if the directors' attendance in audit committee meetings is high. The quality of the audit reports is also higher when there are more audit committee meetings (Asiriwa et al., 2018).

In Malaysian perspective, Kalelkar (2016) argues that audit committee members meet more frequently in the initial year of audit engagement with a new audit partner. They further find that past reporting performance plays a central role in having more meetings of the audit committee. This increase in the number of audit committee meetings positively affects reporting quality. Contrary to above studies, Baatwah (2016) find no significant relationship between modified audit opinion and the number of audit committee meetings. Additionally, Sulehi (2016) reports an inverse association between audit committee meetings and the quality of financial disclosure. Overall, the literature has suggested that number of audit committee meetings is an essential determinant of financial reporting quality; however, its effect on modified audit opinion still needs to be explored further.

2.5.3 External Auditor Characteristics

True and fair financial reporting is central for efficient and valuable capital markets, and to help promote the quality of reporting, the role of external auditors is very crucial. Auditors provide assurance to the stakeholders that financial reports are true and not misstated (PCAOB, 2016). The auditors need to be capable and independent to form an objective opinion about audited financial reports, to perform their responsibility in a trustworthy manner. Habib (2013) concludes that the most appropriate way for independent auditors to report to outside stakeholders on the fairness of the financial records, is the audit report. Eventually, the public's perception of the effectiveness of external auditors is by examining financial statements that significantly influence the reliability of financial reporting.

Auditors are considered as an important external factor that oversees the management's behavior in financial reporting (Cohen et al., 2004). Cohen and Hano (2004) suggest that during the audit process, the overall corporate governance structure is considered by the auditors. They further explain that to control the aggressive behavior of management in financial reporting, auditors hope that the effective monitoring through stronger boards could minimize the risk of irregularities. Carcello et al. (2011) suggest that strong governance is complementary to rather than substituting strong auditing. For example, stronger audit committees and boards are related to stronger auditing. Therefore, in the financial reporting process, the board and audit committee provide internal monitoring and auditors provide external monitoring.

For the confidence of the public, it is fundamental that external auditors ensure the reliability of financial statements. Several issues are involved in assessing the effectiveness of external auditors. To provide objective and independent decisions on the issues having a material effect on financial reports, external auditors must operate in a supportive environment. Lai et al. (2018) suggest that auditors' performance relies on their competence and skills when exercising their role. In addition, as noticed above, the audit report is the ultimate outcome of audit examinations which contains an audit opinion (Porter et al., 2003), and it can be modified or clean on the basis of external auditors' judgment. The modified audit report shows concerns with the financial reporting quality (Sundgren, 2009). Previous studies have looked into the association between various characteristics of external auditors and the propensity of audit report modification, for example, big-4 affiliations, auditor expertise, audit partner tenure, independence of auditor, audit report lag, etc. (Habib, 2013).

In terms of Big-N affiliation, Fung, Zhou, and Zhu (2016) find that the big audit firms are more prone to issue modified audit opinion, and the results are more significant for multinational audit clients and in countries where legal regimes are strong. The results suggest that auditors are more concerned with their reputation rather than lucrative economic benefits of having large clients. Further, in the Malaysian context, Johl et al. (2007) conclude that when there is a high level of abnormal accruals, big five auditors are more likely to issue qualified audit opinion in comparison to their non-big five counterparts. In contrast, Caramanis and Spathis (2006) do not find any relationship between the category of audit firm, either Big-N or non-Big N, and the type of audit opinion. Instead, the result shows that financial metrics, such as operating margin to total assets and the current ratio are associated with audit qualifications.

Another factor that has an impact on audit quality is audit firm or partner rotation (Carey & Simnett, 2006). For instance, Section 203 of SOX Act (2002) asserts that no audit partner can continue auditing for the same client after five years; but some of the critics argue that such a regulation does not necessarily compromise independence. Myers, Myers-A, & Omer (2003) find a positive relationship between audit quality and long tenure, as they assume long tenure improves the client's and industry knowledge and is cost effective. Similarly, Bamahros et al. (2013) suggest earnings management is low when the audit firm tenure is longer. Audit report lag is also an important characteristic and is defined as "the period between a company's fiscal year end and the audit report date, and is one of the few externally observable audit output variables that allows outsiders to gauge audit efficiency" (Bamber, & Schoderbek, 1993). In this regard, Ireland (2003) finds a positive relationship between audit report lag and the probability

of getting modified audit opinion, if there are extended negotiations between the auditor and the clients to resolve disagreements.

This study examined the impact of non-audit fees on the likelihood of receiving modified audit opinion, as previous researchers have found ambiguity in terms of the provision of such fees. DeAngelo (1981) argues that provision of non-audit services may reduce external auditor's independence. Bamahros et al. (2013) argue that the extent of non-audit fees intensifies earnings management, and also suggests moving toward a policy resolution on the restriction of non-audit services in Malaysia. Bystrom and Torung (2016) state there is contradiction that non-audit services along with audit services enhance the auditor's information and result in a more competent and efficient audit. Habib (2012) also examined the empirical studies on the relationship between non-audit services measured by non-audit fees and auditors' tendency to give modified audit opinion and found mixed results.

This study looks at audit partner busyness and the prospect of receiving modified audit opinion. As previous studies have focused more on audit firm characteristics, regulators now are more concerned with the role of individual partners in ensuring the credibility of financial reporting. There is an altercation that a busy partner may not dedicate enough time to correctly audit his or her client due to the workload. Some of the latest studies have examined the relationship between audit partner busyness and various proxies of financial reporting quality, which have led to mixed results in different settings (Goodwin & Wu, 2016; Sundgren & Svanstrom, 2014; Lai et al., 2018).

2.5.3.1 Audit Partner Busyness

The client's audit report and financial statements are signed and approved by the audit partners on behalf of their firm. According to ISA 220, "The engagement partner should take responsibility for the overall quality on each audit engagement to which that partner is assigned". To better perform the responsibilities, audit partners should have appropriate competencies, authority, capabilities and time. Of late, the workload of audit partner has attracted the attention of the regulators and researchers as a factor that influences various accounting outcomes. The PCAOB (2015) has released Audit Quality Indicators (AQIs) and partner workload is one of the important indicators of audit quality. The Audit Oversight Board (AOB) of Malaysia also showed concern regarding partner workload and stated that: "it is imperative for audit partners to have sufficient time to properly lead and supervise audits" (AOB, 2017, p. 29).

Lopez and Peters (2012) recognize that lack of concentration, time to oversee the work and fatigue due to the heavy workload of the audit partner, lead to poor audit quality. Heavy workload increases the busyness of the audit partner and may impact auditing outcomes. Sundgren and Svanstrom (2014) posit an adverse association between audit partner busyness and the probability of receiving going concern audit opinion, based on the argument that audit partner busyness reduces the time the partner has for every client. The findings indicate that there is less possibility for Big4 auditors to have large number of audit assignments. But there is a significant and negative association between the number of assignments Big-4 partners have and going concern opinion in the subsequent year.

Further, consistent with the busyness effect, Gul et al. (2012) report a negative relationship between going concern opinion issuance and audit partner busyness. More specifically, the study finds that in the Chinese regulatory environment, earnings manipulations is more likely to happen when auditors have multiple clients. The negative connection between audit partner busyness and going concern opinion is more pronounced when auditors lack client-specific knowledge. Suzuki and Takada (2016) contend that the auditors may possibly not be able to carry out each audit according to the GAAPs by taking on too many clients, and thus, the required professional competency and diligence are compromised. Using Japanese public firms' data, the results shows that increase in the number of clients allocated to the engagement partner reduces audit quality. The study used restatements and abnormal accruals as audit quality measures and the results are the same for both.

Studies related to the busyness effect have also suggested that audit partners who are responsible for a large number of clients, are possibly linked to lower audit quality. Directors who are holding numerous board seats are "too busy to mind the business" and less effective in their monitoring function (Fich & Shivdasani, 2007). This is also the case for the auditors who are overcommitted and take on more audit assignments, thus becoming "too busy to implement the audit standards in their engagements" and less effective in detecting irregularities in financial statements (Caramanis & Lennox, 2008); thus, the reporting quality is adversely affected. Contrary to above studies on auditor workload, Goodwin and Wu (2016) find that there is no association between audit partner busyness and audit quality. Their results show that there is lack of consistency between audit partner busyness and audit quality association. Karjalainen (2011)

evidence on Finnish companies shows a positive affiliation between audit partner busyness and the absolute value of discretionary accruals. The results are more significant, particularly in the case of large clients and Big-4 audit firms.

In the Malaysian context, Lai et al. (2018) argue that quality of financial reporting is influenced by the individual auditor busyness. The study finds that higher earnings management (proxied by discretionary and total accruals) is linked with the auditors having multiple clients in the subsequent year. Wan-Hussin et al. (2018) argued that partner workload is positively associated with audit report lag, and this effect is more obvious in case of non-big 4, busy season, and short partner tenure. Further, a questionnaire based study by Ismail et al. (2019) concluded that auditor's workload perceived negatively with regards to audit quality in Malaysia.

The agency theory of Jensen and Meckling (1976), postulates that companies assign external independent auditors to reduce agency costs. The current study investigates the effect of audit partner busyness on the propensity to receive modified audit opinions (the proxy for poor financial reporting quality). Indeed, prior literature has shown that the number of clients assigned to a partner represents workload and has an adverse effect on audit quality (Gul et al., 2012; Sundgren & Svanstrom, 2014; Lai et al., 2018; Ismail et al., 2019). In dissimilar, Goodwin and Wu (2016) used a sample of Australian public listed firms and find an insignificant association between busy auditors and audit quality proxies. So, the relationship linking audit partner busyness and accounting outcomes is ambiguous and not clear.

2.5.3.2 Non-audit Fees

A reasonable written assurance from an independent authority that financial reports are prepared in accordance with the accounting standards is the core objective of the audit function. If users of the audit reports deem that auditors are not free from the influence of management, directors or their own conflicting interests, the objective of a credible financial reporting will not be met. The newly released auditing standards of the PCAOB (2015) states that “To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners”. The regulators have been concerned with auditor independence over the years, and have taken actions to mitigate those concerns. Since it is impossible to measure personal integrity and mental attitude of a person, so many difficulties lie in determining the independence and objectiveness of the auditor. Even if the auditor is independent, in reality, one or more factors may raise questions about the fairness and independence of the audit report. The IOSCO (2002), states that auditors should be independent in appearance and actual both.

Initially, the SOX Act (2002) restricts external auditors from providing non-audit services to their clients, as it may compromise auditors’ independence. DeAngelo (1981) suggests that independence and truthfulness of auditors in reporting irregularities is more important with the larger client portfolios. PCAOB (2013) is of the view that to increase auditor independence and objectivity, the name of the engaged partner must be disclosed in the audit report. Providing extra services while performing the audit function is a common practice for the audit firms, for example, helping audit clients to decrease its tax charges or act as a consultant in implementing new systems. As a consequence, the

auditor independence maybe is at stake. Further, if the proportion of non-audit fees is substantial compared to audit fees, the auditor's independence is questionable. Markelevich and Rosner (2013) report that the prospect of being charged by the SEC for fraud is considerably allied with the non- audit services.

The MCCG (2017) recommend that auditor's independence and objectivity cannot be compromised as a result of the extent and nature of the non-audit services rendered. In this regard, Krishnan (2019) argued that there is no prohibition in the MCCG (2017) and Companies Act (2016) on providing non-audit services. He suggest that regulations should be amended for providing non-audit services as this is the way to enhance auditor's independence and integrity. Haji-Abdullah et al. (2017) empirically evidenced that joint provision of audit and non-audit services provided by the external auditors is significantly associated with fraudulent financial reporting in Malaysian setting. In contrast, Abu-Bakar (2018) argued that in family owned firms of Malaysia, there is no significant relationship between non-audit services and the issuance of qualified audit report, suggesting that in family owned firms, auditor independence is not compromised.

It is acknowledged that auditors play an agency role to guarantee the credibility of financial reporting (Cohen et al., 2004); however, non-audit services may decrease significance of auditor's role. Because of the possible compromise of independence, clients are less eager to attain non-audit services from external auditors (Parkash & Venable, 1993). Similarly, Abbott, Parker, and Peters (2012) find that non-audit services are negatively related to firms looking for financing, following the SEC regulation for fee exposure, and larger firms are less inclined to obtain non-audit services. Firth (1997)

also confirms that non-audit services have an inverse association with the higher agency cost of firms.

Several studies, by using accruals as the indication of financial reporting quality (Frankel, Johnson & Nelson, 2002), have found that accruals quality is abnormally correlated to non-audit service fees. Gul, Jaggi, and Krishnan (2007) document that when non-audit services are provided, the quality of accruals is low and more extensive when tenure of the auditor and client size is small. Instead of accruals, by using restatements as an indication of low quality financial reporting, analysts have argued that non-audit fees leads to poor quality financial reporting (Ferguson, Seow, & Young, 2004). From the perspective of audit litigation, Schmidt (2012) finds that higher non-audit service fees leads to an increased probability of litigation due to the restatements. Bystrom and Torung (2016) argue that larger clients may possess the ability to unduly affect auditors' independence by paying high non-audit fees. This result justifies that economic dependency restrain auditors to be fully independent.

Contrary to the above, clients have the benefit of high quality non-audit services at comparatively low cost. Non-audit services are considered more beneficial in economic terms for auditors. Knechel and Sharma (2012) argue that benefits from joint settlement of non-audit services and fees are important for both parties. Short audit report lag, more predictable future cash flows, low information risk and improved earnings quality, are some of the incentives which have been suggested by previous studies (Nam & Ronen, 2012; Koh, Rajgopal & Srinivasan, 2013). In addition, some studies have observed an insignificant association between audit fees (either the provision or magnitude) and non-

audit services (Davis, Ricchiute, & Trompeter, 1993; Whisenant, Swamy, & Raghunandan, 2003).

Based on the investigation of auditors' reporting choices and the accruals quality, a number of studies have not found any confirmation that non-audit services damage actual audit quality. For example, Lassila, Omer, Shelley, and Smith (2010) argue that the use of the auditor for tax services is positively linked to corporate governance efficacy. Hence, empirical evidence related to non-audit services is mixed (Bystrom & Torung, 2016), and there is need to more deeply explore the concept. The current study examines the association between non-audit fees and the quality of financial reporting in the Malaysian setting.

2.6 Summary

In this chapter, a general understanding of modified audit opinion as an indication of low financial reporting quality is provided. The types of modification and its measures are also discussed in line with previous research. Further the theoretical framework is provided on the role of the financial reporting triangle of the corporate governance mosaic. Some new variables are presented after a review of the previous literature, for example, audit committee chair duality and busyness.

CHAPTER THREE: RESEARCH FRAMEWORK, HYPOTHESES, METHODOLOGY AND DATA

3.1 Introduction

The section 3.2 of the chapter presents the research framework of the study. Research philosophy, paradigm and hypotheses are presented in sections 3.3 and 3.4. The section 3.5 presents the statistical model and the description of dependent and independent variables. The control variables incorporated into the model also explained in this section. Next section 3.6 discusses the sampling method and population of the study. The source and type of data is explained in section 3.7. Next, the methods of statistical analysis are explained and the final section 3.9 sums up the chapter with a comprehensive summary.

3.2 Research Framework

On the basis of literature review the following conceptual framework is developed in this study:

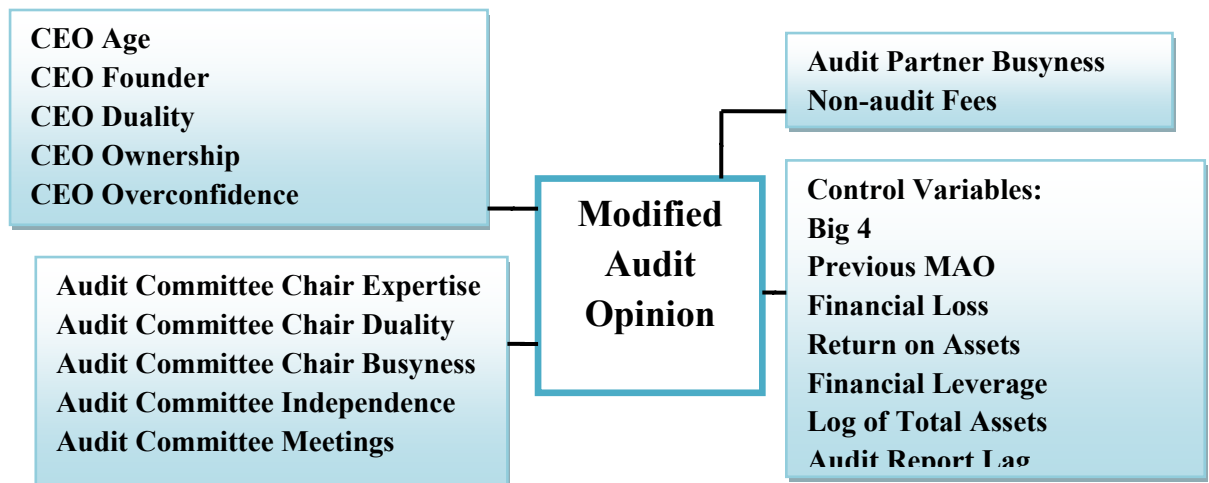


Figure 3.1 Research Framework

3.3 Positivism Paradigm

Positivism appeared as a theoretical paradigm in 19th century by Auguste Comte, asserts that only scientific facts can disclose the certainty of the realism (Leong, 2008). In the 20th century, it was formally recognized as the leading scientific technique by members of the Vienna Circle (Neurath, 1973). As a philosophy, positivism holds the prospect that only “factual” knowledge obtained by observations, along with its dimensions, is trustworthy. Positivism is based on experimental observations that lead toward statistical analysis. The positivist paradigm is mostly used in social sciences because the real events can be examined rationally and illustrated with logical scrutiny (Clark & Dudrick, 2004).

The positivistic paradigm is explained through quantitative or scientific techniques based on the deductive orientation method to explain and analyze the hypotheses tested concerning the association between the measurable variables (Neuman, 1997). This is because it presumes that reality is „objective“ or not dependent on the observers. Hence, the quantitative approach gives room to establish the causal association between variables. It also provides a significant understanding, or better still, improves our understanding of how many variables of interest are interrelated with one another (Crowther & Lancaster, 2008). This approach utilizes scientific techniques to identify the research questions and method of sampling based on the research framework. The research questions constructed under the positivism approach are represented in the form of hypotheses and mathematical equations. This is followed by the use of statistical analyses and econometric measures for hypotheses testing, and providing answers to the research questions, as well as for making the necessary inferences and forecasts.

This research aims to inspect the role of management, audit committee and external auditor in the likelihood of modified audit opinion issuance in Malaysia. Previously, the quantitative technique has been used in studies for the analysis of financial and non-financial data to establish corporate governance efficiency. So, on the basis of prior literature and advantages of the positivism paradigm, this study also employs a quantitative approach. A set of non-financial independent variables are tested empirically on the possibility of receiving modified audit opinion by Malaysian listed firms. The key rationale of this method is to ascertain the association between the dependent variable and the explanatory and control variables employed in this research.

3.4 Hypotheses Development

The following hypotheses are employed on the basis of the agency, power and upper echelon theories to examine the extent and direction of the influence of management characteristics, audit committee characteristics and external auditor characteristics on the issuance of modified audit opinion.

3.4.1 Management Characteristics

The study developed five hypothesis related to the management characteristics, namely CEO age, CEO founder, CEO duality, CEO ownership and CEO overconfidence.

3.4.1.1 CEO Age

In public corporations, the scope of the CEO is very vast and age plays an imperative role in the development of his or her behavior (Mudrack, 1989). Young executives are more concerned with their career development and the job market motivates them to

serve the interests of shareholders. As they approach retirement, career concerns play a lesser role or become extraneous in shaping their behavior and incentives based on current compensations become more relevant (Gibbons & Murphy, 1992). As this career horizon problem occurs, potential agency problems increase. The CEO is in charge the most for the organizational decisions, including effective management of uncertainties, which ultimately affects the firm's processes and outcomes (Cohen et al., 2004). By having considerable influence on the other players of the financial reporting process (Carcello et al., 2011); the CEO horizon problem may lead to misstatements or low quality financial reporting.

This view is echoed in prior studies (Buchholtz et al., 2003; Ali & Zhang, 2015; Davidson et al., 2007; Khuong & Xuan-Vy, 2017) related to CEO age. For example, Conyon and Florou (2003) argue that CEOs cut back the capital expenditure as they become older because they are motivated by the desire to increase present income that accrues from a golden parachute during takeover. But the horizon problem leading to increased agency costs is still an under-researched empirical issue (Serfling, 2014). The current study proposes that the CEO horizon problem increases the prospect of receiving modified audit opinion as older CEOs may involve themselves in upward earnings or misstate the financial reports which could benefit their current compensation. The first hypothesis is:

H1: *There is a positive association between the CEO age and the modified audit opinion, all else constant.*

3.4.1.2 CEO Founder

Instead of maximizing shareholders' wealth, more powerful CEOs seek ways to increase their own compensation (Pavlik, Scott, & Tiessen, 1993). There is no systematic relationship of optimal CEO power with the performance of the firm. Grossman and Hart (1983) suggest that to minimize the agency cost, the board tries to pursue efficient monitoring of executives. But independent directors do not seem effective in preventing financial misreporting if the firm CEO is stronger (Cohen et al., 2012; Cormier et al., 2016). The effectiveness of the audit committee is also reduced due to the influence of a powerful CEO (Carcello et al., 2011). Ownership is one of the CEO's power attributes gained inherently from their status as founder of the firm, which could potentially influence financial reporting quality.

According to the agency theory of Jensen and Meckling (1976), audit committee performs the monitoring role to control management pressure on the financial reporting process. A powerful CEO possibly will provide less or inferior quality information to the audit committee, which will obstruct the capability of the audit committees to efficiently examine the financial reporting process (Harris & Raviv, 2008). The power theory also argues that if CEOs have strong influence, they may appoint directors who are just fulfilling the regulatory requirements but who are less challenging to them. Bebchuk and Fried (2004) find that powerful CEO can control the board to get high compensation. So, based on this argument, it is projects that founder CEOs have more influence on the organizational policies and decisions regarding financial reporting outcomes which may lead to the possibility of modified audit opinion. Hence, the second hypothesis is:

H2: There is a positive association between the CEO founder and the modified audit opinion, all else constant.

3.4.1.3 CEO Duality

CEO duality refers to the non-separated roles of the CEO and the chairperson of the board. In normal circumstances, boards chaired by the CEO are alleged as ineffectual since a conflict of interest might arise. Albuquerque and Miao (2013) premise that CEOs are the primary supporters of governance change. The CEOs will tend to expend more effort in controlling the board in the absence of effective investor protection. From this barricade perception, powerful CEOs can execute massive sway over the boards, to establish appropriate strategies (Bebchuk & Fried, 2004).

Prior studies have also suggested that CEO duality negatively affects financial reporting quality. DeBoskey et al. (2018) find that firms with more powerful CEOs use more bullish tones in earnings announcements. Hashim and Devi (2008) argue that independence of directors and separation of the CEO and chairperson roles reduces the incidence of earnings management to some extent. More recently, Al-Duais et al. (2019), show that CEO duality increases the real earnings management.

The current study proposes hypothesis align to the agency theory that the prime function of the board is to oversee management. This role of the board is impeded when the CEO also serves as the chair of the board. The concerned shareholders feel that an integrated role leads to the lack of supervision and decreases the independence of the board. Various international jurisdictions, such as in South Africa and the UK, support the

separation of roles in their guidelines and best practices codes. Moreover, Kang and Zardkoohi (2005) state that if duality is adopted, the governance decisions are probably to support self-serving behavior of the top executives rather than maximizing the wealth of shareholders, which may lead to low quality financial reporting. So, the third hypothesis is:

H3: There is a positive association between the CEO duality and the modified audit opinion, all else constant.

3.4.1.4 CEO Ownership

The ownership structure conceivably is one of the most important corporate governance features, as it determines the “balance of power” in the company. It is argued that CEOs shareholding ownership is a source of power for them because it gives them voting right in firms decisions (Finkelstein, 1992). In this regard, prior studies indicate that CEOs significant ownership serves as a de facto governance mechanism that aligns management interests with shareholders (Bebchuk & Fried, 2004; Busenbark et al., 2016). Further, Tee (2019) concluded that alignment effect of CEO power is stronger than their entrenchment effect in Malaysian setting.

The agency theory suggest that shareholders are concerned by the divergence of interests between firm’s management, and try to lessen this by incentive packages that tie the CEO’s wealth to improving firm value (Core & Guay, 1999; Murphy, 2013; Denton et al., 2017). Hence, CEOs will have greater motivation to create economic value, as actions that damage company value will reduce the executive’s own wealth. The

incentive provided by shareholding ownership is at least as significant and often sways the incentive provided by standard annual compensation. Ownership also affects risk taking and executives' attitude toward risk is usually prompt by the potential payoff.

On the basis of above arguments, the current study proposes that CEO ownership increases the financial reporting quality and helps to reduce agency costs (entrenchment effect) between management and shareholders. An audit opinion disseminates the external auditor's point of view about the quality of the financial report and if auditors find irregularities or misstatements, they issue modification (Farinha & Viana, 2009; Chen et al., 2016). By combining CEO and shareholders' interest, there can be a decrease in accounting results manipulation. Thus, the fourth hypothesis is:

***H4:** There is a negative association between the CEO ownership and the modified audit opinion, all else constant.*

3.4.1.5 CEO Overconfidence

Overconfidence is a psychological state of a person of feeling superior. Amongst various CEO characteristics, overconfidence has received more intellectual consideration. Overconfident CEOs possibly will be more disturbing, because they have a strong belief that they can do nothing wrong although they misbehave. Malmendier and Tate (2008) identify that hubristic CEOs could endanger the organization, as they have a stubborn conviction that they are performing for the benefit of shareholders, even when they are involved in value destroying activities.

The research has found adverse impact of overconfidence on the probability of accounting and auditing releases (Schrand & Zechman, 2012); and the prospect of delivering a management forecast (Hribar & Yang, 2016; Liby & Rennekamp, 2012). Further, Lee et al. (2016) advocate that overconfident CEOs can ignore the significance of internal control over financial reporting. Malmendier and Tate (2008) also illustrate that CEO overconfidence is certainly linked to value-destroying mergers and acquisitions. Deshmukh, Goel, and Howe (2013) state that organizations with overconfident CEOs are expected to disburse lesser dividends.

Related previous studies have shown CEO overconfidence is negatively linked to the firms' quality of financial reporting, through accounting conservatism, restatements and earnings management. The powerful CEOs' negative influence on the financial reporting quality is greater if they are also overconfident. Overconfident CEOs may overvalue the earnings or understate the losses of the company for personal interests, which will clearly affect financial reporting quality. To sum up, this study enriches the literature by investigating the effect of CEO overconfidence on the prospect of receiving modified audit opinion (proxy of financial reporting quality). So, the fifth hypothesis is:

H5: *There is a positive association between the CEO overconfidence and the modified audit opinion, all else constant.*

3.4.2 Audit Committee Chair Characteristics

The study constructed five hypothesis related to the audit committees characteristics of the sample firms. The factors are included into the research model on the basis of following explanations:

3.4.2.1 Audit Committee Chair Expertise

In accordance with the agency theory, greater audit committee effectiveness is a consequence of increase in the number of its members who are accounting and financial experts. This is because audit committee members with sufficient expertise in financial matters have enough knowledge to assess whether or not accounting proceedings reflect the economic essence of the transactions well and whether or not the estimates and inferences are realistic. This leads to the resolution of difficult accounting matters and higher financial reporting quality (Cohen, Krishnamoorthy, & Wright, 2008), thereby decreasing the prospect of receiving a modified audit opinion. This impact will be more effective if the chairperson of the audit committee has accounting expertise.

The audit committee chair must recognize that the audit committee's effectiveness is an evolving process that requires being updated with fast changing business developments. So, the audit committee chair should have the knowledge needed to evaluate the information it receives and on which he or she will base his or her decisions. Zaman and Sarens (2013) assert that the audit committee's unofficial interactions are extensively and positively related to independence, audit committee chair's knowledge and experience, and the audit quality. Further, Beattie et al. (2014) conclude that chairpersons of audit committees play a gate-keeping role.

The audit committees chair executes a decisive role in governance outcomes. Turley and Zaman (2007) find that risk management, financial reporting and control outcomes are influenced by the audit committee chair's background, and the manner in which the chair is looked up to by those involved in the governance process in the firm together with the higher management. Abernathy et al. (2015), Baatwah et al. (2019), and Ghafran & Yasmin (2017) find a positive connection between audit committee chair's accounting expertise and financial reporting timeliness.

It is supposed that the audit committee chair with financial or accounting expertise will enhance the overall audit committee's performance, which accordingly, will lead to better internal control in the company and better financial reporting quality. An audit committee chair having extensive knowledge regarding auditing and financial reporting is likely to comprehend the auditor's decisions and judgments and be more inclined to give the auditor support in cases of dispute with management. As a result, there would be a decrease in the incidence of getting a modified audit opinion.

This study empirically investigates the relationship between the audit committee chair's accounting expertise and the probability of getting modified audit opinion. The assumption is aligned with the agency theory's proposition that an audit committee chair with accounting expertise helps in assuring high quality financial reports. Thus sixth hypothesis is:

H6: There is a negative association between the audit committee chair expertise and the modified audit opinion, all else constant.

3.4.2.2 Audit Committee Chair Duality

The audit committee members, who are truly independent and determined, are essential for resolving disagreements. The most important member of the audit committee is its chair who acknowledges the efforts of others while working jointly for the benefit of the firm and its stakeholders. The chair of the audit committee must work not only with sincerity but also with grace that inspires others to speak out, and that convinces rather than confronts so as to obtain good results. The effective role of the audit committee chair is vital for the committee's overall performance (Ghafran & Yasmin, 2017). The role of the audit committee and its chair is more challenging and demanding as of late, regulators (MCCG, 2017; CPAB, 2019) and investors have become more concerned with the credibility of financial reporting.

Currently, the audit committee and its chair must handle greater burden of oversight of financial reporting independently and freely, especially in the presence of powerful top management (Ginesti et al., 2017; Aktas et al., 2018). It is assumed that more powerful audit committee chair can play its role more efficiently without any undue influence. Inspired by the power theory, this study suggests that the audit committee's chairperson also gains his or her power from dual position. The leadership character of the audit committee chairperson as board chair enhances the power and capability to influence complicated issues and manage intense agendas which eventually lead to higher quality of financial reporting. The seventh hypothesis is:

***H7:** There is a negative association between the audit committee chair duality and the modified audit opinion, all else constant.*

3.4.2.3 Audit Committee Chair Busyness

The role of the audit committee chair involves a multitude of procedural and formal obligations. For example, the chair of the audit committee should plan committee meetings and also ascertain the agenda together with the management, board chairman, members of the committee and the external auditors. They must ensure that the financial statements, managerial disputes and observations and other supporting documents are distributed prior to the meeting (KPMG, 2018). This study predicts that a busy audit committee chair is less efficient in executing his or her role, which might increase the likelihood of a firm receiving modified audit opinion.

The argument is aligned with the previous studies of Bodine and Heid (2016), Tanyi and Smith (2015), Jaafar et al. (2016) and Al-Absy et al. (2019), which have examined the role of the chair. Since audit committees with busy chairs are less likely to fulfill their overseeing role efficiently, the eighth hypothesis is:

***H8:** There is a positive association between the audit committee chair busyness and the modified audit opinion, all else constant.*

3.4.2.4 Audit Committee Independence

The SOX Act (2002) in the US obliges the audit committees to completely comprise independent members to perform its responsibilities, such as appointment of external auditors and also to set proceedings for managing complaints related to auditing and accounting matters. By following the international standards, MCCG (2012, 2017) also postulates that an independent audit committee can support the board's monitoring

functions. Enhanced financial reporting quality has been quoted as one of the main reasons for firms to set up an audit committee (BRC, 1999). The prime focus of regulatory efforts is an independent audit committee to ensure the credibility of financial reports. Baxter and Cotter (2009), Abbott et al. (2004), Davidson, Stewart, and Kent (2005), Yang and Krishnan (2005) and Judith et al. (2019) argue that audit committee's independent members are efficient and not as likely to neglect faults in the financial statements.

This study proposes that the independent members of the audit committee are likely to lessen the propensity of a firm to obtain modified audit opinion. The significance of the audit committee to ensure financial reporting quality comes from the agency problems. The theory specifies that the audit committee and board serve as agents to protect shareholders' interests. If the audit committee is more independent from the influence of management, it can better oversee the financial reporting process. Klein (2002) finds that earnings management is inversely affected by audit committee independence. The ninth hypothesis is:

***H9:** There is a negative association between the audit committee independence and the modified audit opinion, all else constant.*

3.4.2.5 Audit Committee Meetings

The audit committee is considered as a critical corporate governance mechanism (Gendron, 2004). This study proposes that audit committee members can decrease the frequency of reporting failures by diligently monitoring the financial report. The

members' diligence is signified by the number of audit committee meetings (Kalekar, 2016; Judith et al., 2019). If there are less reporting irregularities, there are fewer chances that the company will receive modified audit opinion. Extant studies have suggested a significantly inverse association between the number of audit committee meetings and chances of restatements (Abbot et al., 2004). Abbot et al. (2002) and Beasley et al. (2000) show low possibility of frauds with a higher number of audit committee meetings. Recently, Qamhan et al. (2018) support the argument by reporting a negative relationship between earnings management and audit committee meeting frequency.

Prior studies have concluded that audit committee activities are essential for limiting the tendency of executives to engage in misreporting or irregularities. Auditors' monitoring provides assertion to the users of the financial statement concerning the reliability of the reports; so an increase in the number of audit committee meetings serves as a governance system expected to strengthen the auditor's practices. The tenth hypothesis is:

***H10:** There is a negative association between the audit committee meetings and the modified audit opinion, all else constant.*

3.4.3 External Auditor Characteristics

In relation to external auditor characteristics, the study includes two hypotheses, i.e., audit partner busyness and non-audit fee.

3.4.3.1 Audit Partner Busyness

The audit process is an important component of a firm's financial reporting quality. It is considered that excessive workload reduces efficiency of the audit partner's engagement with the client. Busy auditors can increase audit report lag because of the excessive work (Wan-Hussin et al., 2018). This busyness effect is based on the premise that the time in which external auditors have to accomplish their audit work is limited, and so, they mostly focus on verifying the legality of the transactions and outcomes instead of vigorously inspecting details. Prior studies on the "busyness effect" have argued that auditors with several clients are linked to low quality audits (Gul et al., 2014; Suzuki & Takada, 2016; Sundgren & Svanstrom, 2014; Ocak, 2018). In the Malaysian context, Lai et al. (2018) also find a negative connection between earnings quality and busy auditors.

As audit is an essential function and cannot be handled dismissively; it is important that external auditors examine the accounts in detail and engage with the clients properly. This study proposes that busy audit partners are less expected to perform efficient audits. The chances for auditors to find irregularities or misstatements in the financial reports are less with multiple clients and the tendency to render modified audit opinion is low. Thus, the eleventh hypothesis is:

H11: There is a negative association between the audit partner busyness and the modified audit opinion, all else constant.

3.4.3.2 Non-audit Fees

The quality of the audited financial statements is usually taken into consideration when a company fails or is charged for financial fraud. In general, the allegation is made that external auditors allowed improper handling of accounting because they are not as independent in their role. Auditors behave in such a way as they have financial benefits of delivering services which are not related to the audit of firm reports; so their impartiality is questioned by over relying on income from non-audit fees. To make certain of independence, MCCG (2017) supports the view of restricting auditors from providing any non-audit service to the clients.

When a statutory auditors provides any non-audit services to the client firms, they serves as an agent to the management and the managers then opportunistically exploit the economic bond to influence the auditing outcome (Bamahros et al., 2015). A previous study by Mishra, Raghunandan, and Rama (2005) finds that the audit related fees are favorable to shareholders, while tax and other consulting service fees are unfavorable. Another study reports a significantly positive relationship between higher discretionary accruals and non-audit services fee (Gul et al., 2007).

The main objective of the external audit process is to provide reliable financial statements to users and the independence of external auditor ensures that this process is transported through an objective approach. Independent auditors are usually more helpful in shielding shareholders and investors from the deceptive or misleading financial information. The MCCG (2017) also provides guidance for independent auditors in rendering the non-audit services. So, the current study premises that auditors

with high non-audit fee are not independent and less expected to give modified audit opinions. The twelfth hypothesis is:

H12: There is a negative association between the non-audit fee and the modified audit opinion, all else constant.

3.4.4 Interaction Effects

The following hypotheses are proposed to examine the interactions between various characteristics of management and audit committee included in the study.

3.4.4.1 Interaction between CEO Age and CEO Founder

Previous literature discussed that older CEOs are more prone to involve in earnings management in order to maximize their post retirement benefits (Elizabeth et al., 2009; Fang et al., 2018). Davidson et al. (2007) and Khuong and Xuan-Vy (2017) also illustrate that CEO age is negatively associated with the financial reporting quality. So, it is arguable that if the older CEO is also a powerful CEO then the said impact will be deeper. In this regard one of the most important indicators of CEO power is founder ship (Finkelstein, 1992), and CEO age can be a potential moderator in influencing corporate decisions.

The role of family ownership is a significant feature of corporate governance landscape in Malaysia. The empirical result of Tee (2019) and Hasnan et al. (2013) concluded that founder CEO is more influential and linked with the low financial reporting quality in Malaysian setting. On the basis of horizon effect this study proposed that interaction

between CEO age and CEO founder positively allied with receiving modified audit opinion. The thirteenth hypothesis is:

H13: There is a positive association between the CEO age and the CEO founder interaction and the modified audit opinion, all else constant.

3.4.4.2 Interaction between Audit Committee Independence and CEO Duality

The dual position in the firm gives CEOs structural power which they can use for personal interests. Ginesti et al. (2017) and DeBoskey et al. (2018) found that CEO structural power is intensified when the CEO serves in a dual leadership role. In this regard, audit committee's role is very significant to ensure the high quality financial reporting. SOX Act (2002), MCCG (2017) and other regulatory frameworks imposes the requirement for the listed firms that their audit committees should be composed of independent directors.

The agency theory of Jensen and Meckling (1976) provides the guidelines related to principal agent roles. It is argued that more independent audit committee limits the negative role of powerful CEO and protects shareholders interests. So, this study proposed that audit committee independence have moderating effect on CEO duality power and leads to better financial reporting quality in Malaysia. Thus, the last and fourteenth hypothesis is:

H14: There is a negative association between the audit committee independence and the CEO duality interaction and the modified audit opinion, all else constant.

3.5 Research Models

To test the extent and influence of each independent variable on the tendency of a firm to receive modified audit opinion the following multivariate regression models has been developed. The statistical model is a mathematical model that symbolizes a set of assumptions concurring the generation of a sample data. It is easy to compare the results of mathematical model with observational of conceptual model and to identify its strengths and weaknesses.

The model equation 1 consists of twelve hypothetical variables linked to the management, audit committee and external auditor characteristics. Further, model equations 2 and 3 are included to test the interaction effects.

$$MAO_{it} = \beta_0 + \beta_1 CEOAGE_{it} + \beta_2 CEOFOUND_{it} + \beta_3 CEODUAL_{it} + \beta_4 CEOOWN_{it} + \beta_5 CEOOC_{it} + \beta_6 ACCEXP_{it} + \beta_7 ACCDUAL_{it} + \beta_8 ACCBUSY_{it} + \beta_9 ACINDP_{it} + \beta_{10} ACMEET_{it} + \beta_{11} APBUSY_{it} + \beta_{12} LnNAF_{it} + \beta_{13} BIG4_{it} + \beta_{14} PMAO_{it} + \beta_{15} LOSS_{it} + \beta_{16} ROA_{it} + \beta_{17} LEV_{it} + \beta_{18} LnTA_{it} + \beta_{19} ARLAG_{it} + \varepsilon_{it} \quad (1)$$

$$MAO_{it} = \beta_0 + \beta_1 CEOAGE_{it} + \beta_2 CEOFOUND_{it} + \beta_3 CEODUAL_{it} + \beta_4 CEOOWN_{it} + \beta_5 CEOOC_{it} + \beta_6 CEOAGE_{it} \times CEOFOUND_{it} + \beta_7 ACCEXP_{it} + \beta_8 ACCDUAL_{it} + \beta_9 ACCBUSY_{it} + \beta_{10} ACINDP_{it} + \beta_{11} ACMEE_{it} + \beta_{12} APBUSY_{it} + \beta_{13} LnNAF_{it} + \beta_{14} BIG4_{it} + \beta_{15} PMAO_{it} + \beta_{16} LOSS_{it} + \beta_{17} ROA_{it} + \beta_{18} LEV_{it} + \beta_{19} LnTA_{it} + \beta_{20} ARLAG_{it} + \varepsilon_{it} \quad (2)$$

$$MAO_{it} = \beta_0 + \beta_1 CEOAGE_{it} + \beta_2 CEOFOUND_{it} + \beta_3 CEODUAL_{it} + \beta_4 CEOOWN_{it} + \beta_5 CEOOC_{it} + \beta_6 ACINDP_{it} \times CEODUAL_{it} + \beta_7 ACCEXP_{it} + \beta_8 ACCDUAL_{it} + \beta_9 ACCBUSY_{it} + \beta_{10} ACINDP_{it} + \beta_{11} ACMEE_{it} + \beta_{12} APBUSY_{it} + \beta_{13} LnNAF_{it} + \beta_{14} BIG4_{it} + \beta_{15} PMAO_{it} + \beta_{16} LOSS_{it} + \beta_{17} ROA_{it} + \beta_{18} LEV_{it} + \beta_{19} LnTA_{it} + \beta_{20} ARLAG_{it} + \varepsilon_{it} \quad (3)$$

Where, MAO_{it} is the dependent variable and β_1 to β_{20} represents the coefficient parameters of independent variables. The ε_{it} is the error term represents the margin of error of the statistical models.

3.5.1 Description and Measurement of Main Variables

The dependent variable modified audit opinion tested as a proxy of poor quality financial reporting. It measured as a binary variable which takes the value of „1“ if the opinion is modified (e.g. disclaimer, qualified or adverse) and otherwise „0“. Prior studies by Johl et al. (2007), Farinha and Viana (2009), Mendez et al. (2016), and Chen et al. (2016) also used the similar measurement of financial reporting quality.

Independent variable *CEOAGE* is the age of the chief executive officer measured in years. The age based differences have a considerable impact on the behavior of individuals (Huang et al., 2012). The variable *CEOFOUND* is the status of chief executive officer as the founder of the company. It takes the value of „1“ if the CEO or MD is the founder or relative of the founder of the firm, otherwise „0“. Earlier studies recommend that the founder status indicates the ownership power of the CEO (Finkelstein, 1992; Hasnan et al., 2013). The third variable *CEODUAL* is the dual position of the company's CEO as the chair of the board also. The value of „1“ is assigned if the firm's CEO is the chairperson of the board as well, otherwise „0“. Finkelstein (1992), Malmendier (2012), and Ginesti et al. (2017) considered CEO duality as an important source of his or her influence on the other players of corporate governance.

The variable *CEOOWN* is the shareholding ownership, the firm's chief executive officer holds. It is measured as the total value of direct and indirect shares in percentage CEO own at the end of the year. O'Connor et al. (2006) and Denton et al. (2017) argued that management incentives help to mitigate agency problems. The last variable related to management characteristics is CEO overconfidence. The *CEOOC* is calculated as the ratio of capital expenditure over the lagged total assets of the firm in consequent year. Prior studies suggest that CEOs overconfidence can be observed by their investment decisions (Malmendier & Tate, 2008; Ben-David et al., 2013). Overestimation of future returns may cause overconfident CEOs to overvalue their assets which lead to less use of unconditional conservatism (Hwang et al., 2014). Schrand (2012) argued that overconfident CEOs found to be more likely to engage in misstatements.

The *ACCEXP* is the independent variable linked to the audit committee characteristics and described as audit committee chair expertise. It is measured as the binary variable; the value of „1“ is given if the audit committee chair holds any professional accounting degree, otherwise „0“. Ghafran and Yasmin (2017) argued that the chair accounting expertise is important to be considered for the usefulness of audit committee. The variable *ACCDUAL* is the audit committee chair's dual position as the board chair also. The variable is hypothesized on the basis of literature and assigned value of „1“ if the audit committee chair holds position of board chairperson as well, otherwise „0“.

The *ACCBUSY* is the audit committee chair busyness. The variable measured as the number of committees the chairperson of audit committee chairs. Tanyi and Smith (2015) argue that there is a considerable impact of audit committee's chair multiple

positions on abnormal accruals. Next variable is *ACINDP* which is the audit committee independence and measured as the percentage of independent directors serving the audit committee of the firm. Finally, *ACMEET* is the audit committee meetings and measured as the frequency of meetings the audit committee held during the financial year. Both audit committee independence and meetings signify the effectiveness and diligence of the monitoring role of audit committees (Abbott et al., 2004; Kalelkar, 2016).

Related to the external auditor two hypothetical variables are included into the model. The variable *APBUSY* is the audit partner busyness or workload. It is measured as the number of clients the audit partner engaged with in the given year. The studies by Lai et al. (2018), Goodwin & Wu (2016) and Wan-Hussin et al. (2018) used similar measurement to investigate the audit partner workload. Next the variable *LnNAF* is the natural log of non-audit fees, employed to measure the affect of auditor independence on his or her performance. The Cohen et al. (2004) suggested that high value of non-audit fees might compromise the independence of external auditor. The next section explains the control variables incorporated into the model.

3.5.2 Control Variables

There are various other factors that affect modified audit opinion but not hypothesized in this study. The factors which used as control variables are audit firm size, previous modification, return on assets, financial loss, leverage, client size and audit report lag. Previous studies found considerable effect of these variables on the likelihood of receiving modified audit opinion (Sanchez-Ballesta & Garcia-Meca, 2005; Pucheta-Martinez & Fuentes, 2007; Johl et al., 2007; Farinha & Viana, 2009; Chen et al., 2016).

If these variables are not controlled, it could possibly lead to bias in the subsequent results of the model, which tests the relationship of dependent and hypothetical variables. Following are the descriptions and measurements of control variables included in the model:

3.5.2.1 Big 4 Auditors

The control variable *BIG4* is the size of the audit firm. The value of „1“ is given if the firm is audited by one of the big four audit firms, otherwise „0“. A number of studies recommend that large audit firms are more expected to issue modified audit opinion and detect earnings management since they have resources and highly knowledgeable partners which have more reputation (Francis & Schipper, 1999). Big audit firms are more conventional than small firms (Chen et al., 2016) therefore large accruals leads to higher probability that modified opinion will be issued. To control the affect of audit firm size on the modification, this study includes a binary variable *BIG4* to strengthen the validity of the model. It is expected that audit firm size positively linked with the prospect of receiving modified audit opinion.

3.5.2.2 Previous MAO

Another aspect need to be control is previous year modification. Pucheta-Martinez and Fuentes (2007) suggests that previous year modification have significant influence on the subsequent modified audit opinion and this could lead to biased results. An initial modification is established when following year audit report was clean or contained a different type of modification than the existing year. In this view, it is possible that a firm that obtained modified audit opinion in the existing year is due to elusiveness of

previous year financial statements, and consequently receives a similar audit opinion, if the conditions have not been changed. It is measured as; if firm received the same modified audit opinion in the subsequent year it takes the value of „1“; otherwise „0“. This study expected a positive relationship between the control variable *PMAO* and the receiving of current modified audit opinion.

3.5.2.3 Financial Loss

The variable *LOSS* is the financial loss of the firm. If the firm observed negative net income in the subsequent two years it assigns the value of „1“; otherwise „0“. Companies that bear repeated losses or those with small equity ratio are differentiated due to higher financial risks. In such situation firms might use aggressive accounting practices to decrease the visibility of the related risks and escape debt covenants breach (Defond & Jiambalvo, 1994). Such corporations convey higher litigation risks for auditors (Heninger, 2001) consequently auditors are more expected to give modified audit opinion. Similar to the above assumption Bartov, Gul, & Tsui (2000) stated that firms which receive qualified opinion are usually have big ratio of long-term debt in comparison with the firms that receive clean audit opinion. The current study anticipated that variable *LOSS* is inversely linked to the probability of receiving modified audit opinion.

3.5.2.4 Return on Assets

The variable return on assets is included in the empirical model to control the effect of firm's profitability. The *ROA* is calculated as the ratio of earnings before interest and taxes over total assets. It is perceived that higher returns on assets would minimize the

prospect that a firm obtains modified opinion. Sloan (1996) argues that it is due to the larger earnings persistence and a lower risk assessment by the external auditor. Bradshaw, Richardson, and Sloan (2001) also find a negative association between performance and the possibility of receiving a modified audit opinion. Following the prior studies of Chen et al. (2016) and, Bradshaw et al. (2001) this study predict negative association between *ROA* and modified audit opinion.

3.5.2.5 Leverage

Financial leverage refers to the utilization of debt to attain supplementary assets; calculated as the ratio of total debt over total assets. By keeping in view that financial health of the firm observed as a factor that can raise the likelihood of obtaining a modified audit opinion (Mutchler, Hopwood, & McKeown, 1997) a control variable is incorporated to control the effect. The leverage as a surrogate for the agency cost of debt (Bauwhede & Willekens, 2004) might enlarge the chances of obtaining modified audit reports (Barbadillo, Aguilar, & Lopez, 2006). This study assumed that *LEV* is positively allied with the opinion modification.

3.5.2.6 Log of Total Assets

The natural log of total assets is used to control the effect of client size. The size of the client firm can influence the type of audit opinion as it can generate an economic reliance which minimizes the probability of receiving modified opinion (Nelson et al., 2002). Prior studies suggest that a more conventional attitude of auditors is linked with bigger clients. Reynolds and Francis (2000) recommend that because of higher litigation

risk of big clients, the auditors are more apprehensive in defending their reputations. Accordingly, this study predicted positive relationship for *LnTA*.

3.5.2.7 Audit Report Lag

Audit report lag is measured as the lag days between financial year end and auditor report date. In recent Meta analyses Habib et al. (2018) and Durand (2019) concluded that audit report lag is positively linked with the probability of receiving modified audit opinion. This is because auditors might have difficulty in obtaining the sufficient audit evidence and it takes more time to examine the financial statements. Further Basioudis et al. (2008), Kaplan and Williams (2013), and Malek and Che-Ahmad (2011) also find that audit report lag have significant positive association with modification of audit opinion. This study control for the affect of audit report lags and expected a strong association between the likelihood of receiving modified opinion and *ARLAG*.

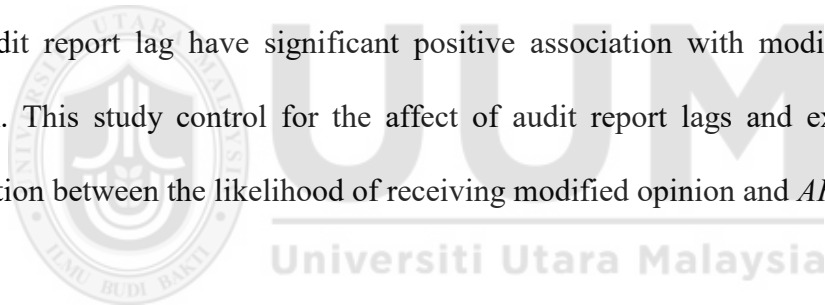


Table 3.1 List of all independent variables

| No. | Variable | Indicator | Expected Sign | Measurement |
|-----|---------------------------------|------------------|---------------|---|
| 1 | CEO Age | <i>CEOAGE</i> | + | 1 if the opinion is modified (disclaimer, qualified, adverse), otherwise 0 |
| 2 | CEO Founder | <i>CEOFFOUND</i> | + | 1 if the CEO is the founder or relative of the founder of the firm, otherwise 0 |
| 3 | CEO Duality | <i>CEODUAL</i> | + | 1 if the firm's CEO is the chairperson of the board as well, otherwise 0 |
| 4 | CEO Ownership | <i>CEOOWN</i> | - | value of direct and indirect shares in percentage, CEO own at the end of the year |
| 5 | CEO Overconfidence | <i>CEOOC</i> | + | ratio of capital expenditure over the lagged total assets of the firm |
| 6 | Audit Committee Chair Expertise | <i>AACEXP</i> | - | 1 if the audit committee chair holds any professional accounting degree, otherwise 0 |
| 7 | Audit Committee Chair Duality | <i>ACCDUAL</i> | - | 1 if the audit committee chair holds position of board chairperson as well, otherwise 0 |
| 8 | Audit Committee Chair Busyness | <i>ACCBUSY</i> | + | number of committees the chairperson of audit committee chairs |
| 9 | Audit Committee Independence | <i>ACINDP</i> | - | percentage of independent directors serving the audit committee of the firm |
| 10 | Audit Committee Meetings | <i>ACMEET</i> | - | frequency of meetings the audit committee held during the financial year |
| 11 | Audit Partner Busyness | <i>APBUSY</i> | - | number of clients the audit partner engaged with in the given year |
| 12 | Non-Audit Fees | <i>LnNAF</i> | - | natural log of non-audit fees of the firm |
| 13 | Big 4 Audit Firm | <i>BIG4</i> | + | 1 if the firm is audited by one of the big four audit firms, otherwise 0 |
| 14 | Previous Modification | <i>PMAO</i> | + | 1 if firm received the same modification in the subsequent year, otherwise 0 |
| 15 | Financial Loss | <i>LOSS</i> | + | 1 if the firm observed negative net income in the subsequent two years, otherwise 0 |
| 16 | Return on Assets | <i>ROA</i> | - | ratio of earnings before interest and taxes over total assets |
| 17 | Financial Leverage | <i>LEV</i> | + | ratio of total debt over total assets |
| 18 | Log of Total Assets | <i>LnTA</i> | + | natural log of total assets of the firm |
| 19 | Audit Report Lag | <i>ARLAG</i> | + | lag days between financial year end and auditor report date |

3.6 Study Sample

The public listed companies under Main or Ace markets of Bursa Malaysia stock exchange identified as the population for the study. The information was closely screened out because some of these companies have changed their names for different reasons but considered as the same if their original listing status is still same. The test sample was selected on the basis of information available publically in the annual reports about the type of audit opinion the firms received. During the time period of five years from 2012 to 2016 total 120 firm-year observations were identified which received modified audit opinion either disclaimer or qualified. The modification issued by the auditor is classified into three categories qualified, disclaimer and adverse opinion according to the ISA 705. The modified audit opinion indicates serious concerns about the financial reporting quality (Chen et al., 2016) hence, used as the base of test sample.

For a firm to receive modified audit opinion is not as common as an unmodified audit opinion report. To inspect the elements that influence the prospect of companies to be given a modified audit opinion, Sanchez-Ballesta and Garcia-Meca (2005) use 32 firm-year observations that obtained a modified audit opinion for the period of 1999-2002, and matched with the same number of companies (observations) that received an unmodified audit opinion for the same period. Likewise, in Malaysian context, Hasnan et al. (2013) also used matched-pair sampling approach to examine the determinants of fraudulent financial reports. Matched samples also known as matched pairs, paired samples or dependent samples are paired up so that the firms share every characteristic except for the one under investigation. In this study, the matched-pair sample considers several criteria including fiscal year, industry, same market and nearest total asset

amount. The previous studies of Sanchez-Ballesta and Garcia-Meca (2005), Farinha and Viana, (2009), Hasnan et al. (2013) etc. also used same criteria for the control sample.

The total sample of the study is 240 firm-year observations² from the period ranging between years 2012 to 2016. The sample composed exclusively of public listed non financial firms on Bursa Malaysia. The financial companies fall under the Banking and Financial Institutions (BFI) Act of 1989, which has distinctive and unique attributes, and carries out its operation in a different regulatory environment as well as different compliance (Yatim, Kent, & Clarkson, 2006). The non-listed companies are also excluded due to the lack of publicly accessed data and different legal environment (Peasnell, Pope, & Young, 2000).

3.7 Data

In light of the nature of this study; to get answers regarding the research questions and to perform multivariate regression analysis, the panel data is used. The archival data is obtained from the publically available information mostly from the sample companies annual reports. The data composed by the annual report of public listed firms appear to be consistent and reliable. This is aligned with the extant previous studies (Chen et al., 2001; Sanchez-Ballesta & Garcia-Mecca, 2005; Caramanis & Spathis, 2006; Firth et al., 2007; Martínez & Fuentes, 2007; Rusmin et al., 2009; Farinha & Viana, 2009; Johl et al., 2013; Mendez et al., 2016; Pucheta-Martinez et al., 2016).

² The test sample firm-year observations belong to the 73 listed firms and matching sample firm-year observations belong to 91 listed firms of Bursa Malaysia.

The conventional approach for studying modified audit opinion is useful, especially if the motive of the study is to examine factors influencing the modified audit opinion. Further this approach is evident due to its ability to allow for large data collection, which is appropriate for the generalization of results. Other than the annual reports the missing data is obtained from the online sources. For some of the financial variables Datastream is also used. Overall varied sources of data collections are used in this study but mainly the annual reports.

3.8 Statistical Analyses

The study uses the descriptive and inferential methods to analyze the influence of management, audit committee and external auditor characteristics on the likelihood of receiving modified audit opinions. Prior studies by Johl et al. (2007), Farinha and Viana (2009), Mendez et al. (2016), Chen et al. (2016) also used the similar quantitative approaches.

3.8.1 Univariate Analyses

The descriptive statistics summarize a set of data by measuring the central tendency and dispersion. The study calculated the mean, median and standard deviation of the model variables included into the model. The minimum and maximum values of continuous independent variables also reported. Further the individual t-test is employed to determine the impact of mean difference of modified and unmodified sample groups. The correlation analysis is also performed to know the associations among the variables. This gives the basic idea about the direction and depth of the relationship among variables included into the model.

3.8.2 Multivariate Analyses

The study employed the logistic regression model to analyze the association of independent variables with the binary dependent variable simultaneously. Logistic regression is a commonly used inferential test when the dependent variable is binary (Freedman, 2009). It is also called the discrete choice model and was produced by statistician David Cox in the year 1958. Johl et al. (2007), Farinha and Viana (2009), Mendez et al. (2016), and Chen et al. (2016) etc. also used logistic regression model to inspect the relationship between modified audit opinion and financial reporting quality. The study fulfills the assumptions of logistic regression model for the robust results.

Unlike to ordinary linear regression model, logistic regression is employed for predicting binary dependent variables instead of a continuous outcome. Specifying this differentiation, the assumptions of linear regression are disrupted. In specific, the residuals cannot be generally disseminated. Further linear regression might formulate ridiculous predictions for a binary dependent variable. What is required is a method to change a binary variable into a continuous one that can obtain any real value (negative or positive). To sum up, the logistic regression model is best to investigate the relationship of binary dependent variable with the multiple explanatory variables.

3.9 Summary

The chapter presents the research framework of the study. The research philosophy and hypotheses development are discussed in the later sections. The statistical model and the variables measurements are also explained in this chapter. Then the sampling method

and data type used in the study are discussed. Finally the chapter sums up with the quantitative analysis methods used in the study.



CHAPTER FOUR: DESCRIPTIVE STATISTICS AND UNIVARIATE ANALYSES

4.1 Introduction

The chapter provides summary statistics and correlation analyses for the statistical model included in this study. In section 4.2, the description of the sample selection is explained. Section 4.3 discussed descriptive stats of variables incorporated into the regression model and presents the results of t-test. Section 4.4 examines the correlation and dependence among predictive variables. Finally, section 4.5 sums up the chapter.

4.2 Sample Description

The sample firms were identified by scrutinizing the annual reports of firms listed on the Bursa Malaysia, on the basis of independent auditor's opinion. The time period of five years from 2012 to 2016 is considered in this study. Further, the test sample firms have been matched with the firms that received clean audit opinion in the same period, as a control sample. Criteria such as financial year, type of industry, market listing, and nearest amount of total assets were followed in the selection of the control sample (matched-pair group). Prior studies on audit opinion by Johl et al. (2007), Sanchez-Ballesta and Garcia-Meca (2005), Hasnan et al. (2013) also used the control group approach.

After the screening process, 120 firm-year observations relating to 73 firms which received modified audit opinions are found to be included in the analysis as a test sample group. The types of modified audit opinion received by sample firms are 49.17%

qualified and 50.83% disclaimer; however there is no any firm which receive adverse audit opinion during study period:

Table 4.1 Type of modified audit opinion (received by sample firms)

| Type | Year | | | | | Total | Percentage |
|------------|------|------|------|------|------|-------|------------|
| | 2012 | 2013 | 2014 | 2015 | 2016 | | |
| Qualified | 9 | 10 | 16 | 11 | 13 | 59 | 49.17% |
| Disclaimer | 11 | 16 | 11 | 13 | 10 | 61 | 50.83% |
| Adverse | 0 | 0 | 0 | 0 | 0 | 0 | 0% |
| Total | 20 | 26 | 27 | 24 | 23 | 120 | 100% |

Further, the reasons why the sample firms received modified audit opinion (qualified or disclaimer) by the auditors are shown in the Table 4.2. There are mainly three reasons, first of all material misstatement e.g. when the falsification of the financial statements independently or collectively are materially misstated but not pervasive. The reasons of receiving modified audit opinion for the sample firms are material misstatement 19 firm-year observations, inability to obtain sufficient appropriate audit evidence but chances of material misstatement exists 85 firm-year observation. Next reason of modified audit opinions are multiple uncertainties related to going concern and inability to obtain relevant audit evidence. In the study sample 16 firm-year observations fall in this category. The possible negative effect of multiple uncertainties on the firm's financial statements cumulatively is a considerable reason for the auditors to issue modified audit opinions.

Table 4.2 *Reasons for modified audit opinion*

| MAO Reason | Year | | | | | Total |
|---|------|------|------|------|------|-------|
| | 2012 | 2013 | 2014 | 2015 | 2016 | |
| Materially misstated | 2 | 2 | 8 | 5 | 2 | 19 |
| Inability to obtain sufficient appropriate audit evidence | 15 | 22 | 14 | 16 | 18 | 85 |
| Unable to form an opinion due to multiple uncertainties | 3 | 2 | 5 | 3 | 3 | 16 |
| Total | 20 | 26 | 27 | 24 | 23 | 120 |

Table 4.2 shows that a large number of listed firms in the study period received a modified audit opinion because of the inability to obtain sufficient and appropriate audit evidence. Collectively, the reasons of issuing modified audit opinion explained above indicate poor financial reporting quality (Chen et al., 2016). Therefore, this study described modified audit opinion as a direct proxy of the lower quality financial reporting.

A total sample of 240 firm-year observations related to 164 firms is tested. The sample consists of equal number of firm-year observations for both the test group and the control group. Previous studies by Sanchez-Ballesta and Garcia-Meca (2005), Johl et al. (2007), Hasnan et al. (2013) also used the matching-groups approach for the empirical analysis. This approach is also known as quasi-experiment and enables to compare outcomes of treated and non-treated observations.

Table 4.3 summarizes the percentage of matching firms that met each selection criterion. The first matching was industry matching, where firms were categorized based on their industry. In this matching process, firms based on the matching criteria were 100% identical; followed by matching from the same market (Main or ACE) and this criterion

was also 100% attained. The third matching process was based on total assets. It was very difficult to find the firms with the exact amount of total assets to match with the test sample firms therefore a firm with the nearest amount of total assets was chosen and thus this criterion is achieved by 99%. Lastly, the fourth matching criterion was the financial year. This was exactly identical and all companies matched with the test sample according to the financial year.

Table 4.3 Criterion of control sample group

| Criteria | Matching Percentage |
|----------------|---------------------|
| Industry | 100 |
| Market | 100 |
| Total Assets | 99.9 |
| Financial Year | 100 |
| Total | 99.98 |

The details of industrial sectors from which the sample firms belongs, depicts in the table 4.4. As explained above that this criterion is 100% identical so each of the sectors consists of equal number of test and control sample group firms.

Table 4.4 Industry description of sample

| Industry | Number of Companies |
|-------------------------------------|---------------------|
| Automobiles & Parts | 2 |
| Beverages | 8 |
| Chemicals | 4 |
| Construction & Materials | 28 |
| Electronic & Electrical Equipment | 8 |
| Food Producers | 14 |
| Forestry & Paper | 8 |
| General Industrials | 2 |
| Health Care Equipment & Services | 4 |
| Household Goods & Home Construction | 14 |
| Industrial Engineering | 12 |
| Industrial Metals & Mining | 28 |
| Industrial Transportation | 14 |

| | |
|-----------------------------------|------------|
| Leisure Goods | 2 |
| Oil Equipment & Services | 4 |
| Personal goods | 18 |
| Pharmaceuticals & Biotechnology | 4 |
| Real Estate Investment & Services | 8 |
| Software & Computer Services | 40 |
| Support Services | 4 |
| Technology Hardware & Equipment | 6 |
| Telecommunications | 8 |
| Total | 240 |

4.3 Descriptive Statistics and Samples T-test

In the study framework, twelve hypothetical and seven control variables are included and the sample is classified by modified audit opinion versus clean audit opinion groups. The current study measures the minimum, maximum, mean, median as well as the standard deviation of all the variables. To check the central tendency of variables these measures are the most common. Table 4.5 shows the descriptive stat of all the independent variables included in the model.

Table 4.5 Summary statistics

| Variables | Min. | Max. | Mean | Median | Std. Dev |
|-----------------|------|-------|--------|--------|----------|
| <i>CEOAGE</i> | 27 | 78 | 51.846 | 53 | 9.442 |
| <i>CEOFOUND</i> | 00 | 01 | 0.317 | 00 | 0.466 |
| <i>CEODUAL</i> | 00 | 01 | 0.317 | 00 | 0.466 |
| <i>CEOOWN</i> | .00 | 77.14 | 18.624 | 8.57 | 21.522 |
| <i>CEOOC</i> | .00 | 61.87 | 3.798 | 1.06 | 8.134 |
| <i>ACCEXP</i> | 00 | 01 | 0.658 | 01 | 0.475 |
| <i>ACCDUAL</i> | 00 | 01 | 0.096 | 00 | 0.295 |
| <i>ACCBUSY</i> | 00 | 03 | 0.642 | 00 | 0.806 |
| <i>ACINDP</i> | 0.67 | 1.00 | 0.919 | 1.00 | 0.137 |
| <i>ACMEET</i> | 01 | 15 | 5.004 | 05 | 1.422 |
| <i>APBUSY</i> | 01 | 21 | 6.473 | 06 | 3.861 |
| <i>LnNAF</i> | 1.10 | 13.06 | 7.354 | 9.15 | 4.110 |
| <i>BIG4</i> | 00 | 01 | 0.225 | 00 | 0.419 |
| <i>PMAO</i> | 00 | 01 | 0.229 | 00 | 0.421 |
| <i>LOSS</i> | 00 | 01 | 0.479 | 00 | 0.501 |

| | | | | | |
|--------------|--------|---------|--------|-------|---------|
| <i>ROA</i> | -64.80 | 0.35 | -0.784 | -0.03 | 5.101 |
| <i>LEV</i> | .00 | 1121.66 | 11.567 | 0.20 | 100.821 |
| <i>LnTA</i> | 7.68 | 15.49 | 11.532 | 11.32 | 1.633 |
| <i>ARLAG</i> | 37 | 729 | 114.75 | 113 | 58.736 |

To determine whether the independent variables differ significantly between the modified audit opinion and clean audit opinion groups t-test is conducted. According to Rusmin et al. (2009) the univariate test is helpful to explain the dependent variable and indicate useful explanatory variables. Table 4.6 shows the outcome of the difference analysis done by using the t-test. Twelve independent variables (test and control) in the total of nineteen which included into the analysis indicate a statistically significant difference in both test sample and control sample. These univariate results give the initial direction of the relationship between test variables and the dependent variable.

Table 4.6 Test of difference

| Variable | Clean Opinion Group (Mean) | MAO Group (Mean) | Mean Difference | T-test (sig 2-tailed) |
|-----------------|----------------------------|------------------|-----------------|-----------------------|
| <i>CEOAGE</i> | 51.600 | 52.092 | -0.492 | -0.403 |
| <i>CEOFOUND</i> | 0.267 | 0.367 | -0.100 | -1.668* |
| <i>CEODUAL</i> | 0.275 | 0.358 | -0.083 | -1.387 |
| <i>CEOOWN</i> | 21.989 | 15.259 | 6.731 | 2.448** |
| <i>CEOOC</i> | 3.594 | 4.002 | -0.409 | -0.388 |
| <i>ACCEXP</i> | 0.642 | 0.675 | -0.033 | -0.542 |
| <i>ACCDUAL</i> | 0.092 | 0.100 | -0.008 | -0.218 |
| <i>ACCBUSY</i> | 0.492 | 0.792 | -0.300 | -2.929*** |
| <i>ACINDP</i> | 0.910 | 0.928 | -0.018 | -0.999 |
| <i>ACMEET</i> | 4.783 | 5.225 | -0.442 | -2.431** |
| <i>APBUSY</i> | 5.625 | 7.321 | -1.696 | -3.481*** |
| <i>LnNAF</i> | 7.894 | 6.815 | 1.079 | 2.047** |
| <i>BIG4</i> | 0.292 | 0.158 | 0.133 | 2.495** |
| <i>PMAO</i> | 0.008 | 0.450 | -0.442 | -9.527*** |

| | | | | |
|--------------|---------|---------|---------|-----------|
| <i>LOSS</i> | 0.283 | 0.675 | -0.392 | -6.574*** |
| <i>ROA</i> | 0.003 | -1.571 | 1.574 | 2.415** |
| <i>LEV</i> | 0.178 | 22.955 | -22.777 | -1.758* |
| <i>LnTA</i> | 11.619 | 11.445 | 0.174 | 0.822 |
| <i>ARLAG</i> | 101.958 | 127.542 | -25.583 | -3.450*** |

Notes: * $p < 0.10$; ** $p < 0.05$; *** $p < 0.01$

4.3.1 Management Characteristics

Firstly, the five variables related to the management power and overconfidence including *CEOAGE*; CEO founder, *CEOFOUND*; CEO duality, *CEODUAL*; CEO ownership, *CEOOWN* and CEO overconfidence, *CEOOC* presented. The mean (median) of *CEOAGE* is 51.85 (53.0) with the minimum age of 27 and a maximum of 78 years. This result is similar to Ting et al. (2015) finding that average age of CEO's in Malaysia is 51.66. In comparing the *CEOAGE* in the two groups of audit opinion (modified audit opinion with that of clean audit opinion) there is no statistically significant difference ($t = -.403$; $p = .688$).

The mean (median) of *CEOFOUND* is .317 (.0); with a least value of „0“ and a max value of „1“ as the study used binary variable, suggesting that the CEOs which are also the founder of the companies is almost 31% in the total group of sample. In this regard Abdul-Latif et al. (2013) somehow uncovers that on average 32% Malaysian companies are family owned. By comparing the *CEOFOUND* mean of both groups of audit opinion (MAO and clean opinion) it is found a statistically weak difference ($t = -1.668$; $p = .097$). Malaysian firms which receive a modified audit opinion have higher number of CEO founders than the control test sample. This result perhaps suggests that the *CEOFOUND* indeed relates to the prospect of Malaysian public listed companies

receiving a modified audit opinion. This initial finding provides directional support for the relationship between founder CEO and modified audit opinion.

One can observe that the mean (median) *CEODUAL* is .317 (.0); in the total groups of the sample. In comparison with test and control sample groups, the mean of *CEODUAL* in the modified audit opinion sample is .358, which is considered higher compared with the mean of clean audit opinion group (the matched-pair sample) .275 which somehow indicates that companies with *CEOs* which are also the chairman of the boards received more modified audit opinion. However by comparing the *CEODUAL* in the two groups of sample set (modified audit opinion with that of clean audit opinion) doesn't show a statistically significant difference in the two groups ($t = -1.387$; $p = .167$).

By looking at the descriptive stat of *CEOOWN* the mean (median) is 18.62 (8.57). This result shows that on average CEOs hold almost 18% shares in their respected firms. Iskandar et al. (2011) also reveal some way the parallel results for average management ownership in Malaysia. The mean value of *CEOOWN* in the MAO group is 15.26 as compared to the mean of control group which is 21.99. The difference of means in both groups is statistically significant also ($t = 2.448$; $p = .015$). This result of t-test indicates that firms with the CEOs owned shares perhaps have fewer chances to obtain modified audit opinion.

In this study the mean (median) number of CEO overconfidence, *CEOOC* is 3.798 (1.057) with (minimum of .00 and maximum of 61.87), in the total groups of the sample. The mean of *CEOOC* in the modified audit opinion sample is 4.002, which is higher

compared with the mean of clean audit opinion (the matched-pair sample) 3.594. Comparing the mean of *CEOOC* of both groups a statistical insignificance result is found ($t = -.388$; $p = .698$). This implies that the *CEOOC* indeed not relates to the prospect of Malaysian public listed companies receiving a modified audit opinion.

4.3.2 Audit Committee Characteristics

Total five hypothetical variables related to the audit committee characteristics are included in this study. These variables are audit committee chair accounting expertise, *ACCEXP*; audit committee chair duality, *ACCDUAL*; audit committee chairman busyness, *ACCBUSY*; audit committee independence, *ACINDP*; and audit committee meetings, *ACMEET*. According to descriptive results the mean (median) of *ACCEXP* is .658 (1.0) which indicates that approximately 65% chairpersons of the public listed companies audit committees holds accounting degrees (ACCA or CPA). By examining the difference test of both groups in the total sample shows that test sample (modified audit opinion) mean value is .675 as compared to control sample (clean audit opinion) mean .642. This difference is not significant statistically ($t = -.542$; $p = .588$) and indicates that audit committee chair accounting expertise is not linked with the prospect of receiving modified audit opinion.

The mean (median) value of *ACCDUAL* is .096 (.0) illustrates that only 9.6% of the audit committee chairpersons in the total sample holds the position of board chair also. In comparison of the modified audit opinion group and clean audit opinion group the means difference is not statistically significant ($t = -.218$; $p = .827$). Further the mean (median) value of *ACCBUSY* showed in the table 5.6 is .642 (.0) with the least value of 0

and max of 3. In distinction the value of mean for MAO group is .792 and for control group is .492. The result of univariate test for *ACCBUSY* is strongly significant statistically ($t = -2.929$; $p = .004$) which illustrate that the audit committee chairpersons who hold the chairpersonships of other board committees also perhaps associated with the modified audit opinions.

Further, the mean (median) value of *ACINDP* which is .919 (1.00), shows that audit committees in the total sample are consists of more than 90% independent directors. This finding is according to the guidelines of MCCG. The mean difference between both the groups of sample is -.018 which is not statistically significant ($t = -.999$; $p = .319$). For the audit committee meetings, *ACMEET* the mean (median) is 5.0 (5.0). In comparison of MAO group the mean of CAO group (4.78) is less which indicates that the frequency of audit committee meetings is higher in the test sample group. The mean difference test is also statistically significant ($t = -2.43$; $p = .016$).

4.3.3 External Auditor Characteristics

In this study mainly two variables related external auditors considered. The first one is audit partner busyness, *APBUSY* and the second one is natural log of non-audit fees, *LnNAF* to measure the independence of external auditors. The mean (median) of *APBUSY* for the total sample is 6.47 (6.0) illustrate that on average every audit partner engaged with almost 6 clients. But if compare the mean of test sample and control sample the difference is -1.696 and it is strongly significant statistically ($t = -3.481$; $p = .001$). The result of univariate test somehow tells that there is a connection between *APBUSY* and modified audit opinion. In respect of *LnNAF* the mean (median) is 7.35

(9.15). In comparison the mean of MAO group is higher than the mean of control group, and the difference is significant statistically ($t = 2.047$; $p = .042$).

4.3.4 Control Variables

On the basis of previous studies by Sanchez-Ballesta and Garcia-Meca (2005), Pucheta-Martinez and Fuentes (2007), Johl et al. (2007), Farinha and Viana (2009), and Chen et al. (2016) there are seven control variables included in the regression model. The size of the audit firm, *BIG4*; previous modified audit opinion, *PMAO*; financial loss, *LOSS*; return on assets ratio, *ROA*; debt over total assets leverage, *LEV*; natural log of total assets, *LnTA* and audit report lag, *ARLAG*. The mean (median) of the first control variable *BIG4* is .224 (.0) demonstrate that 22.4% firms in the total sample audited by the global big four audit firms. The difference test result for *BIG4* is significant statistically ($t = 2.495$; $p = .013$), reveals the direction of the association with modified audit opinion.

The descriptive results shows that the mean (median) of *PMAO* is .229 (.0) and the difference test of means for *PMAO* is statistically significant ($t = -9.53$; $p = .00$). This points up that the firms which received modified audit opinion in the lag year are more probably to receive the same modification in the subsequent year. This study also examine the consecutive financial loss of the sample firms, and the mean median for *LOSS* is .479 (.0). The mean of test sample is .675 as compared to mean of control sample .283 and this difference is statistically significant also ($t = -6.574$; $p = .00$). Another financial variable measured in this study is *ROA*, and the mean (median) value is -.784 (-.030) with minimum of -64.80 and maximum of .35. The difference test of

both sample groups for *RAO* is significant statistically ($t = 2.415$; $p = .017$) confirms that the firms with negative returns perhaps more likely to receive modified audit opinion.

Further the study observe the *LEV* and the mean (median) value is 11.567 (.200). In comparison the sample test (MAO group) mean is 22.955 and control sample (CAO group) mean is 0.178. However this mean difference of *LEV* between both groups is mildly significant statistically ($t = -1.758$; $p = .080$). One more important control variable included into the study is log of total assets or *LnTA*. The mean (median) of *LnTA* is 11.53 (11.32) with the mean difference of both sample groups .174. The result of difference test however not significant statistically ($t = .822$; $p = .41$). Finally the study includes *ARLAG* as a control variable and notices the value of mean (median) as 114.75 days (113). The univariate test for *ARLAG* is significant statistically ($t = -3.45$; $p = .00$) and reveals that *ARLAG* possibly linked with the modified audit opinion.

4.4 Correlation Analyses

In statistics, correlation is any association or dependence, whether causal or not, among two random variables or bivariate data. Extensively the correlation is a method to evaluate whether and how strongly pairs of variables are linearly related. This study use Pearson chi-square and bivariate correlation tests to calculate the dependence or association between categorical and continuous pairs of variables. The box plot matrix also presented which demonstrate the linearity among continuous independent variables.

4.4.1 Pearson's Chi-square Test

The chi-square test for independence or association is used to determine the relationship between two categorical variables if any. The assumption of Pearson's chi-square test is that two variables should be measured at an ordinal or nominal level for example categorical data. If the p -value is lesser than the standard alpha value ($p < .05$) the test rejects the null hypothesis that assert the two variables are independent of each other. The table 4.7 demonstrates the results of chi-square tests related to all the independent categorical variables included into the regression model.

Table 4.7 Pearson's chi-square test of independence

| Variable | Clean Audit Opinion | Modified Audit Opinion | Chi Square Test Sig. (2-sided) |
|-----------------|------------------------|---------------------------|-----------------------------------|
| <i>CEOFOUND</i> | | | $\chi^2 (1) = 2.773$ |
| no | 88 | 76 | $p = .096$ |
| yes | 32 | 44 | $n = 240$ |
| <i>CEODUAL</i> | | | $\chi^2 (1) = 1.926$ |
| no | 87 | 77 | $p = .165$ |
| yes | 33 | 43 | $n = 240$ |
| <i>ACCEXP</i> | | | $\chi^2 (1) = .296$ |
| no | 43 | 39 | $p = .586$ |
| yes | 77 | 81 | $n = 240$ |
| <i>ACCDUAL</i> | | | $\chi^2 (1) = .048$ |
| no | 109 | 108 | $p = .826$ |
| yes | 11 | 12 | $n = 240$ |
| <i>ACCBUSY</i> | | | $\chi^2 (3) = 10.85$ |
| 0 | 78 | 57 | $p = .013$ |
| 1 | 26 | 31 | $n = 240$ |
| 2 | 15 | 32 | |
| 3 | 1 | 0 | |
| <i>BIG4</i> | | | $\chi^2 (1) = 6.117$ |
| no | 85 | 101 | $p = .013$ |
| yes | 35 | 19 | $n = 240$ |
| <i>PMAO</i> | | | $\chi^2 (1) = 66.257$ |
| no | 119 | 66 | $p = .000$ |
| yes | 1 | 54 | $n = 240$ |

| | | | |
|-------------|----|----|----------------------|
| <i>LOSS</i> | | | $\chi^2 (1) = 36.88$ |
| no | 86 | 39 | $p = .000$ |
| yes | 34 | 81 | $n = 240$ |

Note: zero cells (0.0%) have expected count less than 5 except for ACCBUSY.

The chi-square statistic appears on the table above specify the frequencies of categorical variables and values of chi-square (χ^2). The significant interactions of *MAO* with *ACCBUSY*, ($\chi^2 (3) = 10.85$, $p = .01$); *BIG4*, ($\chi^2 (1) = 6.12$, $p = .01$); *PMAO*, ($\chi^2 (1) = 66.26$, $p = .00$) and *LOSS*, ($\chi^2 (1) = 36.88$, $p = .00$) indicates the dependence and reject the null hypothesis that there is no association between these pairs of variables. In respect of *MAO* and *CEOFOUND* the chi-square test is mildly significant which somehow predicts the association.

4.4.2 Multiple Bivariate Correlations

Bivariate correlation is also the measure of association between any two numerical variables. Pearson r correlations are the appropriate bivariate statistics which identify how the distribution of the z scores varies by given that all variables are continuous. Correlation coefficients, r , vary from 0 (no association) to 1 (perfect linear association) or -1 (perfect inverse linear association). Positive coefficients point out a direct connection and indicate that as one variable increases cause the other variable to increase as well. Negative correlation coefficients point out an indirect association and indicate that as one variable increases cause the other variable to decrease. This study measures the correlation matrix by assuming that all variables are continuous, to investigate the direction and strength of the relation. Table 4.8 evaluates the correlation coefficient, where 0.10 to 0.29 represent a weak connection between the two variables,

the values of 0.30 to 0.49 represent a moderate connection, and 0.50 or bigger value represent a strong association (Fleiss & Cohen, 1973).

The study also presented the scatter plots to assess the correlations among continuous independent variables. This is a useful tool to test the linearity as logit analysis assumes that the independent variables are linearly related to the log odds. The scatter plot matrix as shown in the Figure 4.1 is a table of scatter plots and these plots show how much a variable is influenced by the other. The nearer the data points are when plotted to make a straight line, the larger the correlation between two variables. Overall the correlation analyses employed shows the consistency in the results and leads to the further examination of explanatory variables.

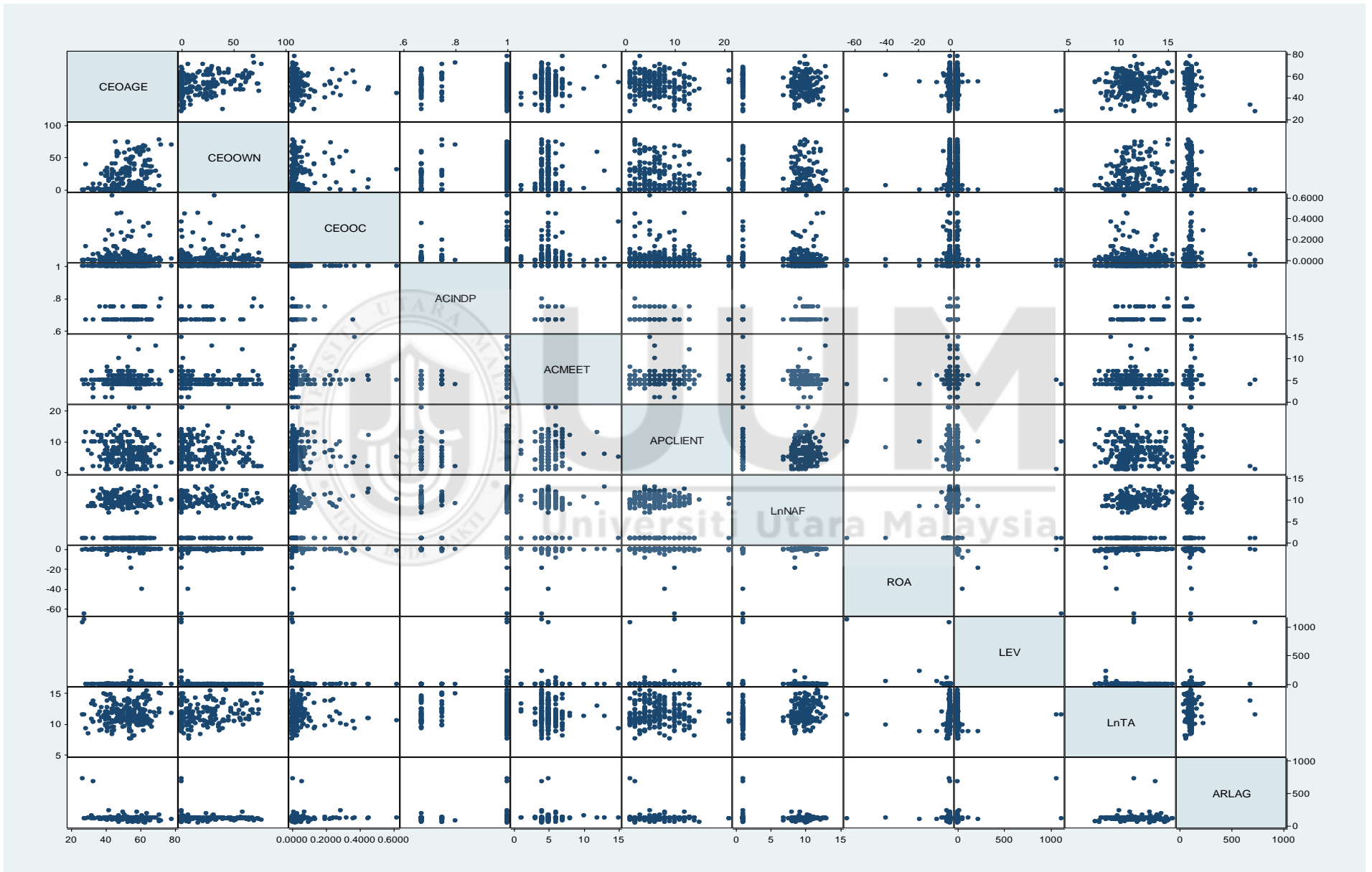


Table 4.8 Correlation matrix

| | MAO | CEOAGE | CEOFOUND | CEODUAL | CEOOWN | CEOOC | ACCEXP | ACCDUAL | ACCBUSY | ACINDP | ACMEET | APBUSY | LnNAF | BIG4 | PMAO | LOSS | ROA | LEV | LnTA | ARLAG | |
|----------|--------|---------|----------|---------|--------|-------|---------|---------|---------|--------|--------|--------|--------|--------|---------|---------|---------|--------|------|-------|--|
| MAO | 1 | | | | | | | | | | | | | | | | | | | | |
| CEOAGE | .026 | 1 | | | | | | | | | | | | | | | | | | | |
| CEOFOUND | .107 | .154* | 1 | | | | | | | | | | | | | | | | | | |
| CEODUAL | .090 | .131* | .037 | 1 | | | | | | | | | | | | | | | | | |
| CEOOWN | -.157* | .340** | .325** | .161* | 1 | | | | | | | | | | | | | | | | |
| CEOOC | .025 | -.043 | .115 | -.082 | .118 | 1 | | | | | | | | | | | | | | | |
| ACCEXP | .035 | .015 | .037 | .056 | -.016 | .069 | 1 | | | | | | | | | | | | | | |
| ACCDUAL | .014 | .007 | .083 | -.222** | .015 | .081 | -.362** | 1 | | | | | | | | | | | | | |
| ACCBUSY | .187** | .031 | -.009 | .125 | .042 | -.017 | -.190** | .127* | 1 | | | | | | | | | | | | |
| ACINDP | .065 | -.099 | .042 | .118 | -.057 | .058 | .047 | -.175** | -.121 | 1 | | | | | | | | | | | |
| ACMEET | .156* | .078 | .042 | -.135* | -.038 | .131* | .076 | .019 | -.028 | .102 | 1 | | | | | | | | | | |
| APBUSY | .220** | -.095 | .076 | -.015 | -.115 | -.015 | -.083 | .092 | .028 | .031 | .080 | 1 | | | | | | | | | |
| LnNAF | -.132* | -.089 | .037 | -.162* | -.088 | .060 | .176** | -.081 | -.132* | -.012 | .077 | .048 | 1 | | | | | | | | |
| BIG4 | -.160* | .084 | .041 | -.131* | -.047 | -.075 | .031 | -.108 | -.244** | -.062 | -.044 | -.061 | .266** | 1 | | | | | | | |
| PMAO | .525** | -.031 | .034 | .226** | -.102 | -.081 | .037 | -.110 | .095 | .092 | .075 | .112 | -.161* | -.104 | 1 | | | | | | |
| LOSS | .392** | .031 | -.061 | .100 | -.070 | -.010 | .040 | .028 | .096 | .050 | .062 | .112 | -.158* | -.117 | .291** | 1 | | | | | |
| ROA | -.155* | .097 | .002 | -.062 | .099 | .025 | .108 | .041 | -.145* | -.077 | .028 | -.084 | .147* | .065 | -.236** | -.158* | 1 | | | | |
| LEV | .113 | -.228** | -.070 | -.034 | -.097 | -.047 | -.117 | -.037 | .180** | .066 | -.034 | -.015 | -.136* | -.057 | .101 | .115 | -.636** | 1 | | | |
| LnTA | -.053 | .089 | .216** | -.255** | .161* | -.056 | .039 | -.051 | -.136* | -.071 | -.106 | -.050 | .318** | .304** | -.120 | -.219** | .110 | -.031 | 1 | | |
| ARLAG | .218** | -.256** | .028 | -.083 | -.085 | .033 | .005 | -.010 | .168** | .104 | .013 | -.064 | -.157* | -.088 | -.028 | .025 | .002 | .456** | .050 | 1 | |

Notes: *p_ 0.05; **p_ 0.01

Fig 4.1 Scatter plot matrix for independent variables (continuous)



4.5 Summary

This chapter discusses the sample description of the study along with descriptive statistics. The tests of independence and correlation analyses were also examined. The description of the sample selection is done in section 4.2. The final sample (control and test) of 240 firm-year observations relating to 145 companies over the period of 2012 until 2016 is examined. The sample statistics illustrate that the majority of the companies receive a modified audit opinion in the study period because of misstatements which are material but not pervasive.

Section 4.3 draws attention to the analyses of descriptive and univariate statistics. The test highlighted those variables that are useful in explaining the modified audit opinion. The results of the descriptive and univariate statistics show that *CEOFOUND*, *ACCBUSY*, *ACMEET*, *APBUSY* and *LnNAF* and other control variables shows the significant mean difference between test and control groups. Further correlation tests are conducted in section 4.4 to verify the appropriateness of the association among independent variables which leads to better regression results. This chapter overall gives the base to further conduct the regression analysis.

CHAPTER FIVE: LOGITISTIC REGRESSION ANALYSES AND RESULTS

5.1 Introduction

This chapter presents and discusses the results of the regression model of the study framework. Section two of this chapter explains the diagnostic tests used to fulfill the logistic regression assumptions. The section 5.3 discusses the logistic regression analysis and reports the results which explain all the independent variables presented in the research framework as a whole examination. The interaction analysis is demonstrated in section 5.4 as, to examine the moderation effects. The chapter concludes with Section 5.5, which summarizes the findings related to modified audit opinion.

5.2 Model Assumptions

Many fundamental assumptions of the linear and general linear regression models such as, normality, homoscedasticity, linearity and measurement level are not applicable for the logistic regression model as these are suitable for OLS algorithms (Peng et al., 2002). However some other assumptions still apply including large sample size, no misspecification error, no multicollinearity and finally no outliers or influential observations that can lead to deceptive outcomes. The diagnostic tests are used to evaluate the assumptions linked with logistic regression to test the robustness of the outcomes. On the basis of previous papers by Peduzzi (1996), Peng et al. (2002), Hair et al. (2018), Pregibon (1981), Menard (1995), Liang & Zeger (1986) and Liu (2016) the following diagnostic tests are applied in this study.

5.2.1 Sample Size Assumption

One of the most important assumptions of the regression analysis is to determine the appropriate sample size. The one in ten rule or ten events per variable (EPV) is an extensively advocated minimum criterion for sample size considerations in logistic regression analysis (Menard, 1995; Peduzzi, 1996; Steyerberg, 2000; Pallant, 2007). The rule states that a minimum of 10 observations are needed for each explanatory variable to avoid bias in the regression results. According to Menard (1995) there are no major problems occurred into the results when the value of EPV is 10 or greater. The sample size in this study is deemed enough to conduct the test as 240 firm-year observations are used which fulfill the sample assumption of $EPV \geq 10$.

5.2.2 Misspecification Error

Logistic regression model presume that the logit of the resulting variable is a linear amalgam of the independent variables. Misspecification error occurs when the logit function as the link function is not the right option or the connection between the logit of resulting variable and the independent variables is not linear (Liang & Zeger, 2016). To ensure that the model do not involve specification errors in terms of the omission of necessary variables and link function, the *link-test* can be used. The idea behind *link-test* is that if the model is correctly specified, it's very unusual to find any supplementary predictors that are significant statistically aside by chance.

The link-test employs the linear values $_hat$ and $_hatsq$ which predict the restructuring of model. The $_hat$ is the predicted value from the model and should be significant statistically. In contrast the squared predicted value $_hatsq$ must not be significant unless

by chance. The current study reports the p-value 0.00 and 0.551 for the predictor variables *_hat* and *_hatsq* accordingly. The test result shows that there is no misspecification error in respect of omitted variable or link function in the logistic regression model of study.

5.2.3 Multicollinearity

Multicollinearity occurred when a predictor variable is linearly predicted by other variables substantially in a regression model. In the existence of multicollinearity the estimate of one variable's affect on the dependent variable whilst controlling for the others tend to be less precise than if predictors were uncorrelated with each other (Gujarati, 2004; Kock, 2012; Lynn, 2012; Hair et al., 2018). Multicollinearity does not lessen the predictive power or validity of the model as a whole, but it might not present reliable results about any independent predictor, or about which predictors are dispensable with respect to others.

The Variance Inflation Factor (VIF) and tolerance are both extensively used measures to identify multicollinearity in the regression model (O'Brien, 2007). It lays out an index that measures how much the variance of an estimated regression coefficient is expanded because of collinearity. As a rule of thumb if the values of $VIF > 10$ and tolerance $1/VIF < 0.10$, then it consider as a sign of stern or serious multicollinearity (Ott & Longnecker, 2004; Pallant, 2007; Hair et al., 2018). On the basis of VIF analysis in this study the highest value of VIF is 3.68 and the lowest value of $1/VIF$ is found to be 0.272 which indicate that there is no multicollinearity issue among individual predictors.

Table 5.1 Variance inflation factor results

| Variable | VIF | 1/VIF |
|-----------------|------|-------|
| <i>LEV</i> | 2.73 | 0.366 |
| <i>ROA</i> | 2.27 | 0.441 |
| <i>ARLAG</i> | 1.80 | 0.555 |
| <i>LnTA</i> | 1.49 | 0.671 |
| <i>CEOOWN</i> | 1.42 | 0.706 |
| <i>LnNAF</i> | 1.38 | 0.724 |
| <i>CEODUAL</i> | 1.36 | 0.737 |
| <i>CEOAGE</i> | 1.35 | 0.740 |
| <i>ACCDUAL</i> | 1.34 | 0.748 |
| <i>ACCEXP</i> | 1.28 | 0.781 |
| <i>PMAO</i> | 1.27 | 0.786 |
| <i>CEOFOUND</i> | 1.25 | 0.797 |
| <i>BIG4</i> | 1.25 | 0.801 |
| <i>ACCBUSY</i> | 1.23 | 0.812 |
| <i>LOSS</i> | 1.18 | 0.845 |
| <i>ACINDP</i> | 1.14 | 0.878 |
| <i>ACMEET</i> | 1.14 | 0.879 |
| <i>CEOOC</i> | 1.10 | 0.907 |
| <i>APBUSY</i> | 1.10 | 0.913 |
| Mean VIF | 1.43 | |

5.2.4 Influential Observations

In regression analysis, a few data points may have disproportionate effects on the slope of the regression equation. Data points that deviate largely from the overall pattern are known as outliers. There are four conditions that a data point may be consider an outlier, firstly it might have an utmost X value compares to other data points, secondly it might have an utmost Y value compares to other data points, thirdly it might have both X and Y extreme values and finally it could be distant from the rest of data even without the utmost X or Y values. The presence of outliers in the dataset can significantly mislead the results obtained through the logistic regression and thus must be considered for treatment (Menard, 2002). The analysis of residuals is an important method in

identifying the outliers in the regression model (Pragya, 2018). Residual is the difference among the observed value of dependent variable (y) and predicted value (\hat{y}). Every data point has residual.

$$e = y - \hat{y}$$

Residual = Observed value - Predicted value

There is a variety of residuals and types of the dependent variable that can be examine in the regression analysis (Norusis, 2011). This study measures two types of residuals namely standard residual and student residual. The residual which divided by its standard error is standard residual. Standardizing is a technique for transforming data as a result its standard deviation is 1 and mean is 0. If the distribution of the residuals is normal approximately, then 95% of the standardized residuals should fall between -3 and +3. The studentized residuals take into notice that the variance of the predicted value use in calculating residuals is not constant. The externally studentized residual or studentized residual is the deleted residual divided by its estimated standard deviation. Studentized residuals are more effectual for detecting outlying Y observations as compared to standardized residuals. If an observation has an extreme or utmost studentized residual that is > 3 considers as an outlier.

Table 5.2 Residual statistics

| | Min. | Max. | Mean | St Dev. |
|-------------------|--------|-------|--------|---------|
| Standard Residual | -2.833 | 2.173 | -0.006 | 1.013 |
| Student Residual | -2.879 | 2.192 | -0.005 | 1.017 |
| Cook's Distance | 0.000 | 0.651 | 0.009 | 0.049 |
| <i>Valid N</i> | | | | 240 |

Further Cook's distance, D_i , is employed in regression analysis to observe influential outliers in a set of predictor variables (Cook, 1977). In other words, it's a technique to recognize points that inversely influence the regression model. The measurement of Cook's distance is a blend of each observation's leverage and residual values; the larger the leverage and residuals, the larger the Cook's distance. A general rule of thumb is that cut-off rate of > 1 should be comparable to identify influencers. As presented in the table 5.2 the maximum value of cooks distance is 0.651 which is less than 1 pointing out that there is no influential observation in the dataset.

5.2.5 Goodness-of-Fit

The goodness of fit test is used to test if sample data fits a distribution from a specific population. In other way, it informs that sample data represent the data which would suppose to find in the actual population. For the logistic regression the Hosmer and Lemeshow (HL) test of goodness-of-fit is most commonly used, especially for risk prediction models (Benedict, 2016). The HL test is base on dividing the sample according to the predicted risks or probabilities. In particular, base on the estimated parameter values $\hat{\beta}_0, \hat{\beta}_1 \dots, \hat{\beta}_p$, for each observation in the sample the probability that $Y = 1$ is calculated; base on each observation covariate values. Like most goodness of fit tests, the small p-value (usually under 5%) of HL test means that model is not a good fit. The p value of HL test for the study logistic model is .988 suggest that model is correctly predicting probability and fitting the data well.

5.3 Logistic Regression Results

The logistic regression model is used in this study because it allows instituting an association amid a binary outcome variable and a collection of predictor variables. Logistic regression models the logit transformed probability as a linear association with the predictor variables (Sperandei, 2014). The coefficients in logistic regression are estimated using MLE (maximum likelihood estimation) which is a point in the parameter space that maximizes the likelihood function (Rossi & Richard, 2018). Table 5.3 reports the results of the estimated model including the values of variables coefficients with the significance level. The model is tested by using statistical software packages Stata/MP and SPSS.

Table 5.3 Multiple logistic regression results

| Variable | Coef. | z | p > z |
|-----------------|---------|-------|----------|
| <i>CEOAGE</i> | 0.088 | 2.50 | 0.012** |
| <i>CEOFOUND</i> | 1.403 | 2.09 | 0.036** |
| <i>CEODUAL</i> | -0.273 | -0.40 | 0.689 |
| <i>CEOOWN</i> | -0.038 | -2.39 | 0.017** |
| <i>CEOOC</i> | 2.597 | 0.75 | 0.454 |
| <i>ACCEXP</i> | 0.805 | 1.23 | 0.217 |
| <i>ACCDUAL</i> | -0.599 | -0.62 | 0.537 |
| <i>ACCBUSY</i> | 0.918 | 2.27 | 0.023** |
| <i>ACINDP</i> | -2.326 | -1.11 | 0.267 |
| <i>ACMEET</i> | 0.447 | 1.86 | 0.063* |
| <i>APBUSY</i> | 0.168 | 2.21 | 0.027** |
| <i>LnNAF</i> | -0.037 | -0.47 | 0.639 |
| <i>BIG4</i> | -1.388 | -1.84 | 0.066* |
| <i>PMAO</i> | 6.320 | 4.02 | 0.000*** |
| <i>LOSS</i> | -0.541 | -0.80 | 0.425 |
| <i>ROA</i> | -11.813 | -4.53 | 0.000*** |
| <i>LEVERAGE</i> | 3.336 | 2.27 | 0.023** |
| <i>LnTA</i> | 0.823 | 3.07 | 0.002*** |
| <i>ARLAG</i> | 0.096 | 4.40 | 0.000*** |
| _cons | -28.546 | -4.93 | 0.000*** |
| Log Likelihood | -50.62 | | |
| Hosmer-Lemeshow | 0.99 | | |
| LR chi2 (19) | 231.48 | | |
| Prob > chi2 | 0.00 | | |

| | |
|--------------------------|-------|
| Pseudo R2 | 0.69 |
| Coxsnell R2 | 0.62 |
| Nagelkerke R2 | 0.83 |
| Correctly Classified (%) | 91.30 |
| No. of Observations | 240 |

Note: *p_ 0.10; **p_0.05; ***p_ 0.01

First of all the model summary contains the information regarding the likelihood ratio chi-square test to assess the goodness of fit. The test is statically significant with the *p-value* .000 which conclude that there is a statistically significant relationship between the variables and the model is a good fit. Further to measure how well the independent variables of the model explain the outcome variable the study reported the Pseudo R-squared. The McFadden's Pseudo R² is the approach used as the default for a logit regression in Stata. The value of Pseudo R² is found to be 0.696 which specify that almost 70% of the variance in the dependent variable is predicted from the independent variables included into the logit regression model of the study. The previous study on the modified audit opinion reports the similar values of Pseudo R² (Sanchez-Ballesta & Garcia-Meca, 2005; Farinha & Viana, 2009; Chen et al., 2016). The Cox-snell and Nagelkerke R² values also reported which are .619 and .825 respectively. Overall the model is accurately classified at the rate of 91.3%, consistent with the prior empirical research in modified audit opinion.

The logistics results for management characteristics indicating the CEO power and overconfidence shows that 3 out of 5 variables are statistically significant. Specifically, *CEOAGE* ($z = 2.50; p = .012$), *CEOFOUND* ($z = 2.09; p = .036$) and *CEOOWN* ($z = -2.39; p = .017$) demonstrate a strong influence on the propensity to receive modified audit opinion. The direction of the relationship of *CEOAGE* and *CEOFOUND* with the

outcome variable is positive means that the firms with older CEO's and the CEO founders are more prone to receive modified audit opinion. These results are in line with the hypotheses that powerful CEO's can influence the quality of financial reporting negatively. On the other hand CEO ownership is allied with the modified audit opinion as the more CEO's shareholding the less the chances to receive modified audit opinion. The remaining two management characteristics *CEODUAL* and *CEOOC* are insignificant but the direction of the coefficient is according to the theoretical background of the study.

The independent variables linked to the characteristics of audit committee including *ACCBUSY* ($z = 2.27$; $p = .023$) shows strong association and *ACMEET* ($z = 1.86$; $p = .063$) shows mild association statistically with the prospect of receiving modified audit opinion. The relationship between *ACCBUSY* is positive which is indicating that if the audit committee chair holds the chairs of other committees also in the company the probability is more to obtain a modified audit opinion. This result is consistent with the hypothesis that busy audit committee chair can be harmful for the financial reporting quality. However the other indicators of audit committee chair including *ACCEXP* and *ACCDUAL* are not found to be significant statistically. The variable *ACINDP* is also not associated statistically with the modified audit opinion in the study sample.

Further one of the external auditor characteristic *APBUSY* is found to be associated significantly ($z = 2.21$; $p = .027$) with the propensity of firm to receive modified audit opinion. However the direction of the relationship is opposite to what the hypothesis predicted. The result indicates that the audit partners with more clients in the given year

are likely to issue modified audit opinion more. The second hypothetical variable related to external auditor included into the study is natural log of non-audit fees. Logistic regression result for *LnNAF* is not significant statistically however the direction of the coefficient supporting the proposed hypothesis.

Other than the hypothetical predictors several control variables also included into the model which are related to the propensity of receiving modified audit opinion. Six out of seven control variables including *BIG4* ($z = -1.84; p = .066$), *PMAO* ($z = 4.02; p = .000$), *ROA* ($z = -4.53; p = .000$), *LEV* ($z = 2.27; p = .023$), *LnTA* ($z = 3.07; p = .002$) and *ARLAG* ($z = 4.40; p = .000$) are found to be significantly connected with the outcome variable. These results indicate that the hypothetical model particularly related to the management is an important aspect in terms of the propensity to receive modified audit opinion. This also specifies that management is an imperative part of corporate governance mosaic to ensure the financial reporting quality of the public listed firms in Malaysia.

Table 5.4 Summary of hypotheses testing

| No. | Hypothesis | Acronym | Direction | Inference |
|-----|------------------------------------|------------------------|-----------|-------------|
| H1 | Age of CEO in Years | <i>CEOAGE</i> | + | Supported |
| H2 | CEO Founder Status | <i>CEOFOUND</i> | + | Supported |
| H3 | CEO Duality (CEO/Chairman Board) | <i>CEODUAL</i> | - | Unsupported |
| H4 | CEO Ownership | <i>CEOOWN</i> | - | Supported |
| H5 | CEO Overconfidence | <i>CEOOC</i> | + | Supported |
| H6 | Audit Committee Chair Expertise | <i>ACCEXP</i> | + | Unsupported |
| H7 | Audit Committee Chair Duality | <i>ACCDUAL</i> | - | Supported |
| H8 | Audit Committee Chair Busyness | <i>ACCBUSY</i> | + | Supported |
| H9 | Audit Committee Independence | <i>ACINDP</i> | - | Supported |
| H10 | Audit Committee Number of Meetings | <i>ACMEET</i> | + | Unsupported |
| H11 | Audit Partner Busyness | <i>APBUSY</i> | + | Unsupported |
| H12 | Log of Non-Audit Fee | <i>LnNAF</i> | - | Supported |
| H13 | CEO Age and CEO Founder | <i>CEOAGEXCEOFOUND</i> | + | Unsupported |

5.3.1 Management Characteristics

There are five hypothetical independent variables including CEO age, CEO founder, CEO duality, CEO ownership and CEO overconfidence are tested with the issuance of modified audit opinion. The empirical results supported three hypotheses of the study which related to management.

5.3.1.1 CEO Age

The study proposed the hypothesis (H1) that CEO age is connected with the prospect that the firm receives a modified audit opinion. The results show significance for variable *CEOAGE* on the 0.05 level and the direction is in line with the predicted relationships. The results hold after controlling for factors recognized by previous studies to be related with firm's propensity to receive modified audit opinion. The findings supports the argument that older or the longer tenure CEO's in their final years of service are more likely to engage in earnings management (Dechow & Sloan, 1991; Buchholtz et al., 2003; Davidson et al., 2007; Ali & Zhang, 2015; Khuong and Xuan-Vy, 2017). This motivation come from the horizon problem that, CEOs approaching to retirement age or those whose profit based bonus is a huge portion of the total compensation (Davidson et al., 2007).

A study by Elizabeth and Wang (2009) also finds out that executives in the final stages of their careers are "trapped" into managing earnings upward in order to control their post retirement labor market value even though the market appropriately foresee this

type of “signal jamming”. As earnings management the modified audit opinion also indicate the low quality financial reporting therefore empirical result sustain the hypothesis that the companies with older CEOs are more prone to receive modified audit opinion that would result in the poorer quality financial reports.

However in contradiction Huang et al. (2012) reported significant inverse relationship among CEO age and quality of financial reporting. They suggested that the older CEOs are more ethical and less expected to involve in meet or beat analyst earnings forecasts and financial restatements. The argument is based on the studies by Dawson (1997) and Peterson et al. (2001) that older professionals display a high standard of moral beliefs and is less prone to be involved in immoral behavior. The concept that aged personals are more ethical and risk averse than young personals is rejected according to current findings.

5.3.1.2 CEO Founder

The variable *CEOFOUND* is positively linked with the prospect of receiving modified audit opinion at the 0.05 level of significance. The result supports the proposition of the second hypothesis (H2) that the companies which controlled by the founder CEO's are more probable to obtain a modified audit opinion. Governance mechanisms do not seem to be effective in the presence of CEO with ownership power and consequently cause the poor financial reporting quality. Similarly to this study finding, Cormier et al. (2016) argue and provide evidence that CEOs power derived from their status as a firm's founder is a sturdy indication of managerial influence and a sign of a risky fraud environment. They found significant positive relationship between CEO power and

financial statement frauds. Early evidence in this regard also indicates that the firms involved in accounting irregularities (restatements) are more likely to have a CEO who is from the founding family or the founder itself (Baber, 2015).

In the context of Malaysia, a study by Hasnan et al. (2013) also shows a positive and significant relationship between founders on the board and occurrences of fraudulent financial reporting, which recommends that founders persuade a culture that makes it acceptable to engage in financial frauds in Malaysian listed companies. They argued that founders have strong emotional commitment with their firms and so tend to go out of the way for the survival of the firm. The current study is consistent with the prior literature and supports the argument that founder CEOs negatively affect the financial reporting quality by influencing the process.

5.3.1.3 CEO Duality

In the relevance to third hypothesis (H3) the study predicted that there is positive association between CEO duality and the prospect of firm to obtain modified audit opinion. The empirical result is not statistically significant at the level of 0.05, means the study reject the hypothesis, and the direction of the coefficient for *CEODUAL* is opposite with the proposed argument. Usually the boards with CEO duality considered ineffective as a conflict of interest may arise. A study by Wan Abdullah et al. (2008) argued that in the existence of a dominant CEO with dual position, the firm intends to lessen the effort to hire quality external auditor however the result was not statistically significant. Hashim and Devi (2008) also didn't find significant influence of CEO duality regarding income decreasing or increasing earnings management.

In the contradictory point of view the dual positions increase the responsibility of the CEOs to lookout the shareholders interests since they also chair the board. In this regard O'Connor et al. (2006) illustrate that CEO duality moderates the association between stock options and the probability of fraudulent financial reporting. The result of this study supports this argument to some extent and indicates a negative sign linking CEO duality and modified audit opinion.

5.3.1.4 CEO Ownership

The current study proposed that there is an inverse connection between CEO ownership and the prospect of obtaining modified audit opinion. The empirical result confirms the proposed hypothesis at a level of significance 0.05. The finding support the agency theory (Jensen & Meckling, 1976) that aligning the CEOs' interests with those of shareholders ensures the common benefit. The general prescription of the theory is that granting stock options to CEOs increases their financial interest in long term share performance which reduces the agency costs. Other empirical studies such as O'Connor et al. (2006), Denton et al. (2007), Al-Duais et al. (2019) and Hasnan et al. (2013) also finds similar results that by giving stock options to executives will minimize the likelihood of earnings management or fraudulent financial reporting.

However there is a counterargument specify that once stock option grants become exercisable it's provide immediate financial incentive for CEOs to hike up the financial performance which could result in low financial reporting quality (Jayaram & Milbourn, 2015; Harris et al., 2019). The current study result validate the theoretical background that CEO influence as a major stakeholder reduces the risk of receiving modified audit

opinion as the top management will less likely to involve in misstatements when their interest are lined up with shareholders.

5.3.1.5 CEO Overconfidence

The study hypothesizes that managerial overconfidence could increase the propensity of a firm to receive modified audit opinion. As Malmendier and Tate (2005) stated that overconfidence is explained as a psychological or behavioral bias leads to the overestimation of the future vague results of existing events. The logistic model results depicted in the table 6.3 shows no significant association among the CEO overconfidence and the outcome variable at the level of 0.05. Consequently the hypothesis H5 is rejected, but the direction of the relationship found to be consistent with the proposed argument. The result somehow insignificantly supports the idea that overconfident CEOs may lead to poor financial reporting. The empirical study by Schrand (2012) argued that overconfident managers are more prone to present an optimistic bias and thus are more expected to start down a slimy slope of increasing misstatements.

Consistent with previous argument, Ahmed and Duellman (2012) shows those overconfident CEOs are more prone to delay loss recognition, indicative of lessen loss recognition conservatism. Ji and Lee (2015) finds that CEO overconfidence negatively affects firm value, as auditors inversely value overconfident CEOs when making audit opinion decisions related to going concern. Presley and Abbott (2013) demonstrate that overconfident executives are more expected to restate prior issued financial statements.

In conclusion these studies support the direction of the current finding that CEO overconfidence negatively affects firm's financial reporting quality.

5.3.2 Audit Committee Characteristics

On the basis of prior literature the study included five variables related to audit committee out of which three are just linked to the audit committee chair. The empirical results show that audit committee chair busyness and audit committees meetings are connected with the prospect of modified audit opinion.

5.3.2.1 Audit Committee Chair Expertise

The first hypothesis related to audit committee chair expertise predicted that there is a negative association between accounting expert chairs of audit committee and the propensity to receive modified audit opinion. The empirical result didn't support the argument and found to be insignificant at the 0.05 p-value with opposite direction. Basically audit committee's role is significant to reduce agency costs through efficient monitoring of financial reporting process (Archambeault, DeZoort & Hermanson, 2008). The SOX Act (2002), MCGG (2017) and other regulatory bodies mandate that all listed firms should have financial expert member in the audit committee. Some empirical research such as Zhang et al. (2007), Krishnan and Visvanathan (2008) also recommend that the domain specific knowledge of audit committee's accounting experts gives them an effective mean of monitoring management financial reporting process hence could reduce allied agency costs.

This study examined audit committee chair accounting expertise only and the finding is not consistent with the general perception about the effectiveness of accounting expertise. This is maybe due to the fact that the agency role of accounting expert is also influenced by the resource dependence of the audit committee chair. Resource dependence theory proposed that valuable non accounting expertise such as industry and business knowledge also an adding toward audit committee member's efficacy (Cohen et al., 2008; Bedard & Gendron, 2010). Another argument by Engel (2009) suggested that the directors' compensation also influence their responsibility of monitoring financial reporting process.

5.3.2.2 Audit Committee Chair Duality

The hypothetical variable *ACCDUAL* found to be insignificant at the level of 0.05, consequently rejects the hypothesis (H7) that audit committee chair duality negatively influence the propensity of a firm to obtain modified audit opinion. The coefficient direction is persistent with the proposed argument that audit committee chair duality can be helpful to improve quality of financial reporting however, the result is insignificant. The study included this variable on the basis of same idea as CEO duality as an indicator of power. The role of the audit committee's chairperson is of gate keeping in relation to overall audit committee strength (Beattie et al., 2014). If the audit committee chair is more powerful it is possible to enhance the overall effectiveness of the monitoring process and protect the rights of the shareholders according to the guidelines of agency theory.

Overall the finding assert that the powerful audit committee's chair authority in handling the audit committees agenda and its communication with the management, boards and external auditors raise the ability of the audit committees in exercising constructive top down pressure.

5.3.2.3 Audit Committee Chair Busyness

Another indicator related to audit committee chair included into the study found significant result at 5% significance level. The hypothesis H8 predicted that the numerous chairs of the audit committee chairperson positively associated with the propensity of receiving modified audit opinion. This indicates that audit committee chair competence to oversee financial reporting might reduce with the increase in workload or busyness. The study result is similar to the finding of Tanyi and Smith (2015), they find significant adverse relationship between quality of financial reporting and audit committee chair workload.

A study by Turley and Zaman (2007) also argues that in affecting governance outcomes audit committee chair play a critical role. To take a "deep dive" into the important accounting policy, estimate or judgment many audit committee chairs set aside time at each meeting, and some chairs request a summary before the meeting about the company's key accounting estimates and judgments. To ensuring both the time lines and quality of pre-meeting materials audit committee chair's need to be more focused.

5.3.2.4 Audit Committee Independence

The hypothesis (H9) linked to the independence of audit committee predicted that proportion of independent members inversely influence the modified audit opinion. The coefficient of the empirical result is persistent with the proposed argument; however p-value (0.27) is not significant statistically. Previous empirical literature in relevance to Malaysia explains the similar results. For example Rashida (2006) demonstrates that insignificant relation linking audit committee independence and quality of financial reporting (earnings management) is because of the influence of other corporate governance players including management power over board matters. Another reason of weak relationship amid audit committee independence and quality of financial reporting is because mostly audits committees recently are composed of independent directors (Kusnadi et al., 2015).

5.3.2.5 Audit Committee Meetings

An inverse relationship was predicted between audit committee meetings frequency and the likelihood of receiving modified audit opinion however, the result is insignificant statistically at the level of 5%. The direction of the coefficient is also contrary to what the study proposed. It finds that the firms with more audit committee's meetings are more prone to receive modified audit opinion. One of the possible reasons can be that audit committees incline to meet more frequently due to the imminent earnings restatement (Larcker et al., 2007). Audit committees directors abnormal turnover also cause reporting failure as argued by Srinivasan (2005).

The current study argued that audit committee tends to meet more if there is concern of irregularities in reporting because the key function of the audit committees is to provide effective oversight to the financial reporting process. According to Bedard (2010) the number of audit committees meetings considers as an indicator of diligence and fewer meeting indicate lack of dedication or inadequate time for monitoring. The more likelihood of getting modified audit opinion is usually more in the firms which conducted more than average number of audit committee meetings. This finding illustrate that the firms were potentially involved in misreporting or irregularities and in consequence the auditor issued modified audit opinion. A study by Sulehi (2016) also reports a negative relationship of audit committee meetings frequency and the financial disclosure quality.

5.3.3 External Auditor Characteristics

The study hypothesizes two independent factors that potentially can influence the prospect of modified audit opinion, including audit partner busyness and natural log of non audit fees used as a measure of auditor independence. The result indicates that the variable *APBUSY* is significant in relevance with the prospect of getting modified audit opinion.

5.3.3.1 Audit Partner Busyness

The hypothesis (H11) predicts that there is an inverse association between audit partner busyness and modified audit opinion, on the basis of the argument that the partners with more clients are unable to devote sufficient time for each client which consequently affects their role. The statistical result indicates that the relationship between *APBUSY*

and *MAO* is significant at the 5% level. However, the direction of the relationship is opposite of what the study predicted.

A negative impact of audit partner workload or busyness on audit quality is reported by various previous studies, on the basis of the argument that by having multiple clients audit partners unable to bestow adequate time for each client. Contrary to those studies, the result of this study is similar to the finding of Goodwin and Wu (2016). They argued that there is no informal relationship between audit partner busyness and audit quality but the auditor choose to give more modifications if have higher litigation risks. Another reason which supports the result of current study is that client specific experience and knowledge mitigate the negative effect of workload on audit quality (Gul et al., 2014; Suzuki & Takada, 2016).

5.3.3.2 Non-audit Fees

Table 6.3 depicts an insignificant relationship between non-audit fees and modification of audit opinions. As the non-audit fees indicates the independence of auditor the direction of the coefficient support the predicted relationship. It was predicted that non-audit fees may compromise the independence of the external auditor and consequently leads to poor financial reporting. A study by Firth (1997) also confirms that non-audit services are negatively linked with the higher agency cost of firms. Similarly Markelevich and Rosner (2013) reports that the prospect of being charged by the SEC for fraud is significantly allied with the non-audit service fees.

5.3.4 Control Variables

The study included seven independent variables to control the effect of significant predictors of modified audit opinion. All control variables except the consecutive loss, shows a strong association with the modified audit opinion; signifying the robustness of hypothetical variables results.

5.3.4.1 Big 4 Auditors

The first variable included to control the effect of audit firm size shows the significant result. The association between audit firm size and the propensity of receiving modified audit opinion is negative at the 0.10 level of significance. This indicate that the firms which audited by big four audit firms are less prone to receive modified audit opinion. The result is opposite to what the study predicted. Rahmat et al. (2009) also find the similar results in Malaysian setting. In a review study Raza et al. (2019) argued that big four audit firms mostly engaged with the big and more established clients so the risk of losing big client is more injurious as it will cause significant losses. On the other hand small audit firms lean to issue more modified audit opinions which will increase their reputation in the audit market.

5.3.4.2 Previous Modified Audit Opinion

The control variable *PMAO* is statistically significant ($p = .00$) with a positive sign as proposed earlier. The result of this study support the justification that companies which received modified audit opinion in the prior year have higher possibility of receiving the same opinion in the consequent year, because the disagreement may prevail between

management and the external auditor. Prior studies by Mutchler et al. (1997) and Pucheta-Martinez and Feuntes (2007) also demonstrate the similar results.

5.3.4.3 Financial Loss

The variable *LOSS* displays an insignificant result statistically, and rejects the argument that companies with consecutive losses are more likely to receive modified audit opinion. The coefficient direction also contradictory to what the study predicted and opposed the generally predicted positive relationship as prior studies by Farinha and Viana (2009) and Pucheta-Martinez and Fuentes (2007) depicted. This is because there is differences in the impact of the loss on the different type of modification but not to modify audit opinion in general (Ireland, 2003).

5.3.4.4 Return on Assets

The variable *ROA* is included into the model to control performance effect of firms. The empirical result is significant at 0.01 level of significance and support the proposed direction of the association between return on assets and prospect of getting modified audit opinion. The result specifies that the firms with high negative value of return on assets are more expected to receive a modified audit opinion. Prior empirical studies also demonstrate the similar results (Bradshaw, Richardson & Sloan, 2001; Chen et al., 2016).

5.3.4.5 Leverage

The result for variable *LEV* is also found to be strongly significant at the level of 0.01 with a positive direction as proposed. It means that if a company shows higher value of

financial leverage, the propensity of the firm receiving modified audit opinion is also higher because the risk is higher for this type of company, particularly for financial obligations and development, further affecting the issuance of modified audit opinion. This result is also compatible with the findings of Pucheta-Martinez and Feuntes (2007), Bauwhede and Willekens (2004) that there is a positively significant relationship among leverage and auditor's modified opinion report.

5.3.4.6 Log of Total Assets

The variable *LnTA* controlling the effect for the client size on the modified audit opinion found to be strongly associated at 1% level. The finding indicates that big clients tend to receive modified audit opinion more as compared to clients with less total assets. This is in the contradiction of the argument that type of audit opinion can generate an economic reliance which minimizes the probability that a modified opinion is delivered (Nelson et al., 2002). The study result supports the predicted view that auditors are more conventional in case of big clients due to the higher risk of litigation hence, more likely to issue modified audit opinion.

5.3.4.7 Audit Report Lag

Finally it is predicted that longer time between the end of the financial year of a firm and the date of audit report issued increases the probability of receiving a modified audit opinion. The empirical result found to be significant strongly ($p = .00$) with the positive coefficient. This result is in endure of the argument that longer audit report lag indicate the misreporting or disagreement between the management and the audit partner which

leads to modification. Prior studies by DeFond et al. (2002), Kaplan and Williams (2013) also found the similar results.

5.4 Interaction Results

To check whether the combination of two explanatory variables has a simultaneous influence on the propensity of receiving modified audit opinion the study included interactions among variables. According to Aguinis (2004) a moderator analysis is just a multiple regression equation with an interaction term.

5.4.1 Interaction between CEO Age and CEO Founder

It is hypothesized that older CEOs with founder status influence the financial reporting quality negatively. Table 5.5 depicts the results of logistic regression model with interaction effect of CEO age and CEO founder on the modified audit opinion. The result of the interaction term $CEOAGE \times CEOFOUND$ is insignificant statistically with the p-value 0.19. The argument that older CEOs who are also the founders of their firms positively influence the prospect of modified audit opinion is not supported. However, the overall effect of the model showed by pseudo R^2 increased to 0.701. The effect size of CEO age and CEO founder with their significance level also changed.

The result is in contrast with the argument of Silberzhan (2018), who estimated that the firms with founder CEOs moderate the prospect that CEOs closer to retirement are more lenient to initiate capital investment and focus more on short term benefits.

Table 5.5 Logistic regression results with first interaction effect

| Variable | Coef. | z | p > z |
|---------------------------------|---------|-------|----------|
| <i>CEOAGE</i> | 0.119 | 2.73 | 0.006*** |
| <i>CEOFOUND</i> | 6.142 | 1.64 | 0.101 |
| <i>CEODUAL</i> | -0.253 | -0.37 | 0.708 |
| <i>CEOOWN</i> | -0.035 | -2.17 | 0.030** |
| <i>CEOOC</i> | 1.918 | 0.56 | 0.578 |
| <i>CEOAGE</i> × <i>CEOFOUND</i> | -0.089 | -1.29 | 0.196 |
| <i>ACCEXP</i> | 0.733 | 1.11 | 0.266 |
| <i>ACCDUAL</i> | -1.399 | -1.29 | 0.197 |
| <i>ACCBUSY</i> | 0.939 | 2.28 | 0.023** |
| <i>ACINDP</i> | -2.415 | -1.10 | 0.270 |
| <i>ACMEET</i> | 0.527 | 2.13 | 0.033** |
| <i>APBUSY</i> | 0.153 | 2.01 | 0.045** |
| <i>LnNAF</i> | -0.048 | -0.59 | 0.555 |
| <i>BIG4</i> | -1.307 | -1.70 | 0.089* |
| <i>PMAO</i> | 6.326 | 4.14 | 0.000*** |
| <i>LOSS</i> | -0.457 | -0.67 | 0.500 |
| <i>ROA</i> | -12.378 | -4.53 | 0.000*** |
| <i>LEV</i> | 3.760 | 2.41 | 0.016** |
| <i>LnTA</i> | 0.784 | 2.90 | 0.004*** |
| <i>ARLAG</i> | 0.098 | 4.44 | 0.000*** |
| _cons | -30.252 | -4.92 | 0.000*** |
| Log Likelihood | -49.74 | | |
| LR chi2 (20) | 233.22 | | |
| Prob > chi2 | 0.00 | | |
| Pseudo R2 | 0.70 | | |
| No. of Observations | 240 | | |

Note: *p > 0.10; **p > 0.05; ***p > 0.01

5.4.2 Interaction between Audit Committee Independence and CEO Duality

Table 5.6 describes the result of logistic regression model with moderating effect of audit committee independence and CEO duality on modified audit opinion. It is found that interaction term *ACINDP*×*CEODUAL* is strongly significant ($p = .018$) and support the study argument. The audit committee independence moderates the relationship between CEO duality and modified audit opinion. This result highlights the importance of independent audit committee in Malaysia and supports the regulatory efforts in this regard such as of MCCG (2017).

The result for CEO duality after interaction also become significant and the pseudo R² increased at 0.714 as shown in Table 5.6. Overall the results are aligning with the agency theory and prior empirical studies.

Table 5.6 Logistic regression results with second interaction effect

| Variable | Coef. | z | p > z |
|-----------------------|---------|-------|----------|
| <i>CEOAGE</i> | 0.075 | 1.96 | 0.050** |
| <i>CEOFOUND</i> | 1.590 | 2.23 | 0.026** |
| <i>CEODUAL</i> | 12.463 | 2.31 | 0.021** |
| <i>CEOEOOWN</i> | -0.036 | -2.16 | 0.031** |
| <i>CEOOC</i> | 2.890 | 0.77 | 0.439 |
| <i>ACINDPxCEODUAL</i> | -13.619 | -2.37 | 0.018** |
| <i>ACCEXP</i> | 0.958 | 1.41 | 0.159 |
| <i>ACCDUAL</i> | -1.114 | -1.00 | 0.318 |
| <i>ACCBUSY</i> | 0.881 | 2.08 | 0.038** |
| <i>ACINDP</i> | 0.001 | 0.00 | 1.000 |
| <i>ACMEET</i> | 0.491 | 1.97 | 0.049** |
| <i>APBUSY</i> | 0.188 | 2.29 | 0.022** |
| <i>LnNAF</i> | -0.023 | -0.29 | 0.775 |
| <i>BIG4</i> | -1.345 | -1.73 | 0.083* |
| <i>PMAO</i> | 6.698 | 4.28 | 0.000*** |
| <i>LOSS</i> | -0.406 | -0.56 | 0.573 |
| <i>ROA</i> | -12.061 | -4.39 | 0.000*** |
| <i>LEV</i> | 3.298 | 2.18 | 0.029** |
| <i>LnTA</i> | 0.813 | 2.89 | 0.004*** |
| <i>ARLAG</i> | 0.116 | 4.31 | 0.000*** |
| <i>_cons</i> | -32.800 | -4.76 | 0.000*** |
| Log Likelihood | -47.55 | | |
| LR chi2 (20) | 237.61 | | |
| Prob > chi2 | 0.00 | | |
| Pseudo R2 | 0.71 | | |
| No. of Observations | 240 | | |

Note: *p > 0.10; **p > 0.05; ***p > 0.01

5.5 Summary

The chapter presented the results of the logistic regression analysis and discusses the hypothesis. Overall the indicators related to management characteristics are found to be the significant determinants of modified audit opinion. Other than that audit committee

chair and audit partner busyness also found to be positively associated with modification. To test the interactions between explanatory variables, the study conducted moderation analysis.



CHAPTER SIX: CONCLUSION AND IMPLICATIONS

6.1 Introduction

This chapter concludes the study by providing an overview of the key results in relation to the research questions. Section 6.3 discusses the importance of the study as well as the theoretical and practical implications. The limitations of the study and recommendations for the future research are provided in the section 6.4. The next section summarizes the final chapter of the study.

6.2 Overview of Study

The effective corporate governance mechanism is very essential to ensure the quality of financial reporting. Modified audit opinion is a direct proxy of low quality financial reporting as it indicates that financial statements are materially misstated or contain some irregularities (Chen et al., 2016). In emerging countries, it is important to study the issues related to the modified audit opinion. The distinctive ownership structure of Malaysian firms and regulatory framework provided motivation for this study. The characteristics related to management, audit committee, and external auditors are explored as the responsibility of a firm's financial reporting is mainly shared between them.

This study employed quantitative analysis approach to examine the study hypotheses in Malaysian setting. Overall 120 firm-year observations ranging in the period of 2012 to 2016 were included into the analysis as a test sample group which received modified audit opinion. The test sample group firms were matched with the same number of firms

that have obtained a clean audit opinion on the basis of specified criterion as a control group. In total the sample comprised of 240 non-financial and non-governmental firms listed publically. The logistic regression model is applied to conclude the hypotheses developed in the present study.

On the basis of empirical investigation between dependent and independent variables several important findings emerged. Firstly the results related to management characteristics shows that three variables out of five have significant relationship with the modified audit opinion. The variable *CEOAGE* and *CEOFOUND* discovered to be positively influence the modification which depicts that the companies with older and founder CEOs are more prone to have bad quality financial reporting. This finding is important in Malaysian perspective where most of the companies are family owned. In the similar context Hasnan et al. (2013) confirmed that founders on the board associated with fraudulent financial reporting in Malaysia.

Further the companies where CEOs own more stocks are less expected to receive modified audit opinion as the *CEOOWN* is inversely associated to the prospect of receiving modified audit opinion. These findings illustrates that management role is very crucial in the overall governance process as the CEO can influence the financial reporting process in a positive or negative way depends on the own interest. However the variables namely *CEODUAL* and *CEOOC* are not found to be significantly connected with the modified audit opinion.

Secondly, by examining the relationship among the audit committees characteristics with the modified audit opinion it was found that the audit committees whose chairpersons chair more than one board committee are more probable to receive modified audit opinion. This result is inclined with the study hypothesis which proposed that role of the audit committee chair is central in ensuring the uprightness of financial reporting and if the chairperson is busier the quality of financial reporting affected negatively. Another variable namely *ACMEET* is positively linked with the propensity of receiving modified audit opinion which is interesting. The reason of this perhaps was that audit committee's shows more concern about the issues related to the financial statements but not fully satisfy the necessities required by the auditors. There is no statistically significant relationship regards to other audit committee's characteristics included into the model. However, there is a positive moderating effect of audit committee independence and CEO dual position interaction on the modified audit opinion.

In terms of external auditor characteristics the variable *APBUSY* is strongly allied with the propensity of receiving modified audit opinion. The result illustrate that the busy auditors also influence the quality of financial reporting inversely as the hypothesis proposed in the present study. But there is no significant relationship found between audit partner independence which is measured as the natural log of non audit fees and modified audit opinion. Overall the empirical investigation provides thoughtful insights regarding corporate governance mosaic and the modified audit opinion. As it can be argued that top management and external auditor role is as important as the audit committee to ensure the integrity of financial reporting quality. By only focusing on the

audit committee monitoring role the governance system cannot achieve its purpose as powerful management have strong influence in the firm.

The study findings confirm that to ensure high quality financial reporting effective corporate governance mechanism is very essential. Corporate governance is a title that generally refers to the processes, laws or rules by which businesses are controlled, regulated and operated. It is concluded that management is an essential player of the corporate governance mosaic and potentially influences the process of financial reporting. Further the role of external auditor is important in the governance process as they oversee financial reporting. To enlarge the authenticity of financial information management, audit committee, and external auditor are equally significant in Malaysian corporate environment.

6.3 Implications

Importance or significance of the study is discussed in terms of theoretical and practical implications.

6.3.1 Theoretical Implications

The results of the study contribute new literature in relevance with the theories argued earlier namely power, agency and upper echelon. The imperative concept of the agency theory is that behavior or decisions vary between member of a group e.g. in the circumstances where agents (management) are motivated to act in their personal best interests, which are contrary to those of their principals (shareholders). Power theory explains the ability of an individual to influence the conduct or behavior of others. In

accordance with the expectations the findings shows that powerful CEOs have strong influence on the financial reporting process. The study found that there is a significant positive association between modified audit opinion and the older and founder CEO's. This result inclined with the power theory as structural power of the CEOs enables them to influence the reporting decisions. Further if there are common interests of CEOs and shareholders as CEOs also owns the stock it help to reduce agency conflicts which ultimately leads to better financial reporting quality. The study found negative relationship between CEO stock ownership and propensity of receiving modified audit opinion.

The role of audit committee to oversight the financial reporting process is also very vital as it helps to protect the interests of principal or in this case shareholder's. The result of the proposed hypothesis confirms that the firms with busy audit committee chairs are less efficient and tend to obtain more modifications. As like audit committee the auditor also performs the monitoring role and evaluates the financial statements as an external player of the governance mosaic. The external auditor works for the shareholders or Principal according to the agency theory and if they fail to perform their duty it harms shareholders interests. The study found that the auditors with more clients are more prone to give modified audit opinion maybe because to maintain their own integrity or save themselves from litigation rather to protect shareholders. In sum the results of the study are inclined with the agency and power theory and added some new insights into the literature.

6.3.2 Practical Implications

In view of the importance of this study from the practical perspective, it proffers new insights for the policymakers and regulators of Malaysia including Securities Commission and Bursa Malaysia Stock Exchange. The study can be helpful to formulate policies and guidelines that could improve the corporate governance practices in Malaysia which ultimately direct towards high quality financial reporting. The release of recent MCCG (2017) introduced a new set of best practices mainly derived from the British approach to mitigate agency problems. However, critics contend that the British approach is unsuitable to Malaysian business environment. Al-Hiyari (2017) argued that MCCG 2017 ignores the uniqueness of Malaysia's capital market, regulation environment and ownership structure. Some of the concerns related to Malaysian corporate governance are empirically examined in this study.

Specifically, the findings of this study provide evidence that management is an integral part of the governance mosaic and to inline the interests of management and shareholders is very inevitable. This could be possible through stock ownership or other compensation packages. Financial reporting quality of firms managed by founder CEO's is more doubtful. There is a need to formulate a regulatory framework which considers the Malaysian ownership features. In countries where family firms dominate, investors should be mindful that type II agency problems may be exacerbated when (1) the founders of the firm play key management role or (2) the CEOs have substantial share ownership. In such situation, the entrenched CEOs who are founders or controlling shareholders may abuse the minority shareholders by misreporting the actual financial situation. Thus, the role of external auditors is crucial to provide assurance to the

shareholders that the financial statements prepared by management are not materially misstated.

The study also highlights the paramount role of the audit committee chair in safeguarding the credibility of financial statements. When the audit committee chair is busy by simultaneously holding other monitoring role in the nomination and/or remuneration committee within the same firm, the oversight of the financial reporting process suffers, and the likelihood of firm receiving modified audit opinion increases. Therefore, investors should be concern when there is overlapping monitoring role by the audit committee chair. More efficient audit committee with strong independent chairperson can also be helpful to protect shareholders interests. Further, as findings illustrate that to limit the workload of audit partner could also be helpful to improve the quality of financial reporting in Malaysia.

The results of this study could be valuable for shareholders, creditors and investors who are concerned about improving the practices of corporate governance and the quality of financial reporting in the Malaysian market. The creditors or investors rely on the reported audited financial statements in their decisions concerning loans, interest rates and bond ratings, etc. This study confirms that modified audit opinion is a red flag for the users of financial statements. The results also demonstrate interesting evidence to researchers and academia as the characteristics of the management, audit committee and external auditor are integrated into a single model which leads to modified audit opinion.

6.4 Limitations and Recommendations

Despite the robustness of study results, it might not be generalized to all population or to all time periods due to some limitations. The results are drawn on the basis of sample, as the total sample consists of two groups test sample and control sample. Test sample comprise of all the listed companies which received modified audit opinion during 2012 to 2016 and control sample consists of the matching companies selected on the basis of predetermined criterion. As the number of companies is limited it was difficult to randomly select the companies. Hence, the findings are valid and only applicable to the degree to which the sample really represents the population.

Further, the alternative measures of financial reporting quality and political connections can be observed to draw causal inferences, as the variables relationship is endogenous in nature. The study excluded financial companies such as banks, insurance companies etc., as well as the government related companies. The firms which are not listed on the stock exchange also not considered in the study. The reason to exclude such companies was that these companies operate under specific regulations and their financial reports are unique and complicated. Thus, the results of this study are not viable to generalize to such companies, Further there can be omitted variables which also influence the propensity of receiving modified audit opinion but due to the limited time and resources the study mainly focuses on the governance mosaic variables. Nevertheless, these limitations should not detract from the value of this study because the results have provided significant insights into the influence of management, audit committee and external auditor characteristics in determining the prospect of Malaysian public listed companies receiving a modified audit opinion.

As mentioned above the aspect which are not covered in this study but might be associated with the audit opinion modifications, future studies can overcome the limitations and uncover such aspects. The results revealed that management power is an important determinant of the audit opinion modification the researchers can explore the phenomena more by employing alternative measures of management power and how it influence the financial reporting quality. The study focuses on some characteristics of the audit committee chair but board chairperson is also important which need to be considered in future research. The longer time period and large sample will also be more helpful in generalizing the influence of corporate governance mosaic on the modified audit opinion in Malaysian setting.

6.5 Summary

To sum up the chapter, it provides overall review of the study, that how management, audit committee and external auditor characteristics influence the propensity of receiving modified audit opinion. The importance of the study with theoretical and practical implications also confers in the section above. The chapter shed light onto the limitations incurred during the study and prospects for the future research too.

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