

c/No: 0550789922

**Corporate Governance and Audit Qualifications: Empirical study
from Saudi Arabia and Oman**

ALFAHAD MOHAMMED NASSER SAAD

**UNIVERSITI UTARA MALAYSIA
2010**

HD
2010
M. 6010
2010

**Corporate Governance and Audit Qualifications: Empirical study
from Saudi Arabia and Oman**

**A Thesis Submitted to College of Business in Partial
Fulfillment of the Requirement for the Degree Master**

Science of International Accounting

Universiti Utara Malaysia

April 2010

By

ALFAHAD MOHAMMED (803840)

ALFAHAD MOHAMMED NASSER SAAD



KOLEJ PERNIAGAAN
(College of Business)
Universiti Utara Malaysia

PERAKUAN KERJA KERTAS PROJEK
(Certification of Project Paper)

Saya, mengaku bertandatangan, memperakukan bahawa
(I, the undersigned, certified that)
ALFAHAD MOHAMMED (803840)

Calon untuk Ijazah Sarjana
(Candidate for the degree of) **MASTER OF SCIENCE (INTERNATIONAL ACCOUNTING)**

telah mengemukakan kertas projek yang bertajuk
(has presented his/her project paper of the following title)

CORPORATE GOVERNANCE AND AUDIT QUALIFICATION:
EMPIRICAL STUDY FROM SAUDI ARABIA AND OMAN

Seperti yang tercatat di muka surat tajuk dan kulit kertas project
(as it appears on the title page and front cover of the project paper)

Bahawa kertas projek tersebut boleh diterima dari segi bentuk serta kandungan dan meliputi bidang ilmu dengan memuaskan.
(that the project paper acceptable in the form and content and that a satisfactory knowledge of the field is covered by the project paper).

Nama Penyelia : **DR. SHAMHARIR ABIDIN**
(Name of Supervisor)

Tandatangan :
(Signature)

SHAMHARIR ABIDIN, PhD
Senior Lecturer
College of Business
Universiti Utara Malaysia

Tarikh : **1 APRIL 2010**
(Date)

Sham1202@uum.edu.my

PERMISSION TO USE

In presenting this thesis in partial fulfillment of the requirements for the postgraduate degree of Master of Science (international accounting) from the Universiti Utara Malaysia, I agree that the University's library may take it freely available for inspection. I further agree that the permission for copying of this thesis in any manner, in whole or in part, for scholarly purpose may be granted by my supervisor or, in his absence, by the Dean of the College of Business. It is understood that any copy or publication or use of this thesis or parts thereof for financial gain shall not be allowed without my written permission. It is also understood that due recognition shall be given to me and to the Universiti Utara Malaysia for any scholarly use which may be made of any material from my thesis.

Request for permission to copy or make other use of material in this thesis in whole or in part should be addressed to:

**Dean (Research and Post-Graduate)
College of Business
Universiti Utara Malaysia
06010 UUM Sintok
Kedah Darul Aman
Malaysia**

Abstract

Since last decade corporate governance has been the focus of many studies worldwide. This stems from the belief that the better governance of the firms lead to more healthy corporations. Prior studies investigated many issues that could be affected by corporate governance of the firms such as performance, earnings management, transparency and disclosure. The current study will contribute to the growing literature in this field of study and mainly focusing on the impact of corporate governance on audit qualifications in Gulf countries, specifically, Oman and Saudi Arabia. The notion behind corporate governance could be extended also to study its impact on the role of auditor. The audit report is considered as a signal to the users of financial information disseminated in that report. Therefore, some argue that occurrence of audit qualifications is directly related to audit quality. In such a way the incentives that may motivate the auditor to express his opinion in a qualified manner could vary. However, it is contended that good corporate governance would lead to enhance the auditor role and mitigate the pressure on him by management and thus he will be more likely to issue a qualified opinion whenever certain circumstances exist. As many studies investigated the issue in different counties, this study will examine the impact of corporate governance mechanisms namely, independence, CEO duality, Board size, board meeting, audit committee independence and meeting on audit qualifications following the enactment the code of corporate governance in 2003 in Oman and in 2006 for Saudi listed firms. This result of study shows that corporate governance mechanisms have no impact on audit qualifications accept for the board size which shows that audit qualifications and board size are associated negatively. The results of study revealed that corporate governance in Gulf countries is a matter of illusion and the efforts should be directed towards enhancing the corporate governance in order to grasp the benefits behind the enactment of corporate governance worldwide.

I wish to dedicate this project to my beloved parents who taught me never to give up and whose influence has been lifelong and has shaped my aspirations and goals. I also dedicate this project to my beloved wife, my children, my family and the Muslim Ummah.

ACKNOWLEDGEMENTS

In the name of Allah, the Most Compassionate and the Most Merciful.

First and foremost, (*Alhamdulillah*) all praises be upon Allah, Lord of the Universe for all blessings that He has given His' creatures. And may His blessings, peace and favours descend in perpetuity on our beloved Prophet Muhammad (PBUH), who is mercy for the entire world. Truthfully, without Allah's blessing, grace and guidance, this thesis could not have been written.

There are many people I would like to thank for enabling me to reach this stage of my Master. First, I want to express my deepest gratitude to my supervisor Dr . Shamharir Abidin, without his encouragement, and his support and commitment of time, this project would not have become a reality. I would also like to record my sincere appreciation to my lecturers for their guidance and encouragement which have enabled me to acquire precious knowledge.

I would like to convey my highest appreciation to my parents without them I would never have had the courage or ability to achieve this stage of learning. My sincere appreciation also goes to my brothers and sisters for giving me their sincere love and prayers. I appreciate their encouragement and support in my study. My grateful thanks go to my wife and my children dear Danah and Nasser, who gave up so much in order for me to complete this study. Finally, if this modest effort is successful, it is by Allah's grace and guidance and if it is falls short of the readers' expectations, we can only pray and hope that Allah will forgive me.

Alfahad Mohammed Nasser

April 2010

All Rights Reserved 2010.

TABLE OF CONTENTS

PERMISION TO USE	I
ABSTRACT	II
ACKNOWLEDGEMENT	IV
TABLE OF CONTENTS	V
LIST OF TABLES	VII

CHAPTER ONE: INTRODUCTION

1.0. Background of the Study	1
1.1. Objectives of the Study.....	2
1.2. Motivation and Contribution of the study	3
1.3. The Organization of the Project.....	3

CHAPTER TWO: LITERATURE REVIEW

2.0. Introduction	4
2.1. Importance of Audit function and significant and types of audit qualified report.....	4
2.2. Corporate governance and auditor role.....	6
2.3. Factors influencing the qualifications of opinion.....	6
2.4.Theoretical framework and hypotheses development:.....	17
2.4.1.Theoretical framework	18
2.4.1.1. <i>Agency theory</i>	18
2.4.1.2. <i>Reputation theory</i>	18
2.4.2.Hypotheses development... ..	18

2.4.2.1. <i>Corporate governance characteristics</i>	19
2.4.2.1.1. <i>Board of directors characteristics</i>	19
2.4.2.1.2. <i>Audit committee</i>	22
2.4.2.2. <i>Auditor characteristics</i>	23
2.5. Conclusion.....	26

CHAPTER THREE: RESEARCH METHODOLOGY

3.0 Introduction.....	27
3.1. Data collection and Sample Selection	27
3.2 Model and Variables Measurement	28
3.3. Data Analysis.....	29
3.4. Conclusion	30

CHAPTER FOUR: FINDINGS AND ANALYSIS

4.0. Introduction.....	31
4.1. Descriptive statistics.....	31
4.2 Independent sample t- test and logistic regression assumption.....	35
4.2.1.The normality assumption.....	35
4.2.2. Correlations assumption.....	37
4.3. The findings of independent sample t-test	38
4.4. The findings of logistic regression	40
4.5. Conclusion.....	43

CHAPTER FIVE: CONCLUSION

5.0. Introduction.....	45
5.1. What the study is about?	45
5.2. Limitations and suggestions for future research	47
5.3. Contribution of the study	48
5.4. implications of the study.....	48

BIBLIOGRAPHY	50
---------------------------	-----------

LIST OF TABLES

<u>Table No.</u>		<u>Page No.</u>
2.1	Summary of literature review	15
3.1	Summary of predictor variables	29
4.1.1	Descriptive statistics for all companies	32
4.1.2	Descriptive statistics for qualified opinion firms (N=51)	33
4.1.3	Descriptive statistics for clean opinion firms (N=51)	34
4.2.1.1	The variables for all firms after transformation of the data into normal score	36
4.2.2.1	Pearson Correlation Matrix	37
4.3.1	Independent sample T-test	39
4.4.1	Model Summary	40
4.4.2	Variables in the Equation	41
4.5.1	Summary of hypothesis	44

CHAPTER ONE

INTRODUCTION

1.0 BACKGROUND OF THE STUDY

The debacle of audit quality in auditing is not a new issue among the auditing and accounting profession as well as the users of financial statements. The issue has been debated since the 1970s until today and is considered among the unresolved issue in the profession. The debate stem from the notion that the usefulness and reliability of the audited financial statements depend on the quality of audit and the integrity of the auditor. One of the measures of audit quality is the auditor's report which contains important information for stakeholders about the quality of the financial statements as well as some indications towards the company's performance (Sucher, 1998). While audit quality is difficult to measure, the extent of auditor willingness to issue qualified opinion often provides some indication of audit quality (Chen et. al., 2005).

Qualified audit opinion is one type of auditor report that conveys some bad news related to the company. This type of report is considered a warning to users and may affect the company's reputation because it is the only decision made by auditor that is objectively observable by the public. Usually, when the independent auditor issues this type of report to shareholders and other users, it indicates that the managers' accounts may be, in some respect, not true and fair view which in turn may reflect that some aspects of stewardship is being brought into question.

The contents of
the thesis is for
internal user
only

BIBLIOGRAPHY

- Abu Bakar, N. B., Abdul Rahman A. R. and Abdul Rashid H. M. Factors influencing auditor independence: Malaysian loan officers' perceptions. *Managerial Auditing Journal* Vol. 20 No. 8 pp. 804-822
- Aguilar, N.G. and Barbadillo M. E. (2003), "Does Spanish firms change auditor to avoid qualified audit report"? *International Journal of auditing* Vol. 7 pp.37-53
- Bellesta ,J. and Meca, E. (2006) "Audit qualifications and corporate governance in Spanish listed firms", *Managerial Auditing Journal* Vol. 20 No. 7, pp. 725-738
- Bell, T.B. and Tabor, R.H. (1991), "Empirical analysis of audit uncertainty qualifications", *Journal of Accounting Research*, Vol. 29 No. 2, pp. 350-70
- Brennan, N. (2006) Boards of Directors and Firm Performance: is there an expectations gap, *Corporate Governance*, Vol 14(6), pp. 577-593
- Caramanis, C. and Spathis, C.(2006), Auditee and audit firm characteristics as determinants of audit qualifications Evidence from the Athens stock exchange", *Managerial Auditing Journal* Vol. 21 No. 9 ,PP 905-920
- Carcello, J.V. and Neal, T.L. (2000), "Audit committee composition and auditor reporting", *The Accounting Review*, Vol. 75 No. 4, pp. 453-67.
- Chan, Y.K. and Walter, T.S. (1996), "Qualified audit reports and costly contracting", *Asia Pacific Journal of Management*, Vol. 13 No. 1, pp. 37-63.
- Chen, K. and Church, B. (1992), "Default on debt obligations and the issuance of going concern opinions", *Auditing: A Journal of Practice and Theory*, pp. 30-49, Fall.
- Chen S. ,Su2 X. and Wang Z. (2005) "An Analysis of auditing Environment And Modified Audit Opinions in China: Underlying reasons and lessons", *International Journal of Auditing* Vol. PP.165-185
- Dopuch, N., Hothausen, R.W. and Leftwich, R.W. (1987), "Predicting audit Qualifications with financial and market variables", *The Accounting Review*, Vol. 62 No. 3, pp. 431-54.
- DeAngelo, L. 1981. Auditor size and audit quality. *Journal of Accounting and Economics* 3(3): 183-99.

- Emory W. and Cooper D. (1991) *Business research methods*, 4th addition, Us Irwin inc.
- Farrugia, K. and Baldacchino, P. (2005), "Qualified audit opinions in Malta" *Managerial Auditing Journal* Vol. 20 No. 8, 2005 pp. 823-843
- Fan J. P. H. and Wong T. J. (2005). Do External Auditors Perform a Corporate Governance Role in Emerging Markets? Evidence from East Asia. *Journal of Accounting Research* Vol. 43 No. 1, PP.35-72
- Haron, H., Jantan, M., Pheng, E.G. 2005. Audit Committee Compliance with Kuala Lumpur Stock Exchange Listing Requirements, *International Journal of Auditing* 9: 187–200
- Hair, J., Babin B., Money, A. and Samouel, P. (2003), *Essential of business research methods*, Wiley and son Us.
- Hopwood, W., McKeow, J. and Mutchler, L. (1989), "A test of the incremental explanatory power of opinions qualified for consistency and uncertainty", *The Accounting Review*, Vol. LXIV No. 1, pp. 28-47.
- Ireland, J. (2003), "An empirical investigation of determinants of audit reports in the UK", *Journal of Business Finance & Accounting*, Vol. 30 Nos 7/8, pp. 975-1015.
- Keasey, K., Watson, R. and Wynarczyk, P. (1988), "The small company audit qualification: a preliminary investigation", *Accounting and Business Research*, Vol. 18 No. 72, pp. 323-33.
- Krishnan, J. and Krishnan, J. (1996), "The role of economic trade-offs in the audit opinion decision: an empirical analysis", *Journal of Accounting Auditing and Finance*, Vol. 11 No. 4, pp. 565-86.
- Laitinen, E.K. and Laitinen, T. (1998), "Qualified audit reports in Finland: evidence from large companies", *The European Accounting Review*, Vol. 7 No. 4, pp. 639-53.
- Lam, K.C.K. and Mensah, Y.M. (2006), "Auditors' decision-making under going-concern uncertainties in low litigation-risk environments: evidence from Hong Kong", *Journal of Accounting & Public Policy*, Vol. 25, pp. 706-39
- Martinez P. and Fuentes, C (2007), *Corporate Governance: An International Review*, *Corporate Governance Journal* Vol.15 6 pp. 1394-1412
- Menon, K., Schwartz, K.B. (1987), "An empirical investigation of audit qualification decisions in the presence of going-concern uncertainties", *Contemporary Accounting Research*, Vol. 3 No.2, pp.
- Palmrose, Z. .1988. An analysis of auditor litigation and audit service quality. *The Accounting Review*. Vol.LXIII.(1)

Spathis, C. (2003), "Audit qualification, firm litigation, and financial information: an empirical analysis in Greece" *International Journal of Auditing*, Vol.7 No.1, pp.71-85.

Spathis, C., Doumpos, M. and Zopounidis, C. (2003), "Using client performance measures to identify pre-engagement factors associated with qualified audit reports in Greece", *The international Journal of Accounting*, Vol. 38 No. 3, pp. 267-84.

Sucher, P., Moizer, P. and Zarova, M. 1998. factors affecting the Assessment of the Quality of A Company's auditors: The Case of the Czech Republic. *International Journal of Auditing 2*: pp. 7-20

Toeh H. Y. and Lim, C.C. (1996) An Empirical Study of the Effects of Audit Committees, Disclosure of Nonaudit Fees, and Other Issues on Audit Independence: Malaysian Evidence. *Journal of International Accounting, Auditing & Taxation 5 (2)*:231-248

Weir, C., Lain, D. (2001), "Governance structures, directors independence and corporate performance in the UK", *European Business Review*, Vol. 13 No.2, pp.86-94.