

**MODIFIED AUDIT OPINION AND MONITORING MECHANISMS:
EMPIRICAL EVIDENCE FROM MALAYSIAN PUBLIC LISTED COMPANIES**

By

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ABSTRACT

Based on the agency theoretical background, the effectiveness of internal corporate monitoring mechanisms enhances the reliability of financial reporting and contributes to protect the interests of all shareholders. This study provides an answer to the following main question of “What are the factors that affect the prospect of receiving a modified audit opinion among Malaysian public listed companies?” to provide an insight-into the issue of internal corporate monitoring mechanisms and modified audit opinion. To date, little is known about this issue, especially in the Malaysian-setting. Accordingly, twelve hypotheses are developed to examine the association between the effectiveness of the board of directors’ characteristics, audit committee characteristics and internal audit function with a modified audit opinion (a proxy for the quality of financial-reporting) in the Malaysian context by using individual and aggregated tests. To examine these hypotheses, logistic regression is used to analyse the data of 136 firm-year observations of seven sectors from the main-market and ACE-market listed on Bursa-Malaysia over the period 2009-2011. Several important findings emerged that are consistent with the hypotheses that Malaysian public listed companies with a large audit committee, audit committee members with greater expertise in accounting and auditing process, outsourcing internal audit function and the investment in the internal audit function are less likely to receive a modified audit opinion. Furthermore, the results confirm the argument that the combined-scores of the board of directors’ characteristics and the audit committee characteristics contribute to their effectiveness in reducing the prospect of receiving a modified audit opinion. Importantly, this study provides evidence that corporate governance reforms in Malaysia can enhance the effectiveness of monitoring mechanisms in order to avoid the Malaysian public listed companies from obtaining a modified audit opinion. Therefore, the results of this study consistent with agency theory and might-be of interest to Malaysian-regulators and policymakers as well as market-participants and researchers.

Keywords: modified audit opinion, corporate monitoring mechanisms, Malaysia

ABSTRAK

Berdasarkan latar belakang agensi teori, keberkesanan mekanisme pemantauan dalaman korporat dapat meningkatkan tahap kebolehpercayaan sesuatu laporan kewangan dan ini juga menyumbang kepada perlindungan kepentingan semua pemegang saham. Kajian ini memberi jawapan kepada soalan utama yang berikut "Apakah faktor-faktor yang memberi kesan kepada prospek menerima pendapat audit diubahsuai kalangan syarikat tersenarai awam Malaysia?" untuk memberikan pemahaman tentang ke dalam isu mekanisme pemantauan dalaman korporat dan pendapat audit diubahsuai. Ini kerana, sehingga kini, sedikit yang diketahui tentang isu ini, terutamanya dalam persekitaran Malaysia. Sehubungan dengan itu, sebanyak dua belas hipotesis dibangunkan untuk memeriksa hubungan antara keberkesanan lembaga pengarah ciri-ciri, ciri-ciri jawatankuasa audit dan fungsi audit dalaman dengan kemungkinan menerima pendapat audit diubahsuai (proksi kepada kualiti laporan kewangan) dalam konteks Malaysia dengan yang menggunakan ujian individu dan agregat. Untuk memeriksa hipotesis ini, regresi logistik digunakan untuk menganalisis data daripada 136 firma-tahun pemerhatian tujuh sektor daripada pasaran utama dan pasaran ACE disenaraikan di Bursa Malaysia dalam tempoh yang 2009-2011. Beberapa penemuan penting muncul yang konsisten dengan hipotesis-hipotesis bahawa syarikat tersenarai awam Malaysia yang mempunyai jawatankuasa audit yang lebih, ahli-ahli jawatankuasa audit yang lebih pakar dalam bidang perakaunan dan proses pengauditan, penyumberan luar fungsi audit dalaman dan pelaburan dalam fungsi audit dalaman adalah kurang berkemungkinan untuk menerima pendapat audit yang diubahsuai. Tambahan pula, hasil-hasil kajian ini telah menyokong dan mengesahkan hujah bahawa gabungan skor lembaga ciri ciri dan gabungan skor ciri ciri jawatankuasa audit menyumbang kepada keberkesanan mereka dalam mengurangkan prospek menerima pendapat audit diubahsuai. Yang penting, kajian ini telah membekalkan bukti yang menunjukkan bahawa pentadbiran korporat yang mengalami pembaharuan di Malaysia boleh meningkatkan keberkesanan mekanisme pemantauan supaya bagi mengelakkan syarikat-syarikat awam Malaysia yang tersenarai daripada mendapatkan suatu pendapat audit diubahsuai. Oleh itu, hasil kajian ini konsisten dengan teori agensi dan mungkin berfaedah dengan pengawal selia Malaysia dan pembuat dasar dan peserta pasaran dan penyelidik.

Kata kunci: pendapat audit diubah suai, mekanisme pemantauan korporat, Malaysia

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LIST OF ABBREVIATIONS

ABB	FULL LIST
ACEScoreM	Audit Committee Effectiveness Score
AICPA	American Institute of Certified Public Accountants
AOB	Audit Oversight Board
BDEScoreM	Board of Directors' Effectiveness Score
BRC	Blue Ribbon Committee
FASB	Financial Accounting Standard Board
GAAP	Generally Accepted Accounting Principles
IAF	Internal Audit Function
IIA	Institute of Internal Auditors
IIAM	Institute of Internal Auditors Malaysia
ISA	International Standards on Auditing
MAO	Modified Audit Opinion
MCCG	Malaysian Code on Corporate Governance
MIA	Malaysian Institute of Accountants
NACD	National Association of Corporate Directors
NYSE	New York Stock Exchange
SEC	Securities and Exchange Commission
SOX	Sarbanes-Oxley Act of 2002

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Accounting can be described as an information system upon which the real economic situation of a particular body is enumerated. According to Ball (2008), financial reporting performs a principal role in the economic activities. The quality of financial reporting highlights the extent of how the financial statement information reveals the actual economic situation of the entity (Watkins et al., 2004). Similarly, according to Beest et al. (2009), the main aim behind financial reporting is to provide an overview of the high quality financial information regarding an entity's economic picture in financial terms and its contribution to economic decision-making (FASB, 1999). In order to efficiently allocate capital, high quality financial reporting is imperative (Healy et al., 2001). Therefore, it can be stated that the financial reporting quality is invaluable to users of such reports including potential investors, creditors, etc., as they base their decisions upon such reports.

However, accounting information of low quality may mislead recipients into making the wrong decisions concerning investment or financing, which will eventually lead to the inefficient allocation of economic resources. Importantly, the absence of audit quality could result in a less efficient capital market, costly capital (higher interest rates for new loans or a change in debt covenant for existing loans), and, ultimately, might reduce the standard of living (Elliot, 1995; Saul, 1996; Wallman, 1995, 1996) due to inefficient

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