UNIVERSITI PUTRA MALAYSIA

AUDITOR SWITCHING AMONG MALAYSIAN SECOND BOARD COMPANIES

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By

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DEDICATION

This thesis is dedicated to my husband; Dr. Mohd Effendy

my two lovely kids; Ahmad Irfan Azfar and Nur Irdina Danisyah

my parents; Ismail and Saadat

and

my sister; Shahrinaz

Abstract of thesis presented to the Senate of Universiti Putra Malaysia in fulfilment of the requirement for the degree of Master of Science

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SHAHNAZ BINTI ISMAIL

November 2002

Chairman : Professor Annuar Md. Nassir, Ph.D.

Faculty : Economics and Management

The auditor switching phenomenon has been widely studied in the developed countries by academicians, accounting professionals and industry experts because of its implication to value credibility of financial reporting and the cost of monitoring management activities. Despite the growing concerns on this issue, few studies appear to have been made in Malaysia to examine the significant reasons and to estimate the shareholders' wealth effect. Thus the objectives of this study are (a) to identify the determinants of auditor switch among companies listed on Second Board of KLSE and (b) to examine the wealth effect of investors due to auditor switch. The period of study is from 1990 to 1999. During this period, there were about 297 companies listed on Second Board and 46 companies involved in auditor switch. This study uses two models namely, logistic regression model and event study method to examine the determinants of auditor switch and its wealth effect. The findings indicate that qualified audit report, audit fee, sale growth, return on asset and longevity of audit engagement, were the determinants of

auditor switching. Using the event study method, the findings on the investors reaction surrounding the announcement date indicate that investors on average reacted positively to auditor switch in general with a significant positive excess return at switched date. The findings also indicate that investors reacted positively towards switching from Tier2 to Tier1 and negatively towards switching involving Tier1 to Tier2 auditor. Further results show that during the financial crisis of 1997, switching (either to Tier1 or Tier2) has no significant impact on shareholder's wealth.

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk ijazah Master Sains

PERTUKARAN JURUAUDIT DI KALANGAN SYARIKAT-SYARIKAT PAPAN KEDUA DI MALAYSIA

Oleh

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Fenomena pertukaran juruaudit telah dikaji sejak sekian lama oleh ahli akademik, ahli profesional perakaunan dan pakar-pakar industri yang berkaitan di kebanyakan negara maju kerana fenomena ini memberi implikasi kepada nilai sesebuah firma , kredibiliti pelaporan kewangan firma dan kos pemantauan aktiviti pengurusan. Hampir tiada kajian yang seumpamanya dijalankan di Malaysia untuk meneliti faktor pertukaran juruaudit dan anggaran kesan kekayaan pemegang sahamnya walaupun ini adalah isu penting di negara maju. Oleh itu objektif kajian ini adalah (a) untuk mengenalpasti fakor-faktor penentu penukaran juruaudit di kalangan syarikat yang tersenarai di papan kedua BSKL (b) untuk menyelidik kekayaan pemegang saham syarikat kesan daripada pertukaran juruaudit. Tempoh kajian ini dibuat dari tahun 1990 hingga 1999. Sepanjang tempoh tersebut terdapat 297 syarikat yang tersenarai di papan kedua dan sebanyak 46 syarikat bertukar juruaudit. Kajian ini menggunakan model regresi logistik dan kaedah kajian peristiwa untuk menentukan faktor-faktor penukaran juruaudit dan kesan kekayaan pelaburnya. Hasil kajian mendapati faktor penentu penukaran juruaudit adalah laporan juruaudit bersyarat, yuran juruaudit, pertumbuhan jualan, pulangan atas aset dan kelanjutan usia perjanjian audit. Kaedah kajian peristiwa pula mendapati reaksi pemegang saham adalah positif terhadap pengumuman pertukaran juruaudit secara amnya. Hasil kajian juga mendapati pemegang saham mempunyai reaksi positif terhadap penukaran juruaudit dari Tier2 kepada Tier1 dan reaksi negatif keatas pertukaran juruaudit Tier1 kepada Tier2. Hasil kajian selanjutnya menunjukkan krisis kewangan tahun 1997 tidak memberikan kesan yang signifikan ke atas kekayaan pemegang saham.

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LIST OF ABBREVIATIONS

Abbreviation	
ISA	International Standards on Auditing
KLSE	Kuala Lumpur Stock Exchange
CPA	Certified Public Accountant
SC	Securities Commission
GAAS	Generally Accepted Auditing Standards
IPO	Initial Public Offerings
GAAP	Generally Accepted Accounting Principles
AGM	Annual General Meeting
AICPA	American Institute of Certified Public Accountant
OLS	Ordinary Least Square Method
MDA	Multivariate Discriminant Analysis
MLE	Maximum Likelihood Estimator
CEO	Chief Executive Officer
CFO	Chief Financial Officer
AR	Abnormal Return
AAR	Average Abnormal Return
CAR	Cumulative Abnormal Return
CAAR	Cumulative Average Abnormal Return
MASB	Malaysian Accounting Standard Board

CHAPTER ONE

OVERVIEW OF THE STUDY

1.1 Introduction

The growth of modern companies today and the absentee owners (shareholders) have led to the use of professional managers to manage the daily business. These settings fulfill the stewardship function and create the agency relationship between shareholders (principals) and the managers (agents). On the other hand, the agency relationship between owner and manager could produce a natural conflict of interest with the presence of information asymmetry (Appendix A1 provides an overview of the agency relationship). The manager, who is the actual person running a firm, generally, has more information about the "true" financial position and results of operations of the firm rather than the shareholders. This situation will lead to an agreement by both parties that the manager will periodically report the management of the assets to the shareholders. The reporting of this financial information to the owner, generally, follows the accounting principles. In order to avoid manipulation of financial reporting by the manager, the need for auditor arises.

Auditors play a vital role in reducing information risk, which is the prime economic reason behind the demand for audit and auditing services. Information risk cannot be totally eliminated, but it can be reduced. One way of reducing it, is through audited financial statements. This is where an extensive and reliable independent audit is performed. The audited information is then used in the decision making process on the assumption that it is reasonably complete, accurate and unbiased.

A guideline is needed to ensure that the audited financial statements are accurate and unbiased. In performing the audit work, auditors are governed by the International Standards on Auditing (ISA) as the framework of auditor's practice. Therefore the ISA are the general guidelines to aid auditors in fulfilling their professional responsibilities in the audit of historical financial statements (Appendix A2 presents the list of ISA's to date). They include consideration of professional qualities such as competence and independence, reporting requirements and evidence.

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. Section 172 of the Companies Act 1965 requires the company to appoint an auditor (or auditors) at every annual general meeting to hold office until the next general meeting. The Act also stated that removal of an auditor from the company should be by resolution in the company's general meeting with special notice given. Furthermore, Section 174 of the Act sets out the powers and duties of the company's auditors to report on the financial statements. The Act empowers the auditor to have the right to access the accounting and other financial and non-financial records of the company at all reasonable times. The Companies Act 1965 also oversees the auditor's interests and responsibilities.

In addition the Kuala Lumpur Stock Exchange (KLSE) listing requirements stated that appointment of external auditors should be made based on the adequacy of the experience, resources of the firm and the persons assigned to the audit. On the other hand, if listed companies wished to remove their external auditors from office, they must forward a copy of any written representations made by the auditors to the KLSE and at the same time send a copy of such representations to members of the listed company. This is in accordance to Section 172 (5)(b) of Companies Act 1965. It became an exception if an order is made by ROC (in accordance with Section 172 (6) of the Companies Act 1965).

KLSE listing requirements also require all listed companies (main and second board) to submit financial reports and must be audited by external auditors. The audit committee of the listed companies recommended the auditors through nomination. The annual audited report should be given to the KLSE for public release within a period not exceeding 4 months from the financial year closing of the company. All listed companies must ensure that all annual audited reports are prepared in accordance with the approved accounting standards of the MASB and the 9th Schedule of the Companies Act 1965.

According to Section 172 (2) of Companies Act 1965, all listed companies are needed to appoint an auditor at each annual general meeting. However, there are no regulations that stated companies must retain their incumbent auditors. Therefore companies can retain or dismiss their incumbent auditor after a year of tenure.

In addition, decision to retain or dismiss an incumbent auditor is considered as information released by companies to the outside parties. Investors of these companies are expected to respond to such information. The investors' reaction can be either positive or negative depending on how they interpret the announcement and in turn this reaction is reflected in the fluctuation of the share prices. The direction of price change depends on the consensus of shareholders on the material content of the announcement (in this case auditor switch) and the expected implication for performance of the firm's value. The directions of the price change are difficult to derive (Johnson and Lys, 1990). Investors are assumed to react positively (negatively) toward favourable (unfavourable) announcement. It is expected that the market will respond positively to the change to higher prestige auditors, as the change is a transformation from a lesser standard auditors to a good quality auditors. However, the shift from a smaller audit firm to a bigger audit firm does not mean that the switch does not benefit the auditors. Therefore, the reaction (favourable or unfavourable) is highly dependent upon the interpretation of the switch information by investors.

1.2 Auditor Switching in Malaysia

Auditor switch phenomenon has been widely studied in the developed countries. The key factors that were identified leading to this phenomenon were management changes, disagreement between client and auditor and dissatisfactions over audit fees (Burton and Roberts, 1967; Bedingfield and Loeb, 1974).

However, recent studies have discovered other reasons such as dissatisfaction with service by the auditors, disagreement over accounting issues, change of engagement partner, resignation, initial public offerings, rapid growth and search for credible auditors (Krishnan, 1994; Johnson and Lys, 1990). Other significant reasons include leverage, income manipulation (Woo and Koh, 2001; Lee, 2002), audit fees, qualified audit report and audit quality (Chow and Rice, 1982; Craswell, 1988; Francis and Wilson, 1988; Simon and Francis, 1988; Pong and Whittington, 1994; Butterworth and Houghton, 1995; Deis and Giroux, 1996; Gregory and Collier, 1996; Hartwell, Lightle and Moreland, 2001) (Appendix A3 presents the summaries of the significant reasons of auditor switches that were documented in earlier studies)

In Malaysia, 135 auditor switches were reported among Main Board listed companies during a 10-year period from 1986 to 1996 (Huson, Ali, Annuar, Ariff and Shamsheer, 2000). This averages to 13 switches a year. It implies that auditor switching is an important phenomenon not only to the developed countries but also to the emerging new economies like Malaysia. However, studies on auditor switching is a new scope in Malaysia with few documentation.

A primary study by Takiah and Ghazali (1993) examined the association between qualified audit opinions and the effects on auditor switching. Unfortunately, they failed to ascertain significant association between qualified reports and auditor switching. This might probably due to the short study period of three years from 1986 to 1989 coupled with a small sample size. In the study, they also found that reporting of losses or profits was not the primary reason of auditor switch.

In a similar study on qualified audit report and auditor switching, Hasnah and Ali (1997), found a different sets of results. Their results suggest that client firm receiving qualified opinion is more likely to switch auditors than one who receives a clean report (unqualified report). Thus, the findings failed to support the previous findings by Takiah and Ghazali (1993). In the same study, they also found that client firms tend to switch auditors following seriousness of audit qualification but there were no tendency of switching to Big-6 (now Big-5) audit firms or non Big-6 (now non Big-5) auditors in order to get unqualified opinion. This suggests that opinion shopping is not popular in Malaysia.

Recently, a wider aspect of auditor switch phenomenon was studied by Huson *et al.* (2000). The study examines the economic rationale for auditor switch by Malaysian listed firms examining auditor switch effect on share prices. The study