

Incidence of Qualified Opinions and the Effects on Auditor Switching: An Empirical Study in Malaysia

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ABSTRAK

Penyelidikan ini mengkaji kesan laporan juruaudit yang bersyarat terhadap pertukaran juruaudit. Penyelidikan telah dilakukan ke atas laporan tahunan syarikat-syarikat yang disenaraikan di BSKL. Hasil penyelidikan menunjukkan bahawa kewujudan laporan juruaudit yang bersyarat tiada kaitan dengan keputusan menukar juruaudit sesebuah syarikat. Kajian juga mendapati bahawa keputusan pertukaran juruaudit tidak ada perhubungan dengan saiz syarikat atau pun untung/ruginya. Adalah didapati bahawa sebahagian besar daripada laporan juruaudit yang bersyarat adalah pada darjah ketenatan yang kurang membimbangkan.

ABSTRACT

This study examines the effect of qualified opinions on auditor switching. Investigation was carried out on companies listed on KLSE based on their annual reports. The results show that there were no relationship between auditor switches and the qualified opinions. The occurrence of profit and loss and size of companies also did not have a relationship with auditor switches. A large proportion of the qualification were also found to be of a lesser degree of severity.

INTRODUCTION

The main responsibility of an auditor is to give an opinion that the financial statement prepared by a company presents fairly its performance and financial position. In relation to this, the auditor will carry out the necessary procedures to determine whether the accounting records and the accounting system for the entity can be held accountable for correctness and validity

In carrying out his duties, the auditor is responsible to bring to the attention of the management any weakness, uncertainty or irregularity which deviates from the normal accounting practice. In some situations, matters that cannot be resolved or adjusted and has material effect must be

mentioned in the audit report. In such a case, the audit report is regarded as being a qualified audit report.

Qualified audit report which specifically reveals the weaknesses of the management will not be to the favour of management. Management will always try to avoid qualified report because such report may have a negative effect on the public's perception of management. This in turn may give rise to three possible consequences: (1) management may put pressure on the auditor to issue a clean opinion, (2) the market price of the company's shares may be affected, and (3) the managements compensation may also be affected (Chow & Rice 1982). If these three consequences were to be true, then of concern is the possibility that auditors might give-in to the demands of management in the hope that they would be retained as the auditors. This itself has an implication on the ability of the auditor to exercise an independent professional judgement. Thus, this study wishes to determine the extent the incidence of qualified audit report may have effect on the decision of auditor switching in Malaysia.

In the United States, the problem of auditor switch had existed within the accounting profession since the early 1960's. The American Institute of Certified Public Accountants (AICPA) agreed that switching of auditor was the major problem faced by them at that time.

Various reasons for auditor switch had been given by several writers based on their research findings. Carpenter and Strawser (1971) found that the incidence of auditors displacement occurred among companies going public. They required the services of bigger audit firms which appeared to be prestigious and have greater technical ability. This will in turn have positive stock market reaction to the security issuance. Among the companies which have been public for some time, auditor switch may have different reasons. Burton and Roberts (1967) reported that the main factor of auditor switch was the change of management. While Eichenser and Shields (1983) argued that audit fees and work relationship were the two important factors which influenced the auditor switch. De Angelo's (1982) study on auditor switch in the petroleum industry found that companies tend to choose an auditor who favoured an accounting method that is consistent with the method favoured by management. In another research, Chow and Rice (1982) found that among other things, companies in the US would change the auditor after receiving qualified audit report. But Schwartz and Menon (1985) found that the rate of auditor switch was high among the failing companies without any correlation with the qualified audit report or management change. Another research finding by Craswell (1988) showed significant relationship between qualified report and auditor switching in Australia. Nevertheless a study in Hong Kong by Gul, Lee and Lynn (1991) suggested that there were no significant number of audit switch by companies after receiving qualified report.

METHODOLOGY

Data on audit reports and auditor switches were collected for all possible public companies listed with the Kuala Lumpur Stock Exchange. The data were collected from available published annual reports of the companies for the periods 1988-1989 and 1986-1987 which contained the auditors report. The period 1988-1989 was chosen to reflect the latest period prior to the break-up of the Kuala Lumpur Stock Exchange with the Stock Exchange of Singapore in 1989. The same period also reflects an upturn in the economy. The period 1986-1987 was characterised as a continuing period of economic depression and was chosen to compare the findings of the 1988-1989 period. The collection process was carried out to identify the companies reporting to the public for the specified period into the following categories

1. Received a qualified opinion and switched auditor subsequently
2. Received a qualified opinion and retained the same auditor.
3. Received a clean opinion and subsequently switched auditor.
4. Received a clean opinion and retained the same auditor.

Such classification was necessary in order to test whether companies switch their auditors after receiving qualified opinion. From the classification, a four cell table was set up as shown in Table 1 for each of the periods.

TABLE 1. Qualification of audit opinion and auditors switching observed and expected frequencies

| | 1988 - 1989 | | | 1986 - 1987 | | |
|---------------------------|---------------|-----------------|-------|---------------|-----------------|-------|
| | Switched | Unswitched | Total | Switched | Unswitched | Total |
| Qualified (Expected) | 4 (2.01) | 30 (31.99) | 34 | 3 (1.30) | 24 (25.70) | 27 |
| Unqualified (Expected) | 11 (12.99) | 209 (207.01) | 220 | 10 (11.70) | 233 (231.30) | 243 |
| Total | 15 | 239 | 254* | 13 | 257 | 270* |

Note:* Paired reports available from a possible 289 companies listed

The Chi-square test is used since the purpose of the study is to determine whether there is a significant relationship between the qualified audit opinion and unqualified audit opinion upon auditors switching. The

null hypothesis is qualified audit opinions does not affect auditors' switch. A significant value of the test would mean that auditors switching was not independent of receiving a qualified opinion.

From Table 1, there is an occurrence of an expected frequency of less than 5 in one of the cell. Therefore the chi-square value is calculated using a formula corrected for continuity as suggested by Cochran (1954), quoted in Siegel (1956). The formula will improve the approximation of the distribution of the computed chi-square by the chi-square distribution. The formula is:

$$X^2 = \frac{N [|AD - BC| - (N/2)]^2}{(A + B)(C + D)(A + C)(B + D)}$$

Besides examining the effect of qualified opinions on auditor switching, other factors and areas will also be researched into. These factors are:

1. The relationship between profitability of the companies and the audit switch.
2. The relationship between the size of the companies and the audit switch.
3. Type of audit report subsequent to qualification year report.
4. Frequency of audit qualification by the type of qualification.
5. The distribution of qualified reports among the various industries.

The issue of *profitability* can be of relevance where the presumption is that companies with losses or low profits would be more defensive toward the preception of the shareholders and public upon their performance. This perception could be related to issues of poor management such as in areas of marketing, administration, accounting, investment decisions and so forth. This in turn would have an impact on market value of the public companies as reflected in their share prices. Therefore, the expectation would be that such companies would be more sensitive to switch auditors so as to get favourable overall audit reports on the companies profit and loss statements. This conformity might result in the auditors failing to comply with the principles of auditing standards. Thus an empirical test will be undertaken to test this presumption.

Another factor to be analysed concerns company *size*. This factor is considered because it is assumed that big companies have greater influence over the auditors in the issuance of audit opinions. For big companies, auditors would logically receive greater amount in audit fees. Hence, there would be a plausible reason of conforming with the needs of management and thus impair their independence in fact. On this basis, we would expect to see more occurrence of switching among big companies relatif to small companies.

Among companies that initially had qualified reports and then changed their auditors, it would be interesting to see if there were to be a change in the *nature of qualification* or even if a clean report could have been issued. Unless the issues related to the qualification has been settled, then we would not expect any change in the subsequent report.

Nature of qualification is also important to be discussed. In this study, qualified reports will be categorised into four types: (1) "subject to" (2) "except for" (3) "disclaimer" and (4) "adverse." A "subject to" qualification can be a major category of qualification when the nature of qualification poses doubts as to the company's viability as a going concern. Most of the cases relate to the need for adequate financing or liquidity of the companies. Subject to the issues under qualification, the accounts still gives a true and fair view of the company. The "except for" case is another category of qualification which relates to non compliance of certain matters with related accounting principles having material effects. Except for such items of non compliance, the accounts still give a true and fair view of the company. A "disclaimer" deals with too many uncertainties and non compliances having great material effects on the accounts such that no opinion could be rendered by the auditors. Nevertheless, the accounts as kept by the company are still in proper order. For an "adverse" opinion to be rendered, this means that even the accounts are not properly kept and thus will not be able to give a true and fair view of the financial position of the company. For the last two category, the opinions are of a higher degree of severity

Finally, the study will investigate the occurrence of *qualified reports by industry* to see if there is any particular industry that has a significant case of qualification that may require special attention by the relevant authorities.

RESULTS AND DISCUSSIONS

The first analysis done dealt with the main issue of qualification and auditor switching. The result is as presented in Table 2.

TABLE 2. Association between qualified audit report and auditor switching

| Period | Chi-square Value | Probability |
|---------|------------------|-------------|
| 1988-89 | 1.1785 | 0.1404 |
| 1986-87 | 1.2930 | 0.1304 |

From Table 2, at alpha equals 0.05, the Chi-square test with a value of 1.1785 shows that there is no significant relationship between qualified

audit opinions and auditors switching in Malaysia. This result is in disagreement with research findings done by Chow and Rice (1981) of US listed companies; Craswell (1988) in Australia and Gul, Lee and Lynn (1991) in Hong Kong. Similar analysis done for the periods 1986-87 which gives a Chi-square value of 1.2930 is also consistent with the findings of 1988-89

The next analysis done concerns the issue of profitability. The chi-square test was applied whereby data among companies that switched, both with qualified as well as unqualified audit reports, were grouped into companies with losses and companies with profits as organized and presented in Table 3.

TABLE 3. Association between profitability and auditors switching

| | 1988 - 1989 | | | 1986 - 1987 | | |
|----------------------|--------------|-----------------|-------|-------------|-----------------|-------|
| | Switched | Unswitched | Total | Switched | Unswitched | Total |
| Profit (Expected) | 7 (11.52) | 188 (183.48) | 195 | 6 (8.96) | 180 (177.04) | 186 |
| Loss (Expected) | 8 (3.48) | 51 (55.52) | 59 | 7 (4.04) | 77 (79.96) | 84 |
| Total | 15 | 239 | 254 | 13 | 257 | 270 |

1988-1989: Chi-square = 2.3218; P-Prob = 0.0682

1986-1987: Chi-square = 4.5026; P-Prob = 0.0187

From Table 3, as indicated by the chi-square of 2.3218 and P-Prob of 0.0682, the results show that there is no significant relationship between profitability and auditors switching at the 5 percent level, for the period 1988-1989. This indicates that companies with losses do not change their auditors more often than do companies with profits. But for period 1986-1987 the chi-square value is significant at the 5 percent level, and thus does reflect that for the period 1986-1987, there is evidence that companies with losses do change their auditors more often. It is not ascertained whether this finding has any relationship related to a period of recession as characterised by the period 1986-1987

The third area researched into was company size. Using the chi-square test, data of switched companies, both with qualified as well as unqualified reports, were grouped into small and big companies based on their paid-up capital as organized in Table 4.

TABLE 4. Association between size and auditors switching

| | 1988 - 1989 | | | 1986 - 1987 | | |
|---------------------|---------------|-----------------|-------|-------------|-----------------|-------|
| | Switched | Unswitched | Total | Switched | Unswitched | Total |
| Big (Expected) | 4 (4.43) | 71 (70.57) | 75 | 6 (4.09) | 79 (80.91) | 85 |
| Small (Expected) | 11 (10.57) | 168 (168.43) | 179 | 7 (8.91) | 178 (176.09) | 185 |
| Total | 15 | 239 | 254 | 13 | 257 | 270 |

1988-1989: Chi-square = 0.2071; P-Prob = 0.3316

1986-1987: Chi-square = 0.7421; P-Prob = 0.2038

From Table 4, as indicated by the chi-square of 0.2071 and P-Prob of 0.3316, there is no significant relationship between company size and auditor switching at the 5 percent significance level for the period 1988-1989. The result for the period 1986-1987 is also consistent with the period 1988-1989. From this it can be indicated that big companies do not use their economic strength to press auditors to issue clean audit reports. These findings are consistent with those of Gul, Lee and Lynn (1991) of Hong Kong companies.

From another aspect, an analysis was done to see whether those companies that initially had qualified reports (both that switched as well as do not switched auditors) were able to obtain clean and favourable reports.

TABLE 5. Frequency of change in audit report of qualified companies

| | 1988 | | 1989 | | 1986 | | 1987 | |
|------------|-----------|---------|----------|-------|--------|---------|----------|-------|
| | Qualified | Q'fied | Unq'fied | Total | Q'fied | Q'fied | Unq'fied | Total |
| Switched | 4 | 4(100%) | 0 | 4 | 3 | 3(100%) | 0 | 3 |
| Unswitched | 30 | 22(73%) | 8(27%) | 30 | 22 | 19(86%) | 3(14%) | 22 |
| Total | 34 | 26(77%) | 8(23%) | 34 | 25 | 22(88%) | 3(12%) | 25* |

Note:* Two auditor's reports were not available

Table 5 shows that for the companies that initially had qualified reports and subsequently switched auditors, none of them received a clean

report. But for those companies with qualified reports and did not change auditors, 8 out of 22 companies (27%) from the 1988-89 period and 3 out of 19 companies (14%) from the 1986-87 period were able to obtain clean audit reports after having taken the necessary actions in the following period as to satisfy the auditors earlier qualification in the previous period. This finding shows that by changing auditors, it does not mean that there is the possibility of getting a favourable report. This corroborates with the findings of Knapp and Elikai (1988) and Gul, Lee and Lyn (1991), both of Hong Kong studies but is the opposite with that of Chow and Rice (1982) (US companies) and also Craswell (1988) (Australian companies).

Since the findings so far has shown that there is no relationship between several factors cited with auditor switch, hence the issue of severity of audit qualifications does not arise; but nevertheless, a frequency distribution on the nature of audit qualification is presented as in Table 6.

TABLE 6. Summary of type of audit qualification

| Category | 1988 | | 1986 | |
|------------|-----------|-------|-----------|-------|
| | Companies | % | Companies | % |
| Subject To | 24 | 70.6 | 19 | 76.0 |
| Except For | 6 | 17.6 | 4 | 16.0 |
| Disclaimer | 4 | 11.8 | 2 | 8.0 |
| Adverse | 0 | 0.0 | 0 | 0.0 |
| Total | 34 | 100.0 | 25 | 100.0 |

Table 6 shows that the majority of audit qualification (1988 and 1986 data) falls into the category of "subject to" (70.6% and 76%); followed by "except for" (17.6% and 16%) and lastly "disclaimer" (11.8% and 8%). There were no cases of "adverse" type of audit report. These qualifications represent 13.39% for the total number of companies under study in 1988 and 10% for the period 1986. The first two categories accounts for more than 85% of all qualification. Incidentally, there were no occurrence of an adverse qualified opinion for both time periods and only 11.8 % for disclaimer in 1988 and 8% in 1986. Thus, from Table 6, it can be concluded that a large proportion of qualification is of the lesser degree of severity.

Finally, the investigation on the occurrence of qualified audit reports by industry is presented in Table 7. From the raw data in Table 7 it can be observed that for 1988, the hotel industry has the highest percentage of incidence of qualification (18.18%) followed by the tin industry (13.64%) and the financial and industrial sectors respectively (12.50% and 12.35%).

In 1986, the distribution was slightly different whereby for finance, the percentage was only 4.17% and 0% for tin industry. On absolute value, industrial has the highest number of qualified cases for both periods. Nevertheless, there exists qualified reports for all industries in 1988.

TABLE 7 Distribution of qualified reports among industries 1988 and 1986

| | 1988 | | | 1986 | | |
|------------|-------|-------|----------|-------|-------|----------|
| | Cases | % | Industry | Cases | % | Industry |
| Industrial | 21 | 12.35 | 170 | 17 | 10.00 | 170 |
| Finance | 3 | 12.50 | 24 | 1 | 4.17 | 24 |
| Hotel | 2 | 18.18 | 11 | 2 | 18.18 | 11 |
| Property | 1 | 5.00 | 20 | 2 | 10.00 | 20 |
| Tin | 3 | 13.64 | 22 | 0 | 0.00 | 22 |
| Oil Palm | 1 | 8.33 | 12 | 1 | 8.33 | 12 |
| Rubber | 3 | 10.00 | 30 | 2 | 6.67 | 30 |
| Total | 34 | | 289 | 25 | | 289 |

CONCLUSIONS

From the analysis and observation of data, several findings can be concluded within the Malaysia environment:

1. No significant relationship exists between qualified audit opinions and auditors switching.
2. A significant relationship does not exist between companies that report losses or profits and auditors switching.
3. Companies of big size are not rendered lesser number of qualified reports than do small firms and are therefore less likely to switch auditors.
4. The nature of qualifications is mainly of the "subject to" category and the data of switched companies with qualified report is too small for meaningful analysis.
5. Switching auditors does not produce favourable reports after an initial occurrence of qualification in the previous year.

While the findings in US by Chow and Rice (1988), Craswell (1988) in Australia and Gul, Lee and Lynn (1991) of Hong Kong showed the existence of a relationship between qualified audit report and auditors switching, the results in Malaysia provide evidence to the contrary. In the Malaysian case, it shows that qualifications of audit reports and auditor

switching are not associated. The same is also true for factors such as profitability and company size. Therefore the issue of independence in Malaysia in relation to audit switching does not arise. Nevertheless, this does not preclude future monitoring by the relevant authorities since other research in this same area was done in well established markets as compared to Malaysia.

The relevant authorities in Malaysia namely the Malaysian Institute of Accountants (MIA), The Malaysian Association of Certified Public Accountants (MACPA), together with the Ministry of Local Trade and Industry and Consumer Affairs have always stressed the need for competent accounting technicians and accountants. Quality Training has been given its due priority in Malaysia and so is the enforcement of the provisions in the Companies Act by the Registrar of Companies. Annually, there is the competition to choose the best annual reports from companies and institutions both from the private as well as public sectors, covering various categories and industries. These and other efforts could possibly be the reasons for the insignificant occurrence of qualified reports.

SUMMARY AND FURTHER RESEARCH

This study complements other research efforts done in other stock markets on the phenomena of auditor switching. The issue of independence related to auditor switching will and should always be of concern to the public since the auditors attestation role of being able to freely exercise his professional judgement is crucial to the stability of the market. The incidence of companies collapsing without "due notice" such as the case of Carran in Hong Kong and Pan El in Singapore are witnesses to this statement. Although this study does not support a significant relationship between qualified reports and auditor switching, the occurrence of a single case of non-independence can still do much harm. This study was done using limited secondary data, mainly being annual reports. Other factors such as management change, merger activities, audit fees, professional "competency" of audit staff and organizational behaviour issues were not looked into. These factors could well have an impact on independence and warrants further research in Malaysia and elsewhere.

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