FACTORS INFLUENCING THE DECISION TO AUDIT INTERIM FINANCIAL REPORTS: EMPIRICAL EVIDENCE OF MALAYSIAN PUBLIC LISTED COMPANIES

BY

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ABSTRACT

Though interim reports may provide more timely and adequate information for shareholders regarding a firm, several studies have highlighted that interim reports are not normally audited (see, for example, Shrives, 1989 and Tan, 2000). They argued that the requirement of a full audit would be too costly particularly for a small listed companies and take too long to issue the report. However, it is interesting to note that there were few companies that voluntarily audit their interim report even though they are not required to do so. This study, therefore, attempts to investigate why some companies choose to have their interim report audited whilst others not to. The study incorporates the four characteristics of a firm which are expected to increase the likelihood of a company's voluntarily audit of their interim reports. They are firm size, financial leverage, audit firm size and managerial share ownership. The sample was made up of 120 main board companies listed on Bursa Malaysia. No particular industry from the main board was excluded as an interim report is applicable for all industries. The study is based on the annual statements (i.e., annual and interim reports) for the year 2004 that were available on the Bursa Malaysia website. The statistical tests employed in this study are descriptive and univariate tests. The univariate test was a simple Chi-square test to examine whether the above characteristics had an influence on the decision whether interim reports would be audited or not. The result shows that the financial leverage, audit firm size and managerial share ownership hypotheses are supported but the firm size is not. The study also reveals that there is a significant difference between financial and non-financial companies in that financial companies are more likely to audit their interim reports than non-financial companies. Finally, the study also runs a logistic regression in order to consider the influence of the independent variables in a multivariate setting. Only one variable, i.e., industry type (financial and non-financial companies) significantly explains the decision of companies to audit their interim reports or not. In conclusion, it is argued that the study makes a positive contribution to enhancing the knowledge of interim reporting practices by Malaysian public listed companies and provides a useful basis to conduct future research.

ملخص البحث

تشـ بعض الدراسات – بالرغم من أن تقارير نصف السنة يئ معلومات أكثر انضباطا زمنيا ودقة فيها افظي الأسهم بالنسبة للشركة- إلا أن مثل تلك التقارير ضع للمحاسبة طبيعيا (انظر على سبيل ا ثال شرايفس 1989 وتان، 2002). وهم تجون بأن ا اجة إ ا اسبة الشاملة تتطلب تكلفة باهظة وخصوصا على الشركات ا صنفة الصغ ة إ جانب استغراق وقت طويل سبيل إصدار التقرير. مع ذلك، فإن من ا لاحظ، أن هناك بعض الشركات ا قامت حاسبة ذلك التقرير النصفي بنفسها على الرغم أ م لا يطالبون بالقيام بذلك. ولذلك حاول هذا البحث قيق ا سألة حول قيام بعض للشركات، بتلك ا اسبة، بينما لى عنها البعض الآخر. يتناول البحث أربعة سلوكيات الشركات ا يتوقع منها رفع اجراءات ا اسبة التطوعية على تقريرها النصفي. تلك السلوكيات الأربعة هي حجم الشركة، والقوة ا الية، وحجم شركة ا اسبة، والامتلاك على ا صة الإدارية. وأُخذت العينة من 120 شركة ا تصنف البورصة ا اليزية. ولا يوجد أي حذف لصناعة ددة اللائحة الرئيسة مع أن التقرير النصفي قابل للتطبيق على كل الصناعات. ويؤسس البحث على حسابات سنوية لعام 2004 ا وجودة على موقع البورصة ا اليزية. فالاختبارات الإحصائية ا ستخدمة هذا البحث وصفية، واختبار ذو ا اه واحد. وهذا الاختبار هو عبارة عن اختبار "تشي-مكعب البسيط" ليخت ما إذا كانت تلك السلوكيات السابقة ا تأث على النتيجة سواء أكانت تقارير نصف السنة اسب أم لا. أشارت النتائج بأن فروض قوة مالية، وحجم شركة ا اسبة وامتلاكها على ا صة الإدارية مدعمة وصحيحة وليس الأمر كذلك بالنسبة جم الشركة. وكشف البحث كذلك على وجود اختلاف واضح بـ الشركات ا الية ا صنفة وغ ا صنفة. وتبـ البحث أن الأو ا ميل أكـ للقيام حاسبة تقريرها النصفي خلافا للثانية. باختصار، قدم البحث مسا ة إ ابية سـ معرفة ارسات التقرير النصفي من قبل الشركات ا اليزية ا صنفة العامة ويعد أساسا نافعا لإجراء البحث ا قبل.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

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Hafiz Majdi Abdul Rashid
Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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LIST OF ABBREVIATIONS

ADTSIZE	Audit Firm Size
AIR	Audited Interim Report
APB	Accounting Principle Board
FASB	Financial Accounting Standard Board
FRS	Financial Reporting Standard
IAS	International Accounting Standard
INDUSTRY	Type of Industry
LEVRG	Financial Leverage
LSE	London Stock Exchange
MASB	Malaysian Accounting Standard Board
MGRSHR	Managerial Share Ownership
NYSE	New York Stock Exchange
OTC	Over-the-counter
SC	Securities Commissions
SIZE	Firm size

CHAPTER ONE

INTRODUCTION AND OBJECTIVE OF STUDY

1.0 INTRODUCTION

Financial statements are the most important and the prime source of information for the public regarding a firm. It provides information about business financial performance and financial position that is useful to those having reasonable rights to such information for making economic decisions. As mentioned by the by FASB (1978), the primary purpose of financial statements is to provide information for both internal and external users in making economic decisions. Since the users of financial statements have no access to a firm's accounting records, they depend heavily on the information disclosed in the annual reports when making judgments and decisions (Mohd Shatari, Muhd Kamil and Mustaffa, 2002).

However, in facing today's forces of competition and with the rapid developments in information technology, users are insisting on more frequent reporting than that offered on an annual basis. Instead of relying only on the previous years' data, they also want the most recent data for making economic decisions. They expect that companies will provide more complete, credible, accurate and updated information as frequently as necessary regarding the firm to achieve transparency in the organization. As a result, today the interim financial reporting has been required by various stock exchanges around the world to provide users with timely and high quality information in making informed financing and investing decisions. In the United Kingdom, for example, the London Stock

Exchange required companies to publish the half yearly reports within 90 days of the end of the quarter. Similarly, in the United States, all listed companies have been required by the Securities Exchange Commission to issue quarterly reports within 45 days of the period end. Thus, with the introduction of the requirement for quarterly reporting to the public, it is expected that the objective of having transparent and quality information would be achieved thus enhancing investors' confidence in the capital market (Ku Nor Izzah and Roy, 2003).

Generally, the primary purpose of the interim report is to provide timely information on the progress of an enterprise. As suggested by the Financial Accounting Standard Board (FASB), the objectives of interim reporting should be: (a) to aid in estimating annual results, (b) to aid in making forward projections, (c) to ascertain turning points in earning's trends, (d) to evaluate management performance, and/or (e) to supplement the annual report (McEwen and Schwartz, 1992). Other views pertaining to the objectives of interim reporting are (a) to communicate in a readily understandable way – timely, reliable and relevant about an entity's operating, investing and financing activities to diverse users who rely on that information as a principal source and who may have limited authority, ability or resources to obtain such information, (b) to provide a focus for resources allocation decisions by providing information to assist in predicting, comparing and evaluating potential earnings and cash flows in terms of the amount, timing and related uncertainty and (c) to report on management's stewardship, financial performance and ability to use resources effectively in achieving the primary goal (Micheal and Paul-Emile, 1991).

From the above discussions, we can see that by having additional current information at various times throughout the year, it could maintain the credibility of financial reporting and consequently build a strong capital market. Companies will provide a more frequent, relevant, complete and transparent picture of their performance so that it could help investors to reduce the likelihood of making the wrong investment decisions. Users need to know the ability of the organizations to manage their affairs and resources efficiently and effectively. As for Malaysia, stringent rules and regulations need to be imposed by the regulatory bodies especially the Bursa Malaysia, the Securities Commission and the Malaysian Accounting Standard Board to ensure the listed companies publish their interim reports within the stipulated period.

1.1 INTERIM REPORTING IN MALAYSIA

In Malaysia, concerning the disclosure of financial reporting requirement, it is governed by the Companies Act (1965), Financial Reporting Act (1997) and the accounting pronouncements issued by the Malaysian Accounting Standard Board (MASB). Other statutes and bodies that also regulate the disclosure of financial reporting include Bursa Malaysia (formerly known as the Kuala Lumpur Stock Exchange), the Malaysian Securities Commission and the Income Tax Act 1967.

Companies which wish to maintain their presence in the listed market (to be quoted on the Bursa Malaysia) must meet certain requirements as set out by the Securities Commission and Bursa Malaysia. For a company to be listed on the main board, they are required to maintain a minimum paid-up capital of RM50 million comprising ordinary shares of RM1 each. For the second board listing, a minimum paid-up capital of RM10 million but less than RM50 million comprising ordinary shares of RM1 each is required. Apart from that, the companies must also disclose or publish all information that is deemed relevant to the investors. Bursa Malaysia has the authority to request additional information on the companies' activities at any time.

Concerning the financial reporting requirements, all listed companies must publish their annual reports as well as their interim reports to their investors. The Malaysian Securities Commissions (SC) under the Post Listing Obligations required public listed companies to submit interim and periodic reports to the SC immediately after figures are available and to announce financial results within a period in accordance with the listing requirements of the stock exchange. However, the Malaysian Accounting Standard Board (MASB) does not mandate which companies should publish their interim reports, but encourages all companies to publish in accordance with the principles as set out in the standards.

Interim reporting in Malaysia began in 1987 when the Bursa Malaysia started requiring listed companies to submit a half-yearly report. However, after the year 1997 following the Asian financial crisis, Bursa Malaysia made a number of amendments to the requirements. This was to enhance and restore the confidence of investors and financiers locally and internationally in the relevance and reliability of the financial statements. In this connection, with effect from 31 July 1999, public listed companies in Malaysia are required by Bursa Malaysia to release their interim financial reporting to the public in the form of a quarterly report instead of a half-yearly report within two months of the end of the financial quarter (Tan, 2000). Starting from 1 July 2002, the preparation of the interim financial report has to follow Appendix 9B in the Bursa Malaysia Listing Requirements and also the Financial Reporting Standard 134_{2004} (hereafter FRS 134_{2004}) "Interim Financial Reporting".

1.2 FINANCIAL REPORTING STANDARD 134$_{2004}$ REQUIREMENTS

The adoption of FRS 134$_{2004}$ on “Interim Financial Reporting” by public listed companies is to ensure that the stakeholders and stockholders are fully informed regarding the progress of the business. Having this standard, allows investors of listed companies to access the most recent developments in the business on a quarterly basis instead of waiting for financial statements at the end of the year. The FRS 134$_{2004}$ became operative for financial statements covering periods beginning on or after 1 July 2002.

The rules of FRS 134$_{2004}$ are similar in all aspects to the International Accounting Standard 34. The objective of this standard is to prescribe the minimum content of an interim financial reporting and to prescribe the principles for recognition and measurement in complete or condensed financial statements for an interim period. Under Paragraph 4 of the Standard, Interim Financial Reports can be prepared either as a complete set of financial statements or a set of condensed financial statements for an interim period. If the listed companies are intended to have a complete set of financial statements, they should conform to the requirements of Financial Reporting Standards 101 (hereafter FRS 101) “Presentation of Financial Statements” which include the balance sheet, income statement, statement of changes in equity, cash flow statement and accounting policies and explanatory notes[1] (paragraph 9). On the other hand, if the companies elect to provide less information at interim dates or a set of condensed financial statement, those condensed should include, at a minimum, each of the headings and subtotals that were included in its most recent annual financial statements and the selected

[1] Prior to this, there was no requirement for public listed companies to publish a cash flow statement on a quarterly basis.

explanatory notes as required by the Standard (paragraph 10). The condensed financial statement includes the condensed balance sheet, condensed income statement, condensed statement of changes, condensed cash flow statement and selected explanatory notes.

However, this standard does not provide a checklist as to what information needs to be included in the financial statements. Management of listed companies will have to think for themselves and use their best judgment as to the extent of the information which needs to be disclosed so that investors are fully informed regarding the most recent developments of the companies. Realizing that there is no standardized form of presentation, PricewaterhouseCoopers(PwC) provided an Illustrative Interim Report to guide the listed companies to comply with the requirements of the current reporting regime. The report consists of two parts, namely, an analysis and interpretation of FRS 134_{2004} and a sample of an annual report based on a fictitious limited liability enterprise with shares listed on the Bursa Malaysia main board. However, the sample should not be considered the only acceptable form of presentation. The form and content are still the management's responsibility and they should include the specific and minimum disclosures prescribed by the FRS 134_{2004} and Bursa Malaysia for interim reporting.

FRS 134_{2004} requires the companies to apply the same accounting policies in its interim financial report as applied in its annual reports except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements (paragraph 31). The frequency of an enterprise's reporting (quarterly report) should not affect the measurement of its annual results. As such, the standard requires that the measurement for interim reporting purposes should be made on a year-to-date basis (paragraph 16). In deciding how to recognize, classify or disclose an item for interim financial reporting purposes, materiality is to be assessed in relation to the interim period financial data, not forecasted annual data (paragraph 26). FRS 134_{2004} further provides that interim reports should include interim financial statements (whether condensed or complete) for the periods as follows (paragraph 23):

a. a balance sheet as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year;

b. income statements for the current interim period and cumulatively for the current financial year to date, with a comparative income statement for the comparable interim periods (current and year-to-date) of the immediately preceding financial year;

c. a statement of changes in equity or statement of recognized gains/losses cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year; and

d. a cash flow statement cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

In conjunction with the issuance of FRS 134_{2004}, Bursa Malaysia has made a number of amendments to the requirements. The Exchanges have removed the fixed format previously prescribed for quarterly reports and adopted the Standard to be the guidance in respect of quarterly reports for all quarters ending on and after 30 September 2002. Such amendments can be seen under Paragraph 9.22(2) of the Bursa Malaysia Listing Requirements which specify that the quarterly report must be prepared in accordance with approved accounting standard of the Financial Reporting Standard. In addition to the requirements of FRS 134_{2004}, the quarterly report must also include the information as set out in Part A of Appendix 9B of its Listing Requirements and any other information as may be required by the Exchange and if a change in the financial year is proposed, the companies must consult the Exchange as to the period to be covered by the quarterly report.

The above amendments are effective for the listed issuer and they need to comply with the new requirements even though the financial quarter ending on 30 September 2002 is not the first quarter of the listed issuer's financial year end.

As indicated earlier, regulation is the most effective way to ensure that firms publish their interim reports on a timely basis. If the company is trying to maintain its presence in the listed market, it needs to comply with the requirements as stipulated by the regulatory bodies. In addition, most of the academic research has consistently found that investors are influenced by interim data, and according to Pacter (1996), the share prices are more accurate when based on historical annual data and on interim data than when based on historical annual data.

1.3 THE TIMELINESS OF INTERIM REPORT

The interim report may be at issued quarterly, monthly or at other appropriate intervals. It consists of either a complete set of financial statements or summarized data. However, the reporting lag permitted for interim reporting differs from country to country. In the US for example, as reported by Ku Nor Izzah and Roy (2003), the Securities and Exchange Commission of New York requires the listed companies to publish their quarterly financial reports within 45 days of the end of each quarter. They include an abbreviated income statement, balance sheet, statement of cash flows and selected footnotes and other relevant disclosures as well as comparative data for prior interim reports.

In the United Kingdom, the London Stock Exchange (LSE) allows companies to issue the half-yearly reports within 90 days. However, there are certain companies that publish the half-yearly reports earlier than the period of 90 days. This has been proven in the research undertaken by Bagshaw (1999) (as cited in Ku Nor Izzah and Roy) who found that 60 per cent of the 30 top Financial Times Stock Exchange issued that interim reports within 60 days of the period.

In Malaysia, the Bursa Malaysia required an interim financial report to be available for publication not later than 60 days (prior to this is 90 days) after the end of the quarter period and it must be prepared in accordance with the approved accounting standards of the Malaysian Standards Board. Paragraph 9.22(1) of the Bursa Malaysia Listing Requirements relating to quarterly reports specifies that "a listed issuer must give the Exchange for public release, an interim financial report that is prepared on a quarterly basis as soon as the figures have been approved by the board of directors of the listed issuer, and in any event not later than two months after the end of each quarter of a financial year." Late submission will cause the Bursa Malaysia to take necessary action against the affected companies. As suggested by Idawati Ibrahim, Hazeline Ayoup & Ayoid Che Ahmad, (2004), the usefulness of the interim reports to the investors in making economic decisions will diminish if the companies submit the interim report far beyond the reporting dateline.

1.4 OBJECTIVE OF THE STUDY

Many questions can be raised with respect to these interim financial reporting practices. For instance, should an interim financial report contain a complete set of financial statements or a condensed set of financial statements? A choice is provided between the preparation of full financial statements and the preparation of condensed financial information. If the companies elect to provide a full financial statement, then they need to comply with FRS 101 "Presentation of Financial Statements". As for condensed financial statements, they should include a minimum and the most recent annual financial statements and the selected explanatory notes. The point is that what constitutes condensed has not been defined and is still subject to additional discussion. The companies might omit one or more of the required financial statements or might present all of the basic statements as required for a complete set but might omit some or many notes. There is no standardized checklist and thus the management has to use their best judgment as to what information needs to be disclosed.

Another question which can be put forward and perhaps the fundamental question in this research, is whether it is necessary for interim financial reports to be audited or reviewed by an independent auditor because an audit adds to the credibility and reliability of reported financial information. In Malaysia, in the case of interim reports practices, no professional body has yet issued standards which have addressed the specific auditing requirements for interim financial reporting. However, there are cases in which firms have audited their interim reports even though it is not mandatory to do so. Recently, when Idawati Ibrahim et al., (2004) examined the issues of the timeliness of interim reports, they found that there were 23 interim reports audited out of 836 reports analyzed and most of them were from the fourth quarter. Therefore, this study searches for the answer of why these companies choose to voluntarily audit their interim reports. In other words, what are the inherent factors that might influence a company to audit its interim reports voluntarily?

The above question is addressed by undertaking a review of the relevant professional and academic literature on the interim report and incorporates literature on the traditional firm's characteristics which are expected to increase the likelihood of a company to audit its interim reports. Four characteristics of firms are used to predict whether a company will voluntarily audit its interim reports. These factors are firm size, financial leverage, audit firm size and managerial share ownership.

To date, there is no empirical study that has examined the audit issues associated with the interim report practices. Therefore, as an exploratory study, the aim is to develop insights into rather than provide a comprehensive discussion on interim report practices. In addition, the study also provides some indication of whether the company's decision to voluntarily audit its interim reports is associated with firm specific characteristics such as firm size, financial leverage, audit firm size and managerial share ownership.

1.5 OUTLINE OF THE STUDY

The study consists of five chapters. In the next chapter, Chapter 2, the relevant literature on the issues of interim reports will be reviewed followed by a discussion of a number of studies on the demand for auditing. Chapter 3 explains the four hypotheses to be tested and the research method employed in the study. Next, Chapter 4 discusses the results of the analysis of Malaysian main board listed companies in 2004. Finally, the conclusion of the study, its limitations and recommendation for future research are presented in Chapter 5.

CHAPTER TWO

LITERATURE REVIEW

2.0 INTRODUCTION

Many prior studies on interim financial reporting have focused on the adoption of the standard by companies in selected countries. This concerns issues such as the (1) compliance level of the standard, (2) the usefulness of interim financial reports, (3) problems encountered in the preparation of these reports and (4) a survey of current interim financial reporting practices among the companies. However, little is said about the significant auditing issues that are associated with interim report practices.

This chapter will highlight some prior studies on the interim report practices that have significant implications on audit. The first part in this chapter, Section 2.1, will discuss the various views on the issues of interim report practices conducted both at the international and national levels. Then, a review of the relevant literature which addresses a number of studies on the demand for auditing is considered briefly in Section 2.2. The discussion of these two bodies of literature is arranged as such in order to provide insights into a number of factors that might influence a particular firm to audit its financial statements voluntarily that could relate to the practice of interim reports. Finally, the summary of the chapter will be presented in Section 2.3.