AUDIT QUALIFICATIONS AND GOVERNANCE CHARACTERISTICS: AUSTRALIAN EVIDENCE

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Abstract

This study extends previous research by empirically investigating the relationship between internal governance monitoring mechanisms and the probability of receiving a qualified audit report. Corporate governance monitoring devices are measured using five alternative proxies: board size, board independence, audit committee size, audit committee independence, and audit committee meeting frequency. The analysis of logistic regression is conducted to test the hypotheses proposed for this study. Using a sample of 121 Australian manufacturing companies listed on the Australian Stock Exchange (ASX), this study adds to the growing body of literature that documents the importance of boards and audit committees' role in monitoring management behavior. This study finds smaller size board of directors appear to more effective than large size boards. In addition, audit committee independence improves the quality of financial reporting leading to receive a clear audit opinion. In regard to control variables, this study provides evidence that Leverage and ROI are important variables in explaining the auditors' propensity to qualify their opinions. Particularly, the study finds a positive (negative) and highly significant (at p<0.01) association between both Leverage (ROI) and the possibility of receiving qualified audit reports. This has significant implications for companies that are moving towards a more regimented corporate governance structure to enhance the quality of financial reporting.

Keywords: *Qualified audit opinion, internal governance monitoring mechanisms, Australian companies*

Abstrak

Penelitian ini memperluas penelitian sebelumnya yang menyelidiki hubungan antara mekanisme pemantauan tata kelola internal dan probabilitas menerima laporan audit yang berkualitas. Elemen tata kelola perusahaan yang dikaji diukur dengan menggunakan lima proksi yaitu: ukuran dewan direksi, independensi dewan direksi, ukuran komite audit, independensi komite audit dan frekuensi pertemuan komite audit. Analisis regresi logistik dilakukan untuk menguji hipotesis yang diajukan untuk penelitian ini. Menggunakan sampel dari 121 perusahaan manufaktur Australia yang terdaftar di Bursa Efek Australia (ASX), studi ini menambah semakin banyak literatur yang mendokumentasikan pentingnya dewan komisaris dan peran komite audit dalam pemantauan perilaku manajemen. Studi ini menemukan ukuran dewan komisaris yang lebih kecil tampaknya lebih efektif daripada ukuran dewan komisaris besar. Selain itu, independensi komite audit meningkatkan kualitas pelaporan keuangan untuk menerima opini audit yang jelas. Dalam kaitan dengan variabel kontrol, penelitian ini memberikan bukti bahwa Leverage dan ROI adalah variabel penting dalam menjelaskan kecenderungan auditor untuk memenuhi pendapat mereka. Khususnya, studi ini menemukan hubungan positif (negatif) dan sangat signifikan (pada p <0,01) antara kedua leverage (ROI) dan kemungkinan menerima laporan audit yang berkualitas. Hal ini memiliki implikasi yang signifikan bagi perusahaan yang bergerak menuju struktur tata kelola perusahaan untuk lebih meningkatkan kualitas pelaporan keuangan.

Kata kunci: *Opini audit yang berkualitas, mekanisme pengawasan tata kelola internal, perusahaan di Australia.*

INTRODUCTION

This study extends previous research by empirically investigating how internal governance monitoring mechanisms affect the probability of receiving a qualified audit report for 121 manufacturing firms listed on the Australian Stock Exchange (ASX). Corporate governance monitoring devices are measured using five alternative proxies: board size, board independence, audit committee size, audit committee independence, and audit committee meeting frequency.

The occurrence of a qualified opinion remains a central concern of financial statement users (Sanchez-Ballesta & Garcia-Meca, 2005; Bhimani, Gulamhussen & Lopes, 2009; Lin, Jiang & Xu, 2011), and a source of client dissatisfaction and client loss (Chow & Rice, 1982). Specifically, previous research documents that going-concern audit opinion qualifications have a strong association with stock returns (Dopuch, Holthausen & Leftwich, 1986; Choi & Jeter, 1992; Jones, 1996) and difficulty in getting debt capital (Firth, 1980). The going-concern audit opinion qualifications are also effective at signalling financial distress and bankruptcy events (Hopwood, McKeown & Mutchler, 1989; Kennedy & Shaw, 1991; Mutchler, Hopwood & McKeown, 1997). Consequently corporate ma n agement may pressure auditors to forego issuing a qualified audit report (Mutchler, 1984; Carcello & Neal, 2000).

The question of audit quality is important within the Australian business context given developments since the turn of the millennium. On 18 September 2002, the Australian Federal Government released the reform proposals[1] in the *Corporate Law Economic Reform Program (CLERP 9) Discussion Paper* in order to strengthen arrangements for the oversight of the accounting and auditing profession (ASIC, 2002). The proposal promised to reshape the corporate governance framework in Australia.[2] On 31 March 2003, the *Principles of Good Corporate Governance and Best Practice Recommendations* (*ASX 2003*) were also adopted as the pivotal component of the framework for reforming the corporate governance system. Among other things, *CLERP 9* emphasises the roles of the board of directors, management and auditors (Gay & Simnett, 2003).

One important change implemented in *CLERP 9* that affects the auditor profession has been the setting up of an audit committee as a sub-committee of the board of directors. An audit committee consists of independent and non-executive members of the governing body of the company. The audit committee represents shareholders in a key role to monitor the performance of management. It oversees the financial reporting and auditing process. For this reason, an audit committee plays important corporate governance roles (Gay & Simnett, 2003) and may have a more direct role in controlling management's actions (Xie, Davidson & DaDalt, 2003). Thus, the role of board of directors and audit committee in supervising management is arguably viewed as the solution for problem arising from agent-principal relations. Previous literature documented the presence of modified (qualified) opinion is associated with the effectiveness of monitoring mechanism variables such as the number of member on the boards and the percentage of the members of the board of directors that are considered independent (Firth, Fung & Rui., 2007).

The finding of this study regarding how internal governance monitoring mechanisms affect the probability of receiving a qualified audit report which is based on Australia evidence also provide insights to researchers interested in looking at the association between corporate governance attributes and audit qualification in some other countries such as Indonesia. More interestingly, in In-

[1] This proposal was passed by Parliament on 25 June 2004, and received Royal Assent on 30 June 2004 under the name of the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (CLERP 9 Act).

[2] The corporate governance in Australia is developed by the ASX Corporate Governance Council. It consists of 10 principles and 28 recommendations. Each principle is accompanied by a series of best practice recommendations in addition to specific guidance on disclosure.

donesia, the Company Law (Law No. 40 of 2007 on Limited Liability Companies) recognizes a two-tiered structure: the Board of Commissioner acts as the supervisory board and the Board of Director acts as the management board.

This study differs from prior research on three main fronts. First, this study provides further evidence of the relationship between internal governance monitoring mechanisms and the propensity to obtain a qualified opinion using data from a different domestic setting (i.e., Australia). Previous literature on the governance monitoring mechanism – audit opinion linkages using Australian data has been limited. Second, this study enriches the literature by analysing the several corporate governance attributes and audit qualification. As Vafeas and Theodorou (1998) remark, the study of key related corporate governance characteristics in isolation may hide key inferences, leading to misleading findings. Third, this study focuses solely on the manufacturing sector. Using data from the manufacturing firms group is expected to ensure data homogeneity.

The remainder of this paper is organised as follows. The next section establishes the theoretical framework underlying internal governance monitoring mechanism–qualified opinion linkages. The hypotheses are also developed in this section. Section three describes the research design. Primary results including descriptive statistics, correlations and regression analysis are presented in section four. Results of the study and implications for future research are discussed in the concluding section.

Literature Review and Hypothesis Formulation

This study use five internal governance monitoring attributes: board size, board independence, audit committee size, audit committee independence, and audit committee meeting frequency, to predict the frequency of receiving qualified audit reports.[3]

Monitoring device and audit opinion

Jensen and Meckling (1976) identify the existence of two agency relationships: (1) the manager-shareholders (e.g., bonus plans) which the manager acts as an agent for the shareholders who are considered to be the owners; (2) the shareholder-debt holder (e.g., debt contracts) where the manager is assumed to act on behalf of the shareholders, thus the manager is an agent whereas the debt holder becomes the principal. Such situations impose agency costs, due to the existence of conflicts of interest between the agents and the principals. Agency theory discusses the types of monitoring and bonding costs that can be employed to reduce agency conflicts.

Various financial scandals that occurred earlier in this decade have raised the issue of whether public companies are being run in the best interests of the shareholders. Consequently, the role of governance in disciplining corporate management has been the topic of an active debate among regulators, corporate governance reformists and academics. Cadbury (1997) suggests strong governance occurs if there is balancing of firm performance with an appropriate level of monitoring. According to Fama and Jensen (1983), the most critical monitoring mechanism is that of the board of directors. The board and its committees are charged with monitoring the decisions and actions of corporate management to ensure the management acts in the best interest of shareholders. The monitoring mechanisms examined in this study are size of directors (Sanchez-Ballesta & Garcia-Meca, 2005; Firth et al., 2007), independent board of directors (Davidson, Goodwin-Stewart & Kent, 2005; Firth et al., 2007; Al-Abbas, 2009; Adeyami & Fagbemi, 2010; Iyengar & Land, 2010; Lin & Hwang, 2010), size, independent and the number of audit committee meeting (Menon & Williams, 1994; Davidson et al., 2005; Al Abbas, 2009; Iyengar & Land,

[3] In addition to the independent variables of interest for which separate hypotheses are formed in the following subsections this study controls for the effects of other factors that are likely to influence the auditor's propensity to issue a qualified audit report: size of firm, leverage, and return on investment (Francis & Krishnan, 1999; Carcello & Neal, 2000; Firth *et al*, 2007).

2010; Lin & Hwang, 2010; Kang, Kilgore & Wright, 2011).

Size of board of directors and qualified opinion

Nam and Nam (2004) argue that board's size is an important determinant of board's effectiveness. Many empirical studies have tried to find the optimal size of a company's board of director. Huther (1997) suggests that just like any other decision making bodies governing boards face coordination problems. These problems increase as the size of governing body increase. Lipton and Lorsch (1992) argue that the maximum size of the board of directors is ten. They (Lipton & Lorsch, 1992) further argue that the size less than ten is optimal as a smaller board works better and could be less manipulated by the delegated director. Jensen (1993) suggests that board sizes in the U.S. tend to be too large and recommends that boards have no more than eight directors.

More recently, there are some studies that model theoretical determinants of board structure including board size. Lehn, Patro & Zhao (2004) find that board size is positively related to firm size and positively related to growth opportunities. Boone, Field, Karpoff & Raheja (2007) find that board size increases as companies grow and diversify over time. They (Boone et al., 2007) also argue that board size reflects a trade-off between the firm-specific benefit and cost of monitoring. Linck, Netter & Yang (2008) report that board structure across companies is consistent with the cost and benefits of the board monitoring and advising roles. They (Linck et al., 2008) provide evidence that board size fell in the 1990s for large firms and board size was relatively flat for small and medium-sized companies. In addition, the trend of board size for larger companies was reversed by the implementation of the Sarbanes-Oxley Act of 2002. In audit opinion studies, Firth et al. (2007) expect firms that have a large board more frequently receive a qualified audit opinion. Firth et al. (2007), however, find the opposite direction. Ballesta and Garcia-Meca (2005), meanwhile, fail to detect any relationship between the two variables. Based on above discussion, therefore, the first hypothesis is:

H_1: The number of member on board of directors influences the probability to receive an audit qualification opinion.

Independent board of directors and qualified opinion

Beasley (1996) and Dechow, Sloan & Sweeney (1996) suggest that the ability of the boards to act as an effective monitoring mechanism depends on their independence from management. The boards are considered to be independent if there is no relationship with the company beyond the role of director. Lipton and Lorsch (1992) define an independent director as a director who has no connection with the company, either as management, customer or supplier of goods or services. Thus, the independent board member refers to a non-executive director who is not employed bythe company and entirely independent from management. Such non-executive directors are more likely to have incentives to guard shareholder interests because of an invested reputational capital in a firm (Fama & Jensen, 1983; Vafeas & Theodorou, 1998).

Empirical findings regarding an association between board independence and corporate performance are inconclusive. Some studies suggest the presence of the non-executive boards improves company value. Beasley (1996) finds that the existence of independent directors associates with less financial statement fraud. Using a sample of 692 U.S. firms, Klien (2002) reports a negative relation between board independence absolute value of discretionary accruals (a proxy for earnings management). Peasnell, Pope & Young (2000) show evidence supporting Klein's findings in the U.K. context. In addition, Dechow et al. (1996) reveal that the greater proportion of independent directors the less likely the firm is subjected to Securities and Exchange Commission (SEC) enforcement actions because of violating U.S. GAAP. Conversely, Agrawal and Knoeber (1996) indicate that the representation of a higher proportion of independent directors on boards is

associated with poor performance. Hermalin and Weisbach (1991), meanwhile, document no association between the percentage of non-executive directors serving on the board and firm value for a sample of 142 U.S. firms. Again, more recently (e.g., Al-Abbas, 2009; Adeyami et al., 2010; Iyengar & Land, 2010) find no relation between the presence of the independent directors and earnings quality. Finally, Ballesta and Garcia-Meca (2005) and Firth et al. (2007) document that the proportion of board independence affects the informativeness of earnings, implying less likely to receive a modified audit opinion. Therefore, this study tests the following hypothesis:

H_2: The fraction of independent directors on the board influences the probability to receive an audit qualification opinion.

Size of audit committee and qualified opinion

The majority of previous studies concerning the relationship between board of directors' composition and firm value have concentrated on the role of the board at large; however, a great deal of board's decision-making occurs at the committee level (Ellstrand, Daily & Johnson, 1999). To oversee the accounting and financial reporting processes of a company as well as the audit of its financial statements, boards of directors delegate their responsibility to an audit committee (Baxter & Gardenne, 2008). Thus, it is expected that this committee provides shareholders with the greatest protection in maintaining the credibility of a company's financial statements (Bradbury, 1990). In performing its primary function, the audit committee meets regularly both with the company's external and internal auditors for reviewing the firm's financial statement, audit process, and internal accounting controls (Klein, 1998, 2002). A study of 142 U.K. firms conducted by Collier (1993) suggests that firms establish audit committees to alleviate agency problems and to reduce information asymmetry between insiders and outsiders. Evidence also shows that the formation of audit committee associates with more informativeness of reported earnings (Mitra, Hossain & Deis, 2007) and less financial fraud (Dechow et al., 1996; McMullen & Raghunandan, 1996).

Empirical studies provide inconclusive evidence of the impact of audit committee size on financial reporting quality. Abbott, Xie et al. (2003) and Parker and Peters (2004) find no significant association between the number of directors on the audit committee and earnings quality measures. Nonetheless, Yang and Krishnan (2005) and Lin and Hwang (2010) reveal that earnings quality is negatively related to the size of the audit committee. Thus, my third hypothesis is:

H_3: The number of members on audit committee influences the probability to receive an audit qualification opinion.

Independent audit committee and qualified opinion

Prior literature indicates that the effectiveness of an audit committee is dependent on the subcommittee objectivity (or independence), diligence (or activity as defined by meeting frequency) and size (Bedard, Chourou & Courteau, 2004; Davidson et al., 2005). It is arguably impossible for the audit committee to function effectively if members are also executives of the firm (Lynn, 1996). Thus, an audit committee should be comprised entirely of non-executive or independent directors (Lipton & Lorch, 1992; Menon & Williams, 1994). This argument is supported by Jiambalvo (1996) who finds that audit committee independence is associated with a higher degree of active oversight and a lower incidence of financial statements fraud. Davidson et al. (2005), Lin and Hwang (2010), and Kang et al. (2011) derive empirical support that the existence of an independent audit committee is significantly associated with a lower level of earnings management. However, Klein (2002), Al-Abbas (2009), and Iyengar and Land (2010) fail to find evidence that the majority of non-executive directors on the audit committee reduces levels of earnings management. Klien (2002), moreover, finds no meaningful relationship between earnings management and audit committee consisting exclusively of independent directors. Addi-

tionally, Carcello and Neal (2000) who investigate the association between the composition of financially distressed companies' audit committees and the propensity of receiving going-concern audit reports, show that the greater percentage of independent directors on the audit committee the higher the probability the auditor will issue a going-concern qualified report. Following previous research, my fourth hypothesis is:

H_4: The fraction of independent directors on the audit committee influences the probability to receive an audit qualification opinion.

Number of audit committee meeting and qualified opinion

In performing its primary function, the audit committee meets regularly both with the company's external and internal auditors for reviewing the firm's financial statement, audit process, and internal accounting controls (Klein, 1998, 2002). Menon and Williams (1994) argue that a signal of an audit committee diligence is the number its meetings. Thus, meeting frequency is a key successful factor of audit committee effectiveness (Abbott, Parker & Peters, 2003b). Some researches support the importance of audit committee meeting frequency. Beasley, Carcello, Hermanson & Lapides (2000) and Abbott et al. (2004) document that audit committee of non-fraud companies meet more often than those of fraud companies. Additionally, audit committees of companies that meet at least four times a year are less likely to have restated their financial statements (Abbott, Parker & Peters, 2003a). Furthermore, Xie et al. (2003) and Lin and Hwang (2010) show that audit committee meeting frequency is negatively related with the levels of discretionary current accruals (a proxy for earnings quality). The fifth hypothesis is:

H_5: The audit committee meeting frequency influences the probability to receive an audit qualification opinion.

RESEARCH METHOD

Sample selection

To ensure data homogeneity, this study only focuses on manufacturing Australian incorporated entities. Due to pragmatic constraints I randomly selected 200 Australian manufacturing firms listed on the ASX as at the end of June 2006. This study focuses on Australia incorporated entities, thus 10 firms incorporated overseas were excluded from sample. In addition, eight IPO firms during the investigation calendar year were excluded from the sample as Caramanis and Spathis (2006) report that the first year of a firm's listing may affect the likelihood of receiving a qualified audit opinion. Of the remaining 182 manufacturing firms, this study was unable to collect sufficient information to calculate proxy measures for 61 entities. Accordingly, the statistical analysis is based on a final sample of 121 companies. Table 1 summarises a sub-manufacturing industry breakdown of the final usable sample that is employed in the statistical analysis.

Table 1. Sample used in analysis and sub-manufacturing industry breakdown

Industry type$^{\Psi}$	N	Audit opinion	
		Unqualified	Qualified
Materials	31	19	12
Capital Goods	18	13	5
Health Care Equipment	12	11	1
Pharmaceuticals & Biotechnology	20	18	2
Real Estate	19	19	0
Food, Beverage and Tobacco	7	5	2
Technology Hardware & Equipment	14	10	4
Total:	**121**	**95**	**26**

Legend: Ψ – Manufacturing sub-industry sectors are defined in accordance with the ASX classification schema.

Empirical model and variables

The following cross-sectional logistic regression model is used to test the hypotheses:

$$Opinion_i = \alpha + \beta_1 BoardSize + \beta_2 IndBoard + \beta_3 AudComSize + \beta_4 IndAudCom + \beta_5 AudComMeet + \beta_6 ClientSize + \beta_7 Leverage + \beta_8 ROI + \varepsilon_i$$

Where:
i is firm 1 through 121; α is constant term; *Opinion* is 1 for firm that received a qualified audit opinion, and 0 otherwise; *BoardSize* is the total number of board of director members; *IndBoard* is the percentage of the board of directors that is independent; *AudComSize is* the total number of audit committee members; AudComMeet is the number of audit committee meeting; *IndAudCom* is the percentage of the audit committee that is independent; *ClientSize* is natural logarithm of total assets; *Leverage* is total debt divided by total assets; *ROI* is net income divided by total assets; and ε_i is the error term.

RESULTS AND DISCUSSION

Univariate tests

Table 2 presents the independent sample t-test results for the variables in the regression model. The univariate tests performed suggest several variables may be helpful in explaining audit qualifications. The large differences in average values of *BoardSize*, *AudComSize*, and *IndAudCom* between firms with unqualified and qualified reports and the high statistical significance ($p<0.01$) indicate that these three independent variables may indeed relate to audit opinion decisions. Conversely, the average values of *IndBoard* and *AudComMeet* do not show significant differences between the two groups of audit opinions. In regard to control variables, the qualified groups have a substantially lower mean for total assets (*ClientSize*), but higher mean values of *Leverage* and *ROI*. The mean differences in these control variables between the two audit opinion groups are statistically highly significant at $p<0.01$.

Table 2. Univariate models for audit opinion on independent and controls variables

Continuous variables	Unqualified		Qualified		t-test	Sig.
	Mean	Std	Mean	Std		
BoardSize	5.54	1.70	3.96	1.28	5.154	0.000
IndBoard	52.53	22.21	48.46	30.76	0.631	0.533
AudComSize	2.78	1.09	1.77	1.39	3.416	0.002
IndAudCom	69.02	32.00	43.33	45.60	2.696	0.011
AudComMeet	2.96	2.17	2.13	2.36	1.606	0.113
ClientSize	506,123	1,016,057	48,144	163,585	4.199	0.000
Leverage	37.90	25.23	57.50	62.87	-2,425	0.014
ROI	37.86	39.84	43.88	34.98	3.566	0.001

Legend: See page 11 for full definitions and descriptions for the dependent, independent and control variables.

Table 3. Pearson and Spearman correlation matrix

	Opinion	*BoardSize*	*IndBoard*	*AudCom Size*	*IndAud-Com*	*AudCom-Meet*	*ClientSize*	*Leverage*	*ROI*
Opinion		-0.373*	-0.069	-0.338*	-0.289*	-0.149	-0.403*	0.217	0.431*
BoardSize	-0.450*		0.140	0.492*	0.340*	0.418*	0.584*	-0.144	0.230**
IndBoard	-0.060	0.190**		0.221*	0.567*	0.173	0.131	0.172	-0.111
AudComSize	-0.350*	0.560*	0.227**		0.520*	0.485*	0.504*	-0.084	-0.385*
IndAudCom	-0.232**	0.330*	-0.592*	0.322*		0.442*	0.351*	0.066	-0.261*
AudComMeet	-0.193**	0.395*	0.149	0.549*	0.422*		0.513*	0.041	-0.226**
ClientSize	-0.438*	0.580*	0.134	0.506*	0.287*	0.491*		0.158	0.556*
Leverage	0.063	0.019	0.087	0.049	0.137	0.136	0.374*		-0.355*
ROI	0.402*	-0.345*	-0.101	-0.336*	0.209**	-0.284*	0.576*	-0.385*	

Legend: * and ** indicate significance at $p<0.01$ and $p<0.05$ (based on two-tailed tests). See page 14 for full definitions and descriptions for the dependent, independent and control variables. See page 11 for full definitions and descriptions for the dependent, independent and control variables.

Table 3 provides a correlation matrix between the dependent, independent and control variables. The upper half reports Pearson pairwise correlation coefficients (cr_p), while the lower half Spearman correlation coefficients (cr_s). There are negative correlations between all independent variables and the frequency of receiving a qualified audit report. However, only *BoardSize, AudComSize,IndAudCom, and AudComMeet* are statistically significant both in the Pearson and Spearman correlation matrix. Findings also show a significant correlation (both cr_p and cr_s) amongst independent variables, except for the relationship between *IndBoard* and *AudComMeet*. The highest correlation is between *IndAudCom* and *IndBoard*, with a coefficient of 0.567 ($p<0.01$ c_{rp}) and 0.592 ($p<0.001$ cr_s). As the correlation value is below the critical limits of 0.80 (Hair et al., 1995; Greene, 1999) it is suggested that a multicollinearity problem between independent variables is not a serious concern. In respect to correlations between independent and control variables, and amongst control variables themselves, the highest correlations are between *BoardSize* and *ClientSize*, with a coefficient of 0.584 ($p<0.01$ c_{rp}) and 0.580 ($p<0.01$ cr_s). Again, this value is below the critical limit of 0.80. Variance inflation factors calculated for all regressions reported in Table 4 for all independent and control variables provide further indications that multicollinearity is not a problem in the model estimations (Hair, Anderson, Tatham & Balck, 1995; Greene, 1999; Cooper & Schindler, 2003).

Multivariate analysis

The results of multivariate logistic regression for testing the hypotheses are reported in Table 4. The overall per cent of correct classification is 91.74%. The relationship between dependent and independent variables is significant ($\boldsymbol{X^2}$ = 71.023, $p<0.000$). The pseudo $\boldsymbol{X^2}$ = 44.4% implies a relatively strong relationship between the dependent and independent variables. The results report that only *BoardSize* and *IndAudCom* predictors are statistically significant at $p<0.05$, therefore, H_1 and H_4 are supported. The *BoardSize* coefficient is negative, supporting the argument that the smaller members sitting on the boards the more likely to function effectively, leading to more possibility to have a best quality of financial reporting and consequently more likelihood of receiving a clean audit opinion. This result supports several past studies. Ballesta and Garcia-Mega (2005) argue that larger boards will not perform monitoring function effectively because of communication, coordination and monitoring problems. Similar to Ballesta and Garcia-Mega (2005), Jensen (1993) also posits that large boards are less effective than small boards. Therefore, he (Jensen, 1993) suggests that to be effective the size of the board should be less than eight. This argument is also supported by empirical evidence documented by Yermack (1996) and Vafeas (2005). However, this finding is contrary with Firth et al. (2007) who report that the larger the boards the greater the probability of receiving unqualified audit reports.

A negative and significant ($p<0.05$) association between *IndAudCom* and *Opinion* infers that independent members of audit committee do act in the best of interest of shareholders. They act as an effective monitoring mechanism to oversee the accounting and financial reporting processes of a company. As reported in Table 2, firms with unqualified audit opinion have significant higher mean values of *IndAudCom* compared to those of with qualified audit report (69.02% versus 43.33%). Thus, this finding support previous studies (e.g., Lipton & Lorch, 1992; Menon & Williams, 1994; Jiambalvo, 1996; Davidson et al., 2005; Lin & Hwang, 2010; Kang et al., 2011) who document that the presence of independent audit committee improves the quality of financial reporting leading to receive an unqualified audit opinion.

In regard to control variables, this study provides evidence that *Leverage* and *ROI* are important variables in explaining the auditors' propensity to qualify their opinions. Specially, the study finds a positive (negative) and highly significant (at $p<0.01$) association between both *Leverage* (*ROI)* and the possibility of receiving qualified audit reports.

Table 4. Results of the multivariate logistic regression

Equation: $Opinion_i = \alpha + \beta_1 BoardSize + \beta_2 IndBoard + \beta_3 AudComSize + \beta_4 IndAudCom + \beta_5 AudComMeet + \beta_6 ClientSize + \beta_7 Leverage + \beta_8 ROI + \varepsilon_i$

	Estimated coefficients	Standard errors	Wald	Sig.
(Constant)	4.260	5.796	0.540	0.462
Independent variables:				
BoardSize	-1.074	0.516	4.326	0.038
IndBoard	2.697	1.832	2.169	0.141
AudComSize	-0.532	0.638	0.696	0.404
IndAudCom	-3.623	1.632	4.928	0.026
AudComMeet	-0.519	1.454	0.127	0.721
Control variables:				
ClientSize	0.099	0.371	0.071	0.790
Leverage	5.700	1.761	10.479	0.001
ROI	-6.323	1.981	10.193	0.001
Model Summary				
Model Chi-square		71.023		
p-value		0.000		
Classification accuracy		91.74		
Pseudo R^2 Cox & Snell		0.444		
Nagelkerke R-Square		0.686		
Sample Size		121		

Legend: See page 11 for full definitions and descriptions for the dependent, independent and control variables.

Overall, the results presented in Table 4 document some evidence that the nature of a corporation's governance structure, especially the size of board and independent members audit committee enable to provide an effective monitoring mechanism on management activities. Subsequently, they are jointly able to oversee the company's financial reporting process. Such oversight seems to improve earnings quality, and thus, more likely to receive a clean audit opinion. The findings, for some extent, support the argument that size of board of directors and independent audit committee enable to reduce agency conflicts.

Conclusion

Despite the prominent attention currently given to the role of corporate governance, little research has been conducted investigating its relation to the audit opinion. This study presents empirical evidence on the relation between internal monitoring function effectiveness and qualified audit opinion. The sample is drawn from the manufacturing public companies listed on ASX for the financial year 2006. I use univariate and multivariate logistic regression analysis to identify the factors associated with qualified audit reports. Five internal monitoring attributes (board size, independent board, audit committee size, independent audit committee and audit committee meeting frequency) are selected for examination as potential predictors of qualified audit reports. Two of the five variables, board size (*BoardSize*) and independent audit committee (*IndAudCom*), are statistically significant.

Consistent with expectations, this study supports that board of directors play an effective monitoring device that leads to higher quality of financial reporting and, therefore, less likelihood of receiving a qualified audit report. Specifically, I find that smaller size boards appear to more effective than large size boards. The smaller members sitting on the board of directors is more likely to receive a clean audit report. This result is in line with previous studies (e.g., Jensen, 1993; Yermack, 1996; Vafeas, 2005). Additionally,

the result is also supported by the latest study conducted by Linck et al. (2008) who report that board size fell dramatically in 1990s for large U.S. firms. Moreover, this study finds that audit committee independence is negatively and significantly associated with a qualified audit opinion. It infers that the presence of independent audit committees provides a greater incentive to monitor management activities reduces agency costs, thus, enhances earnings quality leading to receive an unqualified report. In other words, companies with more independent audit committees have better performance than their counterpart.

The findings of this study have implication, especially, to regulators and corporate governance reformists. Special attentions need to be given by Australian policy makers in strengthening corporate governance framework; primarily, in regard to: (1) the process for monitoring and selection of board of directors and audit committee, (2) enhance the skills and knowledge of boards and audit committee members, and (3) separation of management from the owners and appointment of professional managers.

A major limitation in this study is the possible misspecification of the model estimated. Future studies can seek to focus on refinements to the proxy measures for dependent and independent variables. In addition, this is one fiscal year study with a specific industry classification and a relatively small sample size. With improved methodology, i.e. new statistical techniques and a greater number of sample companies, it should be possible to develop a more powerful analytical tool which could pave the way for the development of greater insights.

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