

**NONAUDIT SERVICES, CORPORATE
GOVERNANCE AND AUDITOR
INDEPENDENCE IN MALAYSIA**

by

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LIST OF ABBREVIATIONS

MASB	-	Malaysian Accounting Standards Board
MCCG	-	Malaysian Code on Corporate Governance
MIA	-	Malaysian Institute of Accountants
MICG	-	Malaysian Institute of Corporate Governance
MSWG	-	Minority Shareholder Watchdog Group
SEC	-	Securities and Exchange Commission
NAS	-	Nonaudit Services
ABS	-	Absolute Value of Estimation Error
IPO	-	Initial Public Offering
FRF	-	Financial Reporting Foundation
MASA	-	Malaysian Approved Standards on Auditing
IFAC	-	International Federation of Accountants
ISA	-	International Standards of Auditing
CMP	-	Capital Market Master Plan
FSMP	-	Financial Sector Master Plan
IAPC	-	International Auditing Practices Committee
MSA	-	Malaysian Standards on Auditing
AICPA	-	American Institute of Certified Public Accountants

DEFINITION OF KEY TERMS

- Auditor Independence - Aptitude of auditor to act in an objective manner without being influence by others.
- Earnings Quality - One of the construct used by prior research to draw inferences for auditor independence. Earnings quality is viewed as great if the earnings figures are valuable for decision making.
- Accruals Quality - One of the earnings quality measurements is based on the interpretation that earnings that map more attentively into cash flows are of better value. The great quality of information indications to higher quality judgement and decision.
- Homogenous Nonaudit Services (NAS) - Nonaudit services in total.
- Types Nonaudit Services - Nonaudit services being partitioned into audit related (*ARNAS*), tax related (*TAXNAS*) and other services (*OTHERS*).
- Audit Related (*ARNAS*) - Assurance and related services that are not required by statue or regulation including due diligence services, consulting financial accounting, and reporting standard.
- Tax Related (*TAXNAS*) - Tax planning, tax compliance and tax advice.

DEFINITION OF KEY TERMS: CONTINUED

Other services
(*OTHERS*) - Nonaudit services other than audit related service and tax related.

Corporate Governance - A mechanism by which stakeholders of a corporation exercise control over corporate insiders and management such that their interest are protected.

Corporate governance is a system by which companies are being managed and controlled and involves not only relationship between manager, directors, shareholder, but also involvement of regulation, and other stakeholders in realizing corporate vision.

**PERKHIDMATAN SELAIN DARI AUDIT, TADBIR URUS KORPORAT
DAN KEBEBASAN JURU AUDIT DI MALAYSIA**

ABSTRAK

Kajian ini meneroka isu yang telah dibincangkan lebih dari 50 tahun dan menawarkan pandangan kritikal terhadap undang-undang yang sedia ada ke atas profesyen pengauditan di Malaysia. Isu kebebasan juru audit berkenaan dengan perkhidmatan selain audit menjadi perhatian bukan hanya kepada ahli akademik, ahli pengkaji, penggubal undang-undang di negara Amerika Syarikat, United Kingdom malah di seluruh dunia termasuk Malaysia. Kes Enron di Amerika Syarikat dan seluruh syarikat yang telah jatuh termasuk Transmile dan Megan Media di Malaysia telah membangkitkan persoalan mengenai kewibawaan juru audit dan tadbir urus korporat. Kebanyakan bukti pengkisahan mendakwa peruntukan kepada perkhidmatan selain audit akan menggugat kebebasan juru audit dan menurun kualiti perolehan. Kajian yang lepas telah menghasilkan bukti yang bercampur iaitu perkhidmatan selain audit menggugat kebebasan juru audit dan perkhidmatan selain audit juga menghasilkan kerja audit yang efisien. Ahli pengkaji menjangkakan kesan ke atas kebebasan juru audit dapat dilihat dengan jelas sekiranya perkhidmatan selain audit dipecahkan mengikut jenis dan perkhidmatan selain audit yang berulang dan tidak berulang. Oleh itu kajian ini mengkaji hubungan diantara perkhidmatan selain audit, jenis perkhidmatan selain audit, perkhidmatan selain audit yang berulang dan tidak berulang, jenis perkhidmatan selain audit yang berulang dan tidak berulang dengan kebebasan juru audit. Kajian ini juga melihat susun tadbir urus korporat ke atas kebebasan juru audit. Interaksi tadbir urus korporat ke atas hubungan antara

perkhidmatan selain audit dengan kebebasan juru audit juga dikaji. Kajian ini menggunakan kualiti terakru daripada modifikasi model Dechow dan Dichev (2002), iaitu salah satu kualiti perolehan yang digunakan untuk mewakili kebebasan juru audit. Bermula Jun 2001, 'Bursa Malaysia Listing Requirement' mengeluarkan arahan kepada semua syarikat yang berdaftar di Bursa Malaysia untuk mendedahkan maklumat mengenai perkhidmatan selain audit di dalam laporan tahunan. Oleh itu dengan maklumat yang tersedia, kajian ini dapat dijalankan untuk jangkamasa 3 tahun (2009-2011), dengan jumlah pemerhatian sebanyak 1118. Hasil kajian menunjukkan bahawa perkhidmatan selain audit secara keseluruhan memberi kesan negatif kepada kebebasan audit, yang mana berlawanan dengan jangkaan. Hasil kajian ini menunjukkan hubungan yang terjalin diantara juru audit dan perniagaan yang diaudit menggugat kebebasan juru audit. Manakala jenis perkhidmatan selain audit memberi kesan yang berbeza kepada kebebasan juru audit. Hasil yang diluar jangkaan tetapi menarik, perkhidmatan selain audit secara berulang merupakan ancaman kepada kebebasan juru audit. Hubungan negatif di antara perkhidmatan selain audit dan perkhidmatan selain audit yang berulang dengan kebebasan juru audit dapat dikurangkan dengan kehadiran tadbir urus korporat yang baik. Hasil kajian dapat menyumbang kepada penggubalan polisi dengan mengambil kira kesan jenis perkhidmatan selain audit, perkhidmatan selain audit yang berulang dan tidak berulang kepada kebebasan juru audit. Hasil dari kajian juga menyumbang kepada teori berkenaan dengan kualiti terakru dan tadbir urus korporat di Malaysia.

**NONAUDIT SERVICES, CORPORATE GOVERNANCE AND AUDITOR
INDEPENDENCE IN MALAYSIA**

ABSTRACT

This study explores the unsolved issues that have been debated for more than 50 years and provides critical insights into the current regulatory issues confronting the auditing profession in Malaysia. The issue of auditor independence on nonaudit services has become a concern to the academicians, researchers, and regulators, especially Securities and Exchange Commissions (SECs) not only in the US, UK, Australia, but also worldwide, including Malaysia. The Enron case in the US and the other collapsed companies throughout the world, including Transmile and Megan Media in Malaysia, has raised question on the credibility of external auditor and the governance aspect. Most of the anecdotal evidence claim that the provision of nonaudit services might impair auditor independence and reduce the earnings quality. Previous studies have provided mixed evidence that nonaudit services affect auditor's independence (due to economic bonding) and nonaudit services yields knowledge spillover and improve auditor efficiency. Past researchers have suggested that nonaudit services should be categorised into types and recurring and nonrecurring to get clear picture on the impairment in auditor's independence. Therefore, this study examines the association of nonaudit services, types of nonaudit services, recurring and nonrecurring nonaudit services, and types of recurring and nonrecurring nonaudit services with auditor independence. The study also examines the relationship between corporate governance variables and auditor independence. The study tests the interaction effect of corporate governance variable between nonaudit services and auditor independence. This study adopts the accruals quality (Modified Dechow and Dichev (2002) Model) as a proxy for auditor independence. Beginning in June 2001, the Bursa Malaysia Listing Requirements came out with the requirement for all companies listed in Bursa Malaysia to disclose information on nonaudit services. Therefore, with the availability of the data, this research covers duration of three years (2009-2011), with 1118 observations. The study found that nonaudit services in total affect auditor independence, which is in contradiction to the hypothesized statement. This empirical result indicates the economic bonding

created between auditor and client restricted the auditors from objectively performing their duty. In addition, different types of nonaudit services pose different threat to auditor independence. In an unexpected but interesting result, recurring nonaudit services indicate a threat to auditor independence. The negative relationship between nonaudit services and recurring nonaudit services and accruals quality weakens with the presence of good governance. These results contribute to policy deliberation in Malaysia to account for the effects of types of nonaudit services, recurring, and nonrecurring nonaudit services on auditor independence. This study also contributes to the theoretical perspectives on accruals quality and corporate governance in Malaysia.

CHAPTER 1: INTRODUCTION

1.1 Background of the Study

Issues concerning auditor independence have been discussed and debated by the legislatures and regulators worldwide (American Institute of Certified Public Accountant 1978; Levitt 2000; Public Accounting Oversight Board (PCAOB) 2005, MIA by-Laws; Malaysian Code on Corporate Governance (MCCG), Bursa Malaysia Listing Requirements). Researchers have investigated the issue and identified several potential threats to auditor independence. However, the issue remains largely unsolved.

Auditor independence has been examined from different angles by different scholars. Antle (1984) stated that the term auditor independence has no definite meaning. Many observers have agreed that auditor independence refers to the conditional probability of reporting a discovered breach (DeAngelo, 1981b), the ability to resist client pressure (Knapp, 1985), a mental state of objectivity and lack of bias (SEC 2000). In addition, the IFAC code, SEC 2000 and MIA by-Laws have defined independence in terms of two aspects: independence of mind and independence in appearance. Independence of mind refers to a state of mind which permits the rendering of a conclusion without being affected by influences that compromise professional judgments. This state of mind allows an individual to act with integrity, while exercising objectivity or professional scepticism. This type of independence is unobservable. In contrast, independence in appearance refers to the avoidance of

facts and circumstances that are so significant that a reasonable and informed third party would reasonably conclude that integrity, objectivity, or professional scepticism has been compromised. The independence issue remains even if an auditor is said to be independence in fact but is perceived to have a lack of independence in appearance.

Prior studies have empirically explored the relationship between potential threats to auditor independence such as financial, business, and employment relationships (Firth, 1980; Geiger & North, 2006; Geiger *et al.*, 2005; Imhoff, 1978; Martinov *et al.*, 2011); the effect of fees from audit clients involving the issue of lowballing (Ahmad *et al.*, 2006; Chung & Kallapur, 2003; Schatzberg & Sevcik, 1994; Shockley, 1981; Simon & Francis, 1988) and issue of audit rotation (Dopuch *et al.*, 2001; Geiger & Raghunandan, 2002; Johnson *et al.*, 2002; Myers *et al.*, 2003). Overall findings from these studies have been mixed.

Another conflicting issue on auditor independence is the provision of nonaudit services which has received attention from regulators, practitioners, researchers, and academicians. An important concern for regulators is the economic bonding created between auditor and client, including a tendency for an auditor to acquiesce to client preferences.

Threats to auditor independence arise from the close relationship between auditor and client, which create a bonding between them. This close bonding, as explained in DeAngelo's (1981b) model of audit pricing, describes incumbent auditors as possessing comparative cost advantages associated with audit start-up and switching

costs. Such cost advantages help incumbent auditors earn quasi rents in the future. Simunic (1984) revealed that the provision of nonaudit services also yield knowledge spillover that generates audit cost saving and improve auditor's independence. In addition, Palmrose (1986) concluded that both incumbent and non-incumbent auditors affect auditor independence. The study takes into consideration nonaudit services as homogenous in their ability to generate 'knowledge spillover'. However, Simunic (1984) highlighted that additional insights might be gained by partitioning nonaudit services into types.

Francis (2006) reviewed the nonaudit services research literature over the past 40 years and concluded that there was no 'smoking gun' evidence linking the provision of nonaudit services with audit failures. A crucial question is whether the relationship between nonaudit services and auditor independence is affected by recurring or nonrecurring auditor-provided nonaudit services.

In the US, the Securities and Exchange Commission (SEC) began in 2003 to require that the information of nonaudit services fees be partitioned into different types: audit fees, audit related nonaudit services, tax related nonaudit services, and other fees (latest). This requirement takes into consideration the requirement of restricting financial information system (FISDI) as issued by Sarbanes Oxley Act 2002 (SOX 2002). In Malaysia, the requirement to disclose information concerning nonaudit services became effective on 1 June 2001.

Agency theory explains the conduct of managers and owner of the business as a consequence of split-up of ownership and domination. Such an increase in

information asymmetry has created agency conflict, leading to situations in which a manager will be incentivized to manage earnings. Previous research has shown that corporate governance is able to mitigate the agency problem apart from the existence of external auditors.

Responsibility for setting objectives and monitoring and controlling the firm's activities rests with the board of directors, which is central to decision-making within the firm (Fama & Jensen, 1983). It is generally considered imperative that an audit committee be confined to non-executive directors if it is to carry out its duties effectively. The independence of the audit committee members is important as the monitoring they provide affects earnings quality, audit quality (Abbott & Park, 2000), and auditor independence (Abbott *et al.*, 2003b). Independent audit committees have been associated with higher disclosure quality (Karamanou & Vafeas, 2005) and a lower cost of debt finance (Anderson *et al.*, 2004). Bronson *et al.* (2009) found that the benefits of audit committees are limited unless the committee comprises of independent directors only.

The study is motivated by several major considerations. First, the subject of nonaudit services and how it affects auditor independence is a topic of concern to both policy makers and regulators. Previous studies raised concern regarding the appropriateness of policies in restricting certain types of nonaudit services. For example, as a result of the Enron case, US regulatory bodies promulgated the Sarbanes Oxley Act 2002, prohibiting nine types of nonaudit services such as bookkeeping, financial system design and implementation, appraisal or valuation services, actuarial services, internal auditing, auditor acting as a director, officer or employee of the audit client,

experts opinion, dealer or investment advisor or investment banker services and any other service that the PCAOB deems impermissible. On the other hand, for non-prohibited nonaudit services, such regulation gives the power of discretion to the audit committee to preapprove in order to upsurge the sustainability of the audit profession.

In Malaysia, the requirement of nonaudit services is stated in the MIA by-Laws, Bursa Malaysia Listing Requirements and the latest is stated in the Revised Corporate Governance 2012. As compared to the US regulation, Malaysia does not prohibit any nonaudit services to be served by the external auditor, which means that this requirement is still lacking. This study has been motivated by a desire to help policy makers in policy deliberation as a way of harmonizing the merit of nonaudit services towards audit pricing in Malaysia.

The motivation of this study is to distinguish recurring and nonrecurring non audit services resulting from the conclusion highlighted by Schneider *et al.* (2006) in his review of nonaudit services issues and a study conducted by Paterson and Valencia (2011). Per findings of Paterson and Valencia (2011), even though recurring and nonrecurring audit-related nonaudit services are both positively associated with restatement, effects are significantly larger among nonrecurring audit related non-audit services. Similar to tax results these audit related nonaudit services findings support the idea that distinguishing recurring and nonrecurring non audit services is important.

Furthermore, the study is also motivated by the limitations highlighted by Chung and Kallapur (2003):

“For example, it is possible that not all nonaudit services have the effect of compromising independence. ASR No. 264 mentions tax advice as an example of a service that has obvious economies of scope with the audit function (for auditing the deferred tax accruals). If there are economies of scope and some of the resulting cost savings are passed on to the client, then a client would have to pay more to purchase such services from a party other than the auditor; a threat to stop purchasing such services is therefore less credible than a threat to stop purchasing other kinds of services. Also, an expectation of recurring purchase of a service creates more incentives for the auditor than does a one-time purchase. However, the proxy disclosures do not separate the different kinds of services so we are unable to control for the possibility that the inclusion of fees for such services in the ratios weakens the power of our tests”.

(2003, pg. 938)

This study considers conflicting empirical evidence from previous studies. Prior researchers focused on homogenous nonaudit services (Abbott *et al.*, 2003b; Ashbaugh *et al.*, 2003; Craswell, 1999; Frankel *et al.*, 2002; Kinney *et al.*, 2004; Simunic, 1984) and types of nonaudit services (Abbott *et al.*, 2007; Huang *et al.*, 2007; Paterson & Valencia, 2011) on auditor independence and the results are still inconclusive and remain elusive. Specifically, for types of nonaudit services, the study conducted by Paterson and Valencia (2011) found that tax and audit related service pose less threat to auditor independence. Huang *et al.* (2007) also fail to find evidence in support of claims that client with higher level of tax fee ratio and other nonaudit fees ratio are more likely to have a bias financial reporting. On the other hand, the study conducted by Abbott *et al.* (2007) provides evidence of independence problem for recurring services rather than nonrecurring.

Voluminous studies have been conducted in different institutional setting to see the association of nonaudit services and auditor independence, such as in the US, (Francis *et al.*, 1979, Frankel *et al.*, 2002; Abbott *et al.*, 2003a; Ashbaugh *et al.*, 2003; Brandon *et al.*, 2004; Chung & Kallapur 2003; Larcker & Richardson 2004; Krishnan *et al.*, 2005; Huang *et al.*, 2007; Dhaliwal *et al.*, 2008; the UK (Lennox 1999, Firth 2002), New Zealand (Hay *et al.*, 2006); Zhang & Emanuel 2008) Australia (Sharma & Sidhu 2001, Ruddock *et al.*, 2006 ; Gul *et al.*, 2006) and Malaysia (Kamaruddin *et al.*, 2012a; Shafie *et al.*, 2007; Che Ahmad *et al.*, 2006). The latest study was conducted by Paterson and Valencia (2011) and Abdul Wahab *et al.* (2014) focusing on the recurring and nonrecurring nonaudit services in the US and Malaysia respectively. However very little research has looked into the association between recurring and nonrecurring nonaudit services in type and accruals quality in emerging capital.

The study builds on and extends the studies of Abdul Wahab *et al.* (2014), Paterson and Valencia (2011), Frankel *et al.* (2002), and Kinney and Libby (2002). These studies use earnings quality as proxies for auditor independence, to test whether auditor independence would compromise with the provision of nonaudit services. Kinney and Libby (2002) examined five different types of nonaudit services and found that different types of nonaudit services give different impact to auditor independence. In addition, Paterson and Valencia (2011) extend it by modelling restatement using recurring and nonrecurring for three types of nonaudit services and found that recurring tax services are the only nonaudit services provided by the auditor which is negatively associated with restatement. The study treats nonaudit services as homogenous, while Frankel *et al.* (2002) used discretionary accruals

(DACC) as a measurement for earnings quality, which reveals that an auditor may compromise their independence while they serve that service.

The study extends the current researches in a number of ways. First, this study uses Malaysia data, where the institutional setting may not be the same as compared to developed countries such as the US, UK, and also Australia. Although Paterson and Valencia (2011) examined the different types of nonaudit services by focusing on recurring and nonrecurring non audit services to auditor independence, that kind of study employs the financial restatement to proxy for auditor independence without the interaction of corporate governance variables, board of director in terms of bumiputera and non-bumiputera, and audit committee characteristics. Furthermore instead of restatement this study employs earnings quality focusing on accruals quality to proxy for auditor independence and this will add to the literature on accruals quality and nonaudit services which are regarded as limited in Malaysia. Paterson and Valencia's study was conducted in the US setting with established rules and regulation on auditor. The study believed that the different institutional setting in Malaysia might contribute to the different view with reference to the auditor independence issue.

The study models the accruals quality that applies earnings quality as a function of recurring and nonrecurring for different types of nonaudit services. Quality financial reporting aligns with auditor independence, and therefore it is an ideal way to represent accruals quality to auditor impairment. The lower accruals quality would represent the lower earnings quality and the increase impairment in auditor independence.

Thirdly, the study will use the latest data, spanning from 2009 to 2011. The chosen years of observation will help to see nonaudit services pattern as compared to the previous year which have been explored by previous researchers. The current year of observation helps to shed light on the issue of auditor independence in relation to recurring and nonrecurring types of nonaudit services.

The study also examines the effect of corporate governance on auditor independence and the interaction of corporate governance with nonaudit services and auditor independence. The study focused on board quality; board of director independence, board of director duality, and the audit committee characteristic (internal corporate governance mechanisms) as it has the specific charge of overseeing financial reporting (Krishnan *et al.*, 2011). Corporate governance attributes help investors by aligning the interests of managers with the interests of shareholders and by increasing the reliability of financial information and the integrity of the financial reporting process (Watts & Zimmerman, 1986).

1.2 Problem Statements

Malaysia offers a different institutional setting which is branded as highly concentrated ownership, the prevalence of family controlled business, close ties between controlling families and top executives, government intervention, and also political influence (Abdul Wahab *et al.*, 2007). This type of business nature in Malaysia has increased information asymmetry as well as having a negative effect on earnings quality (Claessens *et al.*, 2000; Fan & Wong, 2002). Therefore, Jensen and Meckling (1976) highlighted the need to have an independent auditor to solve that

kind of problem in aligning the interest of manager and owner of the business. Thus auditor independence is fundamental in maintaining quality audit and to restore public confidence in the quality of financial reporting and an efficient capital market.

The independence of an auditor is aligned with the quality of accounting information. The quality of accounting information worsened after the 1997 Asian Financial Crisis and the issue of many collapsed companies associated with accounting scandal such as the well-known case of Enron and World Com in the US, HIH insurance in Australia, Parmalat in Italy, and also Malaysian companies such as Megan Media, Transmile Group Berhad, Technology Resources Industries Berhad, Nasiocom Holding Berhad, GP Ocean, Ocean Capital Berhad, Welli Multi Corporation Berhad and Southern Bank Berhad. Out of all the cases mentioned, it was claimed that such incidences were due to the governance failure and also auditing issues. It was stated that in the US, there have been a major changes from the scandal mentioned such as the change in audit industry where the big 4 audit firms have either divested or publicly announced plans to diminish their consulting businesses, the demise of Arthur Anderson in July 2002, the issuance of Sarbanes-Oxley Bill (also known as the Corporate Oversight Bill) into law and in November 2003, the New York Stock Exchange (NYSE) and NASDAQ adopted an additional set of corporate governance rules that apply to most companies with stock listed on these markets. The American Stock Exchange (AMEX) joined in with similar rules in December 2003.

Due the above mentioned financial turbulence that creates corporate and audit failure, Lee and Md. Ali (2008) stated that it is no surprise that the public is sceptical about the integrity of the audit function. The scandals mentioned brought to the

question on the quality of auditing (issue of auditor independence), auditors reputation, accountability, transparency, and governance process particularly in Malaysia.¹ According to Lee *et al.* (2008), the practice of joint provision of audit and nonaudit services adds to the factors that might affect the quality of auditing and auditor independence.

According to Lee *et al.* 2008, the joint provision of nonaudit services has been a major concern for the auditing profession in Malaysia, as it has a serious implication to the accounting profession. The issue of joint provision of nonaudit services has been empirically tested in the US, UK, Australia, and the whole world, including Malaysia, using various setting and various proxies for auditor independence. However, the results remain inconclusive.

Even though it involves worldwide conditions, many significant reforms have been done and stringent regulations have been put in place in order to protect the economy from financial turbulence. The recent outbreak of a world-wide crisis in financial institutions suggests that steps taken to safeguard the trustworthiness of formal and statutory financial reporting and auditing may not be effective. For example, some auditors have argued that even though the Malaysian Institute of Accountant (MIA) has provided guidelines for audit pricing in Malaysia, such guidelines have not been

¹ For example, following the Enron case, which was audited by Arthur Anderson, one research conducted by Chaney and Philipich (2002) to investigate the impact of the Enron audit failure on auditor reputation. The results designate that on the three days after Andersen's admission that a substantial number of documents had been destroyed, show that Andersen's other clients experienced a statistically adverse market reaction, suggesting that investors downgraded the quality of the audits performed by Andersen. The study reveals that audits performed by Andersen's Houston office suffered a more severe decline in abnormal returns on this date After Enron's October 16, 2002, third-quarter earnings announcement; Andersen's independence from Enron began to be questioned because the audit firm had provided significant nonaudit services to Enron in addition to its fees associated with the Enron audit. Andersen received \$47.5 million in fees from Enron. Of this amount, \$34.2 million, or 72%, was audit related and tax work. Total fees for other services totalled \$13.3 million. Also, Enron had outsourced some internal audit functions to Andersen. Andersen's Houston office came under fire.

adopted by most of the CPA firms due to the lack of proper enforcement by its regulatory authority (Lee & Md Ali, 2008). However, in the US the issuance of Sarbanes Oxley Act 2002 (SOX) is a response to the Enron and World Com cases and provides frameworks for the reform of the corporate governance system based on integrity, accountability, and for the accounting profession based on the independence and fiduciary duty to the public interest. SOX 2002 emphasizes the role of audit committee in enhancing the credibility of public company's reported earnings.

Therefore, an empirical study has to be carried out to confirm such contentions in other countries. Since the effect of the joint provision of nonaudit services case remain unsolved, this study investigates such effect using local setting, namely among Malaysian companies listed in the main market of Bursa Malaysia.

1.3 Research Questions

The issue in this research is auditor independence. Auditor independence is aligning with earnings quality. This study applies the accruals quality using the modification model by Francis *et al.* (2005) from Dechow and Dichev model (2002) by taking the absolute value of estimation error (ABS) as a proxy for auditor independence. To align with research objectives, the study addresses the following research questions in relation to accruals quality:

1. What is the relationship between nonaudit services with accruals quality?
2. What is the relationship between types of nonaudit services and accruals quality?
3. Do recurring or nonrecurring nonaudit services fees affect accruals quality?

4. Do recurring or nonrecurring for different types of nonaudit services affect accruals quality?
5. What is the relationship between board quality and audit committee characteristics and accruals quality?
6. What is the relationship between nonaudit services and accruals quality with the presence of good corporate governance?

1.4 Research Objectives

The objective of this study is to explore the issue of auditor independence. Since there is no consensus on the issue of nonaudit services on auditor independence, an empirical study is required, especially to determine at the impact of different types of nonaudit services, recurring and nonrecurring non audit services towards auditor independence. This study believes that Malaysia provides an interesting context to study the merits and costs of the supply of nonaudit services with the availability of the data since 1 June, 2001. In order to draw inferences for auditor independence, this study apply earnings quality, focusing on accruals quality construct by modification model of Francis *et al.* (2005) from original model Dechow and Dichev (2002).

The study seeks to explore the following research objectives²:

1. To examine the effect of nonaudit services fees on accruals quality.
2. To examine the effect between types of nonaudit services fees on accruals quality.

² All research objectives are based on accruals quality. In the literature review, auditor independence is used to represent the accruals quality.

3. To examine whether recurring or nonrecurring nonaudit service fee that affect accruals quality.
4. To examine whether recurring or nonrecurring types of nonaudit services fees affect accruals quality.
5. To examine the relationship between board quality and audit committee characteristics on accruals quality in Malaysia.
6. To examine the relationship between nonaudit services and accruals quality with the presence of board qualities and audit committee characteristics.

1.5 Contributions of the Study

The significance of the study can be seen from both theoretical and practical perspectives. From the theoretical practice, the study adds to the growing body of empirical evidence that questions whether there is any logical rationale for restricting the scope of the services that auditors provide to their audit clients. Result from the study help policy makers in Malaysia such as Bursa Malaysia Listing Requirements, MIA by-Laws, and Securities Commission for deliberation purposes. In Malaysia, particularly to date, not much research has been carried out for recurring and nonrecurring type of nonaudit services fees on earnings quality. This kind of information is very much informative for the new reform as to ban certain types of nonaudit services in homogenous nature without taking into consideration recurring and nonrecurring for different types of nonaudit services will leave bad impact to auditing profession in balancing the cost and benefit.

The study contributes directly to the audit committee in Malaysia, since as stated in Bursa Malaysia Listing Requirements an audit committee should review and screen

the appropriateness and independence of external auditors by instituting policies governing the circumstances under which contracts for the provision of nonaudit services can be entered into and procedures that must be followed by the external auditors. In relation to the outcome of the research, an audit committee must be alert that nonaudit services pose a threat to auditor independence. Furthermore, in terms of taxation, audit related nonaudit services have been revealed to affect auditor independence. However, nonrecurring nonaudit services have been proven not to affect audit profession as compared to recurring. Then recurring taxation services tend to jeopardize the auditors' work. This information will help audit committee in establishing the policies and procedure in relation to nonaudit services. This is required under MCCG revised 2012, in which the audit committee needs to establish rules and procedure for the provision of nonaudit services.

In addition, the study contributes to the literature on auditor independence proxies by quality financial reporting, corporate governance and most importantly to the nonaudit services which is still under debated. This study extends upon studies by Abdul Wahab *et al.* 2014 and Paterson and Valencia's (2011) on recurring and nonrecurring nonaudit services and auditor independence proxies by accruals quality and interaction of corporate governance variables. The US findings and inferences may not hold to other developing countries such as Malaysia with different institutional settings, governance strategy, and the business environment.

Another contribution can be seen in terms of the aspects of academic and knowledge by providing to a better understanding on the characteristics of nonaudit services in types, also recurring and nonrecurring for different types of nonaudit services that

could affect auditor independence. Past researchers have been unsuccessful in solving the underlying problem in relation to non-audit services and auditor independence since most of the studies concentrate on nonaudit services in homogenous nature and also without taking into consideration the corporate governance variables. This study aims to contribute to the literature on the effect of recurring and nonrecurring types of nonaudit services on auditor independence in the Malaysian audit market.

The study also will shed light on the issues of corporate governance, especially audit committees in Malaysia. These include the monitoring mechanisms in corporate governance, and anecdotal claims that their roles are very much important in maintaining independence for auditor.

1.6 Organization of the Remainder of the Chapters

The study is organized into the following chapters:

CHAPTER ONE: INTRODUCTION

Chapter 1 provides the background of the study including the motivation, problem statement, research question, research objectives, and contribution of the study and organization of the remaining chapters.

CHAPTER TWO: INSTITUTIONAL SETTING

Chapter 2 is about an institutional setting. It contains an introduction of the chapter, development of Malaysian capital market, auditing background in Malaysia,

financial reporting and audit market in Malaysia, corporate governance, auditor independence: Current regulatory on nonaudit services in Malaysia, US, Australia and UK and the last is chapter summary.

CHAPTER THREE: PRIOR RESEARCH

Chapter 3 explores the prior studies on auditor independence, corporate governance and nonaudit services. It starts with the introduction, auditor independence focusing on the definition and threat to auditor independence such as audit lowballing, other threat to auditor independence, accruals quality proxies for auditor independence, nonaudit services relating to the measurement used, literature on nonaudit services and auditor independence, literature on corporate governance and it ends with the summary of the chapter and the development of the conceptual framework.

CHAPTER FOUR: HYPOTHESIS DEVELOPMENT

Chapter 4 induces the hypotheses from the literature that comprise of introduction, theories in the study, nonaudit services and auditor independence, corporate governance and auditor independence, the effect of corporate governance on the relationship between nonaudit services and auditor independence and the summary of the chapter.

CHAPTER FIVE: RESEARCH METHODOLOGY

Chapter 5 outlines the research methodology that deals with introduction, sample size and data collection, research design that explains the measurement for auditor independence, nonaudit services and corporate governance variables, empirical

model of the study, data analysis on descriptive, univariate, and multivariate analysis, and lastly focusing on the sensitivity and robustness test of the study.

CHAPTER SIX: RESULTS AND DISCUSSIONS

This chapter discusses on the result of the findings. It consists of introduction, descriptive statistics on the variable under study, results using univariate analysis, discussion of the result using multivariate analysis, sensitivity test, and lastly the discussion and conclusions.

CHAPTER SEVEN: SUMMARY AND CONCLUSION

This chapter highlights the summary and discussion. The chapter starts with introduction, summary of the research, limitation of the study and study contribution.

CHAPTER 2: INSTITUTIONAL SETTING

2.1 Introduction

This chapter present an overview of the institutional setting in Malaysian and other developed countries. Section 2.2 describes the development of Malaysian capital market. Section 2.3 focus on the financial reporting and audit market in Malaysia. Section 2.4 focuses on corporate governance globally. Section 2.5 elaborates on the corporate governance in Malaysia. Section 2.6 discusses on the current regulation of nonaudit services in Malaysia, United States (US), Australia, and the United Kingdom (UK). Lastly, section 2.7 provides a summary of the chapter.

2.2 Development of Malaysian Capital Market

In Malaysia, the development of capital market can be determined to be the late 1980s. 1989 was a milestone in the development of Malaysia's equity market starting with market delisting from the stock exchange. The boost of privatization projects and the equity boom in 1993, market capitalization exceeded that of Singapore by the mid-1990s, making the Malaysian market one of the fastest growing in the region.

As Singapore was formerly part of Malaysia, companies in these two countries listed on both KLSE (now known as Bursa Malaysia) and the Stock Exchange of Singapore (SES) until the end of 1989. Since then, KLSE has made several attempts, including the foundational of computerized trading, a central depository, and well-organized clearing and settlement systems in order to safeguard market infrastructure. In addition, the governing framework has been reviewed to support initial public offering (IPOs) and equity investments by domestic and foreign investors. Due to

that some big privatized companies such as Telekom Malaysia Berhad and Tenaga Nasional Berhad were listed on Bursa Malaysia, crafting it one of the resourceful-developing markets in the region in the mid-1990s (Shimomoto, 1999).

Before the Asian financial crisis, there were a total of 621 firms listed on the Kuala Lumpur Stock Exchange which amounted to a total market capitalisation of RM806 billion in 1996. The crisis hit Malaysia on 14 July 1997 when the country's Bank Negara dismissed freezing the ringgit to the US dollar. In the middle of the year after the crisis, the ringgit declined 46.3% against the US dollar. In 1998, real GDP fell 7.5% domestic demand drop about 25%, the Kuala Lumpur Stock Exchange fell 75% from its pre-crisis level 47.21% of 627 Malaysian companies were financially distressed, with interest coverage ratios less than 1.00 and the number of corporate bankruptcies increase about 250%. Inflation, however, was only a surprisingly modest of 5.3% in 1998 (Morris *et al.*, 2011).

The stock market had an essential place in the Malaysian economy at the beginning of the crisis. During the crisis, in 1997, 708 companies were listed on the Kuala Lumpur Stock Exchange's main market with a total market capitalization of RM375,769 million. At that time, the KLSE's market capitalization was 2.017 times GDP, a ratio second in Asia, while Malaysia categorized fourth among Asian countries in the number of listed companies per capita. Nevertheless, the role of the KLSE in financing firms was second by a large margin to that of debt markets and the banking sector. In 1997, nearly 58% of net funds raised came from the banking sector, while 11% were from the domestic debt market, 14% from the equity market, and 16% from foreign borrowings although Malaysian listed companies' dependence

on debt finance was noticeably less than in the other Asian countries sternly affected by and lower the average leverage of 35 countries between 1988 and 1996 (Claessens *et al.*, 2000).

The KLSE listing rules (KLSE, 2001c, clause 3.05) required that 25% of a company's issued shares be held by the public, up to 10% of which could be held by Bumiputera (mainly indigenous Malay) investors as part of the country's National Development Policy. Tun Dr Mahathir (previous prime minister) took alternative steps to stabilize the economy such as cutting interest rates, raising foreign debt from neighbouring Asian countries, re-pegging the ringgit against the US dollar in September 1998, restricting the trading of Malaysian stocks outside Malaysia, introducing a punitive tax for holding Malaysian stocks less than one year and making unofficial trading of the ringgit illegal. It has been said that, by refusing IMF intervention and pursuing its own course, Malaysia suffered less and emerged earlier from the crisis than other Asian countries (Morris *et al.*, 2011).

After the financial crisis of 2008, the equity capital market in Malaysia has experienced intense development with a stable growth in the number of listed companies and the amount of funds acquired. After the financial crisis in 1999, the number of companies listed on the exchange increased to a total of 757 companies with market capitalisation amounted to RM552 billion. By the end of 2004, there were 963 companies with a total market capitalisation of RM722 billion. The equity market has increased the development of the private sector by allowing several companies to get low-cost financing through initial public offerings (IPOs) and issuances of new shares (Marzuki, 2014).

Currently Malaysia's capital market expanded by 10.5% to RM2.7 trillion in 2013, underpinned by steady growth in key. The bond market ended the year at RM1.0 trillion and maintained its position as the third-largest in Asia relative to GDP. Equity market capitalization grew to RM1.7 trillion with the benchmark index rising 10.5%, making the market one of the top performers in Asia. The domestic small-cap index documented a 36.7% increase, supported by growing participation by institutional funds and greater interest by retail investors. The capital market continued to be a main foundation of financing with RM94 bil rose through corporate bonds and initial public offerings (IPOs). The SC has pointed out the market's space and depth underpinned the strongest period of capital-raising activities on record as RM240bil was raised over the last two years markets (The Star, 2014).

With the stable capital market in Malaysia, the increase in the companies listed on the main market, helps increase the number of populations in this study and thus will increase the generalization of the study.

2.3 Financial Reporting and Audit Market in Malaysia

According to Arens *et al.* (2011), the accounting and auditing system play an important role to ensure high confidence in chartered accountant firm and the audit process. The audit process provides the vital link to ensure credibility of financial statement prepared by management of companies to be used by its stakeholders for various purposes. Accounting concepts and principles are used by the accounting standard setting authority, the Malaysian Accounting Standard Board (MASB), for enhancing comparability and consistency of the financial statement. The Accounting

profession under the leadership of Malaysian Institute of Accountant (MIA) provides suitably trained, qualified accountant to ensure proper accounting and auditing system is of the highest quality in the corporate sector.

Among the important key players, the accounting profession is responsible in ensuring proper accounting and auditing system. This body are being supported by other regulatory bodies such as Securities Commission, the Bank Negara, and the Companies Commission of Malaysia, together with the Accountant's General Office and the Auditor's General Office or Department, as well as corporate players, directors and management of the companies play a significant role in ensuring the sound system of financial reporting has been put in place to protect the public interest (refer to figure 2.1).

There are various pieces of legislation and regulatory organization in financial reporting framework in Malaysia. The purpose of the framework is intended to provide an essential level of regulation on the financial reporting system and the auditing practice in Malaysia. The accounting regulatory framework in Malaysia comprised of Financial Reporting Act 1997 that established the Malaysian Accounting Standard Board (MASB) and Financial Reporting Foundation (FRF), Accountant Act 1967 that establish the Malaysian Institutes of Accountant (MIA), Securities Commission Act 1967 and Company Act 1965. Besides that, all public listed companies in Malaysia are required to adhere to Bursa Malaysia Listing Requirements.

The Securities Commission was established under the authority of the Ministry of Finance and started its operations in 1993 under the Securities Commission Act 1993. The Securities Commission (SC) licenses capital market players and oversees the activities of the several exchanges and institutions that comprise the KLSE. The establishment of the SC in 1993 was intended to streamline the regulatory framework of the Malaysian capital market that helps the efficiency, professionalism and orderly development of both the securities and futures industries to ensure protection of the interests of investors. The SC also attempts to ensure the proper conduct of market institutions and licensed persons. The SC has a very wide scope, encompassing all aspects of the securities industry, including advising the Minister of Finance on all matters relating to the securities and futures industries. Additionally, it is also the registering authority for the prospectuses of corporations.

The Companies Act 1965 was based on the UK Companies Act 1948 and modelled on the Australian Uniform Companies Act 1961. Since independence in 1957, a number of amendments have taken place to suit the evolving Malaysian legal and corporate environment. The Companies Act 1965 requires that all the listed companies and those that wish to be listed on the Bursa Malaysia to prepare annual reports in accordance with the Ninth Schedule of the Act. The Ninth Schedule prescribes only minimal disclosure requirements for the profit and loss accounts, balance sheets and the director's reports of companies in accordance with Section 169 and 326 of the Companies Act 1965. Additionally, the Companies Act 1965 requires that the published accounts present a true and fair view, although no statutory definition is accorded to this term.